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## Background Information on Demutualization

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### 2.1 Introduction

This chapter provides background information on demutualization of exchanges. Demutualization has generally involved conversion of an exchange from a not-for-profit member-owned organization to a for-profit shareholder-owned corporation. The specific reasons for demutualization and the structure of the demutualized exchange vary among jurisdictions. However, a number of themes emerge as common to the demutualizations that have taken place.

This chapter is divided into four parts. Part 2.2 discusses what demutualization means. Part 2.3 considers the reasons why exchanges demutualize. Part 2.4 discusses the models of demutualized exchanges. Part 2.5 provides an update on a number of exchanges since demutualization. This chapter is designed to provide background information for other chapters regarding the process of conversion to a demutualized exchange, the structure of a demutualized exchange, conflicts of interest and regulation of a demutualized exchange.

### 2.2 What Demutualization Means

Traditionally, stock exchanges have been mutual associations owned by their members. Generally, they have been operated on a

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not-for-profit basis so that any profits are returned to members in the form of lower trading costs or access fees, but this has not always been the case.<sup>2</sup> There are differences in the manner in which stock exchanges are operated and regulated. They differ in terms of the role of the board and the staff of the exchange, the powers of the chief executive and chairman and the composition and powers of exchange committees. Exchanges have a variety of voting structures and the balance of power between different users varies among them as well.

There are different ways in which external bodies and public interest representatives are able to influence the policies of the exchange. Legal and regulatory frameworks vary considerably, as does the degree of oversight of exchanges by government or their designated regulatory authorities. Membership may be open to any persons who satisfy stipulated requirements or it may be closed. If membership of an exchange is acquired through seats on the exchange, the seats are usually not freely transferable.

Perhaps the most distinguishing feature of the traditional stock exchange structure is its cooperative governance model; the close identity between ownership of the organization and the direct use of its trading services. The owners of the mutual enterprise are also its customers. Owner/customers may share in the net gains of the enterprise in proportion to their ownership interest. Decisions are usually made democratically, on a one member, one vote basis and often are made by committees of representatives of member firms.

The ability to influence the decisions of the exchange is thereby separated from the level of economic interest a member has in the exchange.<sup>3</sup> Ownership rights may not be freely tradable or exchangeable and on cessation of membership, those rights are forfeited. Because the organization's constituting documents may expressly (or impliedly) adopt a non-profit objective and prohibit the distribution of surpluses, mutually owned exchanges are seldom able to raise capital from anyone other than their members.

In contrast, most for-profit entities are organized as corporations with share capital in which the owners, principal decision-makers and customers are three separate groups. The shareholders vest

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<sup>2</sup> From 1802 until 1948 the London Stock Exchange was operated on a for-profit basis and paid large dividends to its members. Frank Donnan, *Self-regulation and the Demutualisation of the Australian Stock Exchange*, 10 *Australian J. Corp. L.*, at 5 (1999).

<sup>3</sup> Technical Committee of the International Organization of Securities Commissions (IOSCO) Issues Paper on Exchange Demutualization, at 3 (June 2001).

decision-making power in a board of directors who are subject to election and removal by shareholders and this power is exercised on a day-to-day basis by the management of the corporation. The voting rights of shareholders usually are proportionate to their economic interest in the corporation: one share, one vote. Ownership rights are distinct from trading privileges. For-profit corporations may raise new capital from a variety of sources.<sup>4</sup>

Recently, the appropriateness of the mutual structure has been challenged. The first stock exchange to demutualize was the Stockholm Stock Exchange in 1993. Several other exchanges followed Stockholm's lead: the Australian Stock Exchange (ASX), Toronto Stock Exchange (TSE), Singapore Stock Exchange and Hong Kong Stock and Futures Exchanges among them. In December 1998, the Securities and Exchange Commission (SEC) in the United States determined that a stock exchange could be registered with the SEC and operated on a for-profit basis.<sup>5</sup>

In May 2000, the Pacific Exchange (PCX) became the first US stock exchange to demutualize part of its business. The Chicago Mercantile Exchange became the first US financial exchange to demutualize in November 2000, converting its membership interests into shares of common stock in the Chicago Mercantile Exchange Inc. that can trade separately from exchange trading privileges.

Demutualization is literally the process of changing an organization from its mutual ownership structure to a share ownership structure. The process entails first converting memberships into shares, which step may or may not be followed by a public issue of those or treasury shares. In this manner, a quasi-governmental institution transforms itself into a profit-oriented, publicly traded company. Ownership and trading privileges are effectively separated. Stockbrokers are no longer owners but customers of the exchange. Directors are elected by shareholders and answerable to them.

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<sup>4</sup> Id. at 4.

<sup>5</sup> *Securities Exchange Act* Release No. 40760 63, Fed. Reg. 70844 (8 December 1998); at 70848, 70883 (22 December 1998).

## **2.3 The Reasons to Demutualize**

### **2.3.1 Rationalized Governance**

The mutual association model functions well if an exchange is a provider of trading services with limited competition and the interests of members are homogeneous. If greater competition exists and the interests of members diverge from one another and from the exchange, the mutual governance model ceases to function well. Consensus decision-making becomes slow and cumbersome. The exchange is unable to respond quickly and decisively to changes in the market.

The product of a stock exchange demutualization is, ideally, a corporation that operates in a more customer-focused manner and is able to respond more easily and quickly to changes in the business environment and meet competitive challenges.

The corporate model will enable management to take actions that are in the best interests of customers and the exchange itself. With the separation of ownership and trading privileges, an exchange will achieve greater independence from its members with respect to its regulatory functions. Owners interests will be aligned with those of the exchange—both will seek to maximize the profits of the exchange. In a governance structure in which consensus need not necessarily be reached and owners will be able to influence decision-making, strategic decisions will be able to be made by management in a much more efficient manner. One of the great advantages of a corporate structure versus a mutual or co-operative one is the requisite degree of transparency. Demutualized exchanges will be forced to account to their shareholders not only regarding the bottom line, but regarding issues arising in corporate governance.

### **2.3.2 Investor Participation**

The new corporation will be more profit-oriented due to shareholder accountability. However, in today's competitive environment, a stock exchange must be responsive to the needs of its many stakeholders, including participating organizations, listed companies, and institutional and retail investors. Exchanges may perceive a need to shift power within the exchange from one group of members to another and to afford institutional customers direct access to exchange facilities. Separating exchange membership from ownership may be a politically and economically feasible way to effect such a shift and resolve conflicts

of interest between exchange members and between exchanges and their members.

Unlike a mutual structure where often only broker-dealers may be members, a demutualized exchange affords both institutional investors and retail investors the opportunity to become shareholders. The assets managed by institutional investors have grown significantly in recent years and the trading needs of institutional investors differ dramatically from those of retail investors. In particular, institutional investors have a strong preference for anonymity when they are effecting large block trades. Institutional investors also require much greater liquidity to accommodate block trading and place far more emphasis on negotiating the lowest price. A demutualized exchange will have greater flexibility to accommodate the needs of institutional investors as customers, and potentially, as owners.<sup>6</sup>

### 2.3.3 Competition from ATs and Upstairs Trading

The threat of competition from alternative trading systems (ATs) has forced traditional exchanges to examine their role as trading arenas and to take measures that facilitate more competitive future strategies. An AT is a privately operated computerized system that performs many of the functions of an exchange by centralizing and matching buy and sell orders and providing post-trade information. They are often operated by exchange members or member-affiliates and are similar to exchanges because they allow two participants to meet directly on the system and are maintained by a third party who also serves a limited regulatory function by imposing requirements on each subscriber.<sup>7</sup>

Although some ATs have been in operation for many years, technological advances, trading value increases and pressures on trading profits have enabled some of them to become serious competitors to exchanges. The US Securities and Exchange Commission (SEC) became concerned that ATs would impair the fair and orderly functioning of markets. In December 1998, SEC implemented the Regulation ATs that permitted ATs to continue to be regulated as broker-dealers, but required them to comply with rules designed to improve transparency and surveillance, as well as systems capacity, integrity and security of ATs.

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<sup>6</sup> The Toronto Stock Exchange: *A Blueprint for Success*, at 5–6 (8 October 1998).

<sup>7</sup> Jeffrey W. Smith et al., *The NASDAQ Stock Market: Historical Background and Current Operation*, NASDAQ Working Paper, at 36 (24 August 1998); available at <[http://www.academic.nasdaq.com/docs/wp98\\_01.pdf](http://www.academic.nasdaq.com/docs/wp98_01.pdf)>.

The Canadian Securities Administrators have also proposed a rule governing ATs.

Many broker-dealers have internal systems to automate the firm's execution of customer orders, particularly firms that internalize or purchase order flow. These systems are not generally considered ATs because all trades effected on internal systems, generally referred to as "upstairs trading," involve only the operator of the system and not external parties. Upstairs trading occurs when a stock exchange member matches customer orders against other customer orders or against its own inventory position within the firm, rather than exposing the order to auction on the exchange. The market only learns of the trading activity after the fact.

In Canada, upstairs trading has been on the rise as a result of several factors, among them regulatory changes in the 1970s and 1980s that permitted investment dealers to trade as principals and to internalize orders. Consolidation of investment dealers and their willingness to commit capital to facilitate trades have improved the services offered. As trading moves away from the central order book of a traditional exchange, the exchange's ability to maintain sufficient liquidity is impaired.<sup>8</sup> Block trades in the upstairs market account for the majority of the volume and value of the transactions on the TSE.

Although traditional exchanges offering bundled services may offer scale and liquidity advantages, there is a growing role for specialty, niche player exchanges. It is unclear how demutualization will improve the competitive position of traditional exchanges against ATs. However, it is unlikely that traditional exchange business models, offering more integrated services than ATs, will become obsolete so long as they remain competitive in terms of price, variety and quality of their services.

### 2.3.4 Globalization and Consolidation

Historically, brokers and exchanges were locally focused. Exchanges did not face meaningful competition from exchanges in distant places. National exchanges developed when the telegraph and telephone made it easier to deal on a distant exchange.<sup>9</sup> Modern telecommunications have enabled issuers and investors to access foreign capital markets. As nationality has become less of a defining characteristic of capital markets, global centres have grown in importance, and the relevance of national

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<sup>8</sup> Supra note 6, at 5-7.

exchanges has been challenged. This challenge is more acutely felt in relatively small home markets such as Canada. Today, either the New York Stock Exchange or the NASDAQ Stock Market (NASDAQ) is the major market for 88 Canadian-based TSE listings.

Strategic alliances and consolidations are also affecting capital markets and exchanges globally. Mergers among stock and derivative exchanges in the US are redefining North America's competitive landscape and creating super-exchanges. The merger of NASDAQ and the American Stock Exchange (Amex) for instance, created an exchange with a market capitalisation of US\$1.9 trillion offering an unprecedented variety of products. Alliances and consolidation are also occurring in Europe (Euronext, for example) as well as in other parts of the world. These alliances are motivated by a variety of factors. Scale is increasingly important, particularly in leveraging technology costs and other investment opportunities. Through alliances, exchanges seek to attract more investors by harmonizing distinct trading environments and by offering greater product variety. Alliances are a means of pursuing the conventional wisdom that "liquidity attracts liquidity."<sup>10</sup>

### 2.3.5 Resources for Capital Investment

A competitive stock exchange must be able to respond quickly to global competitive forces and technological advances. With the capital raised from an Initial Public Offer (IPO) or private investment and a heightened awareness of accountability to stakeholders, a stock exchange should have both the incentive and the resources to invest in the competitiveness of its information systems. To be competitive, products and services must not only be timely and cost-effective, but also reliable.

One of the drivers of stock exchange demutualization is screen trading, which has replaced floor trading on most exchanges. Once customers have direct access to screens, exchange memberships no longer have as much economic value and clearing firms rather than traders become a dominant force in exchange activities. Also, the move from floors to screens has required considerable capital investment. Demutualization offers an opportunity to buy out trader interests since they are no longer necessary and shift power to other firms, while raising capital for continued modernization of trading information systems.

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<sup>9</sup> Timothy Baikie, *From Toronto Stock Exchange to TSE Inc.: Toronto's Experience with Demutualization*, at 6, 11.

<sup>10</sup> *Supra* note 6, at 5.

Continued investment in technology may serve as an effective way to meet competition from ATSS and upstairs trading as well as justifying the scale of the traditional integrated exchange model.

## 2.4 The Models

In 1996, the Amsterdam Stock Exchange changed its governance structure from a mutual association to a public limited company, which acts as a holding company owning the assets of the exchange. Former members, institutional investors and listed companies own the holding company's shares.

Also in 1996, the Copenhagen Stock Exchange was converted from a semi-public institution into a limited company. Its share capital was issued in a ratio of 60-20-20 to its members, the issuers of shares and the issuers of bonds. The Italian and Helsinki Stock Exchanges have also been privatized with their shares being issued to brokerage firms, banks and financial institutions.<sup>11</sup>

In 1999, members of the International Federation of Stock Exchanges (FIBV) reported that 15 exchanges had demutualized, 14 had member approval to demutualize and 15 were actively considering demutualization.<sup>12</sup>

The Appendix to this chapter outlines the Demutualization Status, Demutualization Process, Reasons for Demutualization, Post-Demutualization, Corporate Governance and Regulatory Framework for the demutualization of the Toronto, Australian, Hong Kong, Singapore and Stockholm Exchanges.

The following is a discussion of two distinct experiences, the TSE and ASX. ASX did not delay in going public while TSE remains private, although it is planning to go public.

### 2.4.1 The Toronto Stock Exchange (TSE)

In 1999, Canada's four major stock exchanges were streamlined into three specialized markets, with the TSE becoming the sole senior equity market. With its more focused business strategy, TSE was ready to demutualize on 1 April 2000.

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<sup>11</sup> Supra note 2, at 2.

<sup>12</sup> Supra note 3, at 2.

TSE became the Toronto Stock Exchange Inc. (TSE Inc.), a for-profit corporation. Each member of the pre-demutualization TSE received 20 common shares of TSE Inc. per seat. Each common share carries one vote; however, the new corporation's by-laws prohibit any person or combination of persons acting jointly to beneficially own or control more than 5% of TSE Inc. without the prior approval of the Ontario Securities Commission. Members who received more than 5% by virtue of the demutualization conversion of seats to shares have been "grandfathered" from the provisions, but are not allowed to exercise more than 5% of the votes outstanding without prior approval from the Ontario Securities Commission. Subject to securities legislation, the shares will become freely tradable after two years, but before then, board approval or the approval of a majority of the shareholders of TSE Inc. is required for their transfer.

The distribution of pre-demutualization TSE's accrued surplus immediately before its continuance date was at issue in structuring the demutualization. It was decided that the surplus would be internally restricted and would remain undistributed to shareholders until winding up.

The effect of the chosen demutualization structure at the TSE is that shares of TSE Inc. are held by brokerage firms that were formerly members of the pre-demutualization exchange. New participating organizations are not required to own shares of TSE Inc. However, access to trading does not entitle participating organizations to participate in the ownership or governance of the TSE. TSE Inc. remains privately held although it is proposing a public offering, likely to coincide with the expiry of the restricted transfer period, although there have been discussions regarding waiving the restricted period.<sup>13</sup>

#### **2.4.2 The Australian Stock Exchange (ASX)**

The ASX, an exchange created as a result of the merger of six provincial exchanges in Australia, was also demutualized in response to technological change and increasing competition from abroad and from ATSS domestically. Furthermore, despite growing public share ownership and a bull market, the pre-demutualization ASX was prohibited from paying any profits or income to members and any surplus had to be applied toward promoting the objects of the exchange.<sup>14</sup> In addition to developing new trading platforms and mechanisms, the exchange

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<sup>13</sup> G. Marr, TSE to Go Public in Next 6 to 12 Months, National Post, 30 May 2001.

<sup>14</sup> Supra note 2, at 7.

determined that it had to be more responsive to the needs of market users, particularly investors and issuers, and that to accomplish such a customer focus it was no longer appropriate for individual stockbrokers to control the exchange.<sup>15</sup> On 13 October 1998, the Australian Stock Exchange converted to a public company.

In order to provide for a mechanism by which to convert membership interests to shares, the Australian legislature enacted the *Corporations Law Amendment (ASX) Act* in record time. The new legislation also

- (i) expanded the regulatory and public interest responsibilities of securities exchanges as self-regulatory organizations as well as the exchange's accountability to the Australian Securities and Investments Commission (ASIC);
- (ii) separated stockbrokers' rights to trade on an exchange from shareholders' rights;
- (iii) imposed a 5% limit on shareholdings in the ASX;
- (iv) allowed a securities exchange to self-list on its own exchange; and
- (v) provided for the supervision of any such self-listing by ASIC.<sup>16</sup>

The ASX then demutualized and on 14 October 1998, listed on its own board. Listing on the same exchange poses some obvious regulatory issues. The *Corporations Law Amendment (ASX) Act* offers some guidance in this respect. The legislation requires that the exchange enact provisions to the satisfaction of ASIC for dealing with conflicts of interest that might arise from the self-listing. More generally, the legislation requires that the exchange enter into such arrangements with ASIC as may be required for the purpose of ensuring the integrity of trading in securities of the exchange, which may include paying ASIC a fee for overseeing the exchange's listing.

Overall, ASIC is designated to be the arbitrator for conflicts of interest arising out of the exchange's self-listed shares. Critics argued that the job should go to a more disinterested third party entity.<sup>17</sup> Either way,

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<sup>15</sup> Richard G. Humphry, *The Future Structure of Securities Markets, ASX Perspective*, at 10 (4th Quarter 1995).

<sup>16</sup> *Supra* note 2, at 24, 31.

<sup>17</sup> *Supra* note 2, at n.89.

ASX remained self-regulating, even with respect to its self-listing. Last November, however, the ASX decided to incorporate a subsidiary to essentially take over ASIC's role with respect to listings on the ASX, including ASX's own. Critics of the move remain unsure as to whether the subsidiary, ASX Supervisory Review Pty Ltd., is far enough removed to offer effective oversight.<sup>18</sup>

### 2.4.3 Addressing Competitive Forces

While the exchange industry may evolve to a point where low cost or niche players realize even greater opportunities than today, full service exchanges believe integrated services will continue to play an important role in the industry. As a result, exchanges like the TSE will use the more streamlined business model resulting from a demutualization to:

- (i) invest in core and new trading modalities and technology;
- (ii) integrate market information and perhaps ATs themselves into the traditional exchange model;
- (iii) restructure market support mechanisms for retail investors;
- (iv) improve value propositions for listed Canadian companies by offering more services and maintaining liquidity; and
- (v) enhance their global specialization strategy through strong brand management and by becoming a more entrepreneurial organization.<sup>19</sup>

## 2.5 An Update Since Demutualization

Critics of the goals of exchange demutualization have argued that the process simply serves to substitute one private interest group for another. The broker-dealers, and later retail investors, who would be shareholders of the exchange would likely wish the exchange to pursue profit maximization goals that may not be consistent with regulatory steps

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<sup>18</sup> Will ASX Strike Right Balance? *Australian Financial Review* (10 November 2000); available at <[http://ptg.djnr.com/ccroot/asp/publib/story\\_clean\\_cpy.asp?rndnum=344840](http://ptg.djnr.com/ccroot/asp/publib/story_clean_cpy.asp?rndnum=344840)>.

<sup>19</sup> Supra note 6, at 15-20.

that impose burdensome listing requirements on issuers, or drive brokers or dealers to execute their trades elsewhere.<sup>20</sup>

Of course, any conclusions as to the success of any particular model or of exchange demutualization may only be reached by tracking the experiences of various demutualized exchanges over a longer period of time than that which has elapsed thus far. In the meantime, the following is a discussion of developments among various exchanges. From the following update, one can see that some exchanges are meeting their demutualization objectives while others are experiencing difficulties adjusting to the new pressures of public life.

### 2.5.1 Sweden

Demutualization of the Stockholm Stock Exchange took place in 1992-1993 in response to legislation that effectively ended its long-standing monopoly. It sold shares to issuers and exchange members, but those shares were not freely tradable for one year. The new board of directors was considerably smaller and consisted of members elected by the shareholders. Just over five years after its demutualization, a listed company and former derivatives exchange competitor, OM Gruppen AB (OM), increased its ownership to 20% and proposed a merger. The merger was approved by the Swedish Government because it was believed to be in the best competitive interests of both entities. However, in conjunction with the merger, the Swedish Government acquired a significant interest in the combined entity. It also passed new legislation, which would serve to increase regulatory oversight of the combined entity.

Although the demutualization of the Stockholm exchange was meant to thwart the competitive threat from OM, it actually ended up facilitating both its take-over by OM and increased government involvement in the company's regulation. Nevertheless, the beneficiaries of the take-over and, by extension, the demutualization have been the shareholders. The initial demutualization and the subsequent merger of the two exchanges' resources and market base has strengthened its position in the market and enabled the Stockholm Stock Exchange to modernize its business operations and governance structure.

The first act of the Stockholm Stock Exchange as a private company was to allow remote membership and direct execution of orders from

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<sup>20</sup> See J.D. Cox, *Premises for Reforming the Regulation of Securities Offerings: An Essay*, 63 *Law & Contemp. Probs.*, at 11 (Summer 2000); available at <<http://www.law.duke.edu/journals/lcp/articles/lcp63dSummer2000p11.htm>>.

other cities. In 1995, a clearing link was created between OM and the Finnish derivatives exchange. In 1997, these exchanges were united by the world's first electronic trading link between independent exchanges. Quite recently, on 21 June 1999, Sweden and Denmark launched the first cross-border joint equities trading system, Norex, designed to raise liquidity in the Baltic markets.<sup>21</sup>

Since the Stockholm Stock Exchange went public and listed itself on its own exchange, it launched the first hostile take-over bid for another stock market. At the end of August of last year, OM submitted an official bid to take over the London Stock Exchange Plc (LSE). The initial bid was rejected. The bid period was extended to late October and the terms of the bid were improved. LSE rejected that bid too.<sup>22</sup>

### 2.5.2 Australia

Soon after demutualizing and going public, the ASX turned its attention to a proposed take-over of the Sydney Futures Exchange, hoping perhaps to create as fruitful a union as that between the Stockholm Stock Exchange and OM. However, in pursuing the Sydney Futures Exchange, ASX experienced for the first time the competitive perils inherent in the bid process. It was caught in a bidding war and ultimately outbid by Computershare Ltd, Australia's pre-eminent share registry and software firm. The loss was precipitated by a decision from the country's competition bureau that the merger would be anti-competitive. The key issue before the Australian competition bureau was whether the exchange should receive special protection as the national capital markets institution or whether it should be treated as just another entity competing in the marketplace. The decision was highly unwelcome by ASX management, who accused the competition bureau of being short-term oriented and "largely unsympathetic to global market arguments."<sup>23</sup>

In other developments since then, the Australian Government has expressed a desire to lift ownership limits under the *Corporations Law Amendment (ASX) Act* from 5 to 15%. ASX has also branched into share

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<sup>21</sup> Rod Stone, Swedish, Danish Bourse Link Starts Well; More Links Seen, *Dow Jones International* (21 June 1999).

<sup>22</sup> Swedish Securities Dealers Association, Sweden: Country Report to the International Council of Securities Associations (May 2001); available at <<http://www.icsa-intl.com/pdf/sweden2001.pdf>>.

<sup>23</sup> Excerpt of Maurice Newman, Chairman of the ASX in Ben Seeder, ASX Chief Attacks ACCC Action, *Australian Financial Review* (5 Apr. 2001); available at <[http://ptg.djnr.com/ccroot/asp/publib/story\\_clean\\_cpy.asp?rndnum=344840](http://ptg.djnr.com/ccroot/asp/publib/story_clean_cpy.asp?rndnum=344840)>.

registry work (competing directly with its Computershare Ltd.) and public relations. There are rumours that the ASX is also seeking to enter the third-party clearance and back-office support markets for brokers.<sup>24</sup>

### 2.5.3 Canada

Approximately a year after demutualizing, TSE built upon its dominance of the Canadian market by announcing the planned acquisition of Vancouver's Canadian Venture Exchange (CDNX). Shareholders of both TSE and CDNX voted overwhelmingly in favour of the merger. The deal will close at the end of July assuming that the path is cleared by the OSC.<sup>25</sup>

The CDNX is the primary exchange in Canada for junior listed companies. Once the take-over is complete, CDNX will operate as a wholly-owned subsidiary of the TSE and the two exchanges will share a common board of directors. Under the terms of the deal, the TSE's board will expand to 18 members from 15 with CDNX getting five of those appointments and CDNX's former chairman becoming the vice-chairman of TSE Inc.

The acquisition was part of TSE Inc.'s strategic plan to maintain and enhance the TSE's position as the best market the world for Canadian equities and to maintain its leadership role in serving the capital-raising needs of Canadian companies.<sup>26</sup> The move was a successful attempt at vertical integration since just under half of the TSE's new listings last year came from CDNX.

Despite suffering through a rough first quarter this year that saw operating revenue drop more than 26%, TSE Inc. expects to go public in the next six to 12 months. Net income for the quarter was \$13.2-million but operating revenues have been sensitive to the drop in equity trading in the last year. It remains unclear as to whether TSE would place any limits on foreign ownership once it goes public. Because TSE Inc. does not need additional equity capital, a secondary offering is more likely than a public treasury issue. TSE has also completed its planned technological overhaul.<sup>27</sup>

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<sup>24</sup> J. Durie, Snags in the ASX Expansion Plans, *Australian Financial Review* (2 March 2001); available at <[http://ptg.djnr.com/ccroot/asp/publib/story\\_clean\\_cpy.asp?rndnum=344840](http://ptg.djnr.com/ccroot/asp/publib/story_clean_cpy.asp?rndnum=344840)>.

<sup>25</sup> R. Blackwell, TSE, CDNX Approve Merger, *The Globe and Mail* (30 May 2001), available at <[www.globeandmail.com](http://www.globeandmail.com)>.

<sup>26</sup> Barbara Stymiest, CEO of TSE Inc. quoted in an article by G. Marr, TSE to Go Public in Next 6 to 12 Months, *National Post* (30 May 2001).

<sup>27</sup> *Id.*

## 2.6 Conclusion

Demutualization is typically but one component of an exchange gearing itself up for survival in the face of frantically paced globalization. In some circumstances a national exchange reorganization such as occurred in Australia and Canada is a precursor to demutualization. Exchanges must get things in shape domestically as part of steeling themselves for a more global focus. Shareholder-owned market-oriented corporations are more capable of rapid change, allowing for the implementation of various steps necessary to become and stay competitive. To be competitive, exchanges must be transparent, fair and efficient. Demutualization may facilitate the changes necessary to improve standards of self-regulation and increase investor confidence. However, as Shamshad Akhtar, Manager, Finance and Industry Division (East) of the Asian Development Bank cautioned in May 2000 “Demutualization is not necessarily a panacea for poor self-regulation by an existing stock exchange. ... Unless the new owners of a demutualized exchange are committed to consistent and effective self-regulation, the regulatory benefits of demutualization are likely to be illusory.”<sup>28</sup>

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<sup>28</sup> Doris C. Dumlao, Demutualization Not a Cure to All of the PSE's Problems, *Philippine Daily Inquirer* (9 May 2000).

## APPENDIX I: *The Models*

### TORONTO STOCK EXCHANGE (TSE)

Demutualization Status	Demutualization Process	Reasons for Demutualization
<ul style="list-style-type: none"> <li>• became a private, for-profit company in 2000</li> <li>• was a not-for-profit organization incorporated without share capital</li> </ul>	<ul style="list-style-type: none"> <li>• in 1999, through a realignment plan, Canada's four major stock exchanges were streamlined into three highly focused, specialized markets, with the TSE becoming the sole senior equity market</li> <li>• each member or person owning a TSE seat received 20 common shares of TSE Inc. and will no longer have rights as a seatholder</li> <li>• each common share carries one vote</li> <li>• no person or combination of persons acting jointly or in concert may beneficially own more than 5%; persons who hold more than 5% immediately following continuance will be "grandfathered" from these provisions, meaning that such persons may not vote in excess of 5% without prior consent of the OSC</li> <li>• initially, transfer of shares restricted in first two years following continuance such that either consent of Board or consent of shareholders with over 50% of votes is required</li> <li>• at time of continuance, any revenue in excess of expenses is internally restricted and may not be distributed to shareholders except upon winding-up</li> </ul>	<ul style="list-style-type: none"> <li>• to improve responsiveness to a fluctuating marketplace</li> <li>• deconstruction—traditional integrated financial services businesses are being disaggregated; specialized players offering low-cost order routing and matching have emerged</li> <li>• alliances and consolidations between exchanges are becoming wave of future—scale and greater product variety are key</li> <li>• liquidity of TSE threatened as institutional investors "trade upstairs" for anonymity</li> <li>• US competitive threat</li> <li>• Alternative Trading Systems (ATs)</li> <li>• see "A Blueprint for Success"</li> </ul>

*APPENDIX I: The Models*

Post-Demutualization	Corporate Governance	Regulatory Framework
<ul style="list-style-type: none"><li>• in 2001, TSE will acquire the Canadian Venture Exchange (CDNX); the CDNX will function as a wholly-owned sub of the TSE, and the two exchanges will share a common board of directors</li></ul>	<ul style="list-style-type: none"><li>• the Board of Directors (at time of 1998 Report) consisted of 15 members—7 from participating organizations (firms which have privilege of trading on the exchange), seven independent, and the President</li><li>• the President is the only member of management who serves on the Board</li></ul>	<ul style="list-style-type: none"><li>• the basic rules applicable to all markets are subject to ongoing oversight by the OSC</li><li>• TSE rules are to be approved by the OSC</li><li>• the TSE is an SRO; it develops its own rules over and above the rules administered by the OSC</li><li>• as of 1997, regulation of TSE members' (now participating organizations) business affairs and dealings with customers became the responsibility of other SROs, such as the Investment Dealers Association (IDA)—this allows the TSE to focus on market regulation</li></ul>

### AUSTRALIAN STOCK EXCHANGE (ASX)

Demutualization Status	Demutualization Process	Reasons for Demutualization
<ul style="list-style-type: none"><li>• is now public, listed on its own exchange</li><li>• exchange formed in '87 through amalgamation of six independent stock exchanges</li><li>• exchange was not a legally mutual society—it was company limited by guarantee with no shares, and was prohibited from paying profits; surplus had to be applied towards promoting objects of the exchange</li></ul>	<ul style="list-style-type: none"><li>• legislation allowed for demutualization in 1998: expanded the regulatory and public interest responsibilities of exchanges as SROs, as well as the exchange's accountability to the ASIC; separated stockbrokers' right to trade on an exchange from shareholder rights; imposed 5% limit on shareholdings in the exchange; allowed an exchange to self-list and provided for supervision of this arrangement by ASIC</li></ul>	<ul style="list-style-type: none"><li>• deregulation, open competition and technological advances</li></ul>

*APPENDIX I: The Models*

Post-Demutualization	Corporate Governance	Regulatory Framework
<ul style="list-style-type: none"> <li>• when ASX, Ltd. parent of the exchange proposed to take over the Sydney Futures Exchange, it found itself in a bidding war;</li> <li>• also the Australian Competition and Consumer Commission (ACCC) considered ASX's merger plan to be anti-competitive</li> <li>• "key issue before the ACCC was whether a securities exchange should be protected and fostered as a national capital markets champion or just another entity competing in the marketplace like the companies that use it to raise capital"</li> </ul>	<ul style="list-style-type: none"> <li>• 9 member board of directors</li> </ul>	<ul style="list-style-type: none"> <li>• ASX develops and implements business and listing rules and supervises trading activity, markets participants such as stockbrokers and broker firms, including surveillance, investigation, discipline of stockbrokers and broker firms, and notification of Australian Securities &amp; Investments Commission (ASIC) of certain supervisory matters</li> <li>• ASIC supervises ASX's listing and undertakes the day-to-day supervision of its compliance with the listing rules to ensure ASX subject to independent scrutiny</li> <li>• MOUs between ASX and ASIC: (1) Markets MOU covering the referral to ASIC of matters detected by ASX in its supervision; (2) Membership matters MOU covering ASX's responsibility for supervision of brokers and broking firms; (3) Companies matters MOU covering ASX's supervision of listed entities; (4) Transfer of information MOU relating to arrangements for ASX to provide documents released to the market by listed entities; (5) Self-listing MOU detailing arrangements for ASX to be listed on its own market and supervised as a listed entity by ASIC</li> </ul>

## HONG KONG EXCHANGES AND CLEARING LIMITED (HKEx)

Demutualization Status	Demutualization Process	Reasons for Demutualization
<ul style="list-style-type: none"> <li>is now public, listed on its own exchange</li> </ul>	<ul style="list-style-type: none"> <li>in 2000, The Stock Exchange of Hong Kong Limited (SEHK), Hong Kong Futures Exchange Limited (HKFE) demutualized and together with Hong Kong Securities Clearing Company Limited, merged under a single holding company, HKEx</li> <li>upon the exchanges becoming subsidiaries of HKEx, Council and Committee members of SEHK and board and committee members of HKFE immediately before the merger retired; in each case a new board was appointed and new committees were formed</li> <li>as a result of the merger, ownership in shares of the exchanges were separated from access to trading facilities; with immediate effect, shareholders of the new exchanges became holders of trading rights and trading members before the merger were deemed exchange participants; holders of a trading right for an exchange are eligible to trade on that exchange subject to requirements</li> <li>later in 2000, HKEx listed its shares</li> </ul>	<ul style="list-style-type: none"> <li>to compete vigorously for opportunities in the region and around the world</li> <li>“it is a market-driven business, operating business-driven markets”</li> </ul>

*APPENDIX I: The Models*

Post-Demutualization	Corporate Governance	Regulatory Framework
<ul style="list-style-type: none"> <li>• 5 different business units have been set-up within HKEx to pursue different business goals and implement various business strategies</li> </ul>	<ul style="list-style-type: none"> <li>• 8 Public Interest Directors appointed by the Financial Secretary, 6 Directors elected by the shareholders, and the Chief Executive of HKEx as ex-officio board member</li> </ul>	<ul style="list-style-type: none"> <li>• Securities and Futures Commission (SFC) is the principal regulator of HK's securities and futures markets</li> <li>• the making of, and changes to, the rules of HKEx, the Exchanges and the Clearing Houses requires the approval of the SFC.</li> <li>• there is a prohibition on holding 5% or more of the voting power at any general meeting of HKEx in the <i>Merger Ordinance</i> and in the articles of association of HKEx; however the SFC, in consultation with the Financial 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</li> <li>• pursuant to the <i>Merger Ordinance</i>, no person may become or continue to be the controller of either the Exchanges or any of the Clearing Houses unless that person has been: (a) recognised as such by the SFC with consent of the Financial Secretary, or (b) exempted from such prohibition by the Financial Secretary. SFC may only recognize someone as exchange controller where satisfied it's in the public or investing public's interest, or for proper regulation of markets</li> <li>• as a listed company, HKEx will be regulated by the SFC to avoid conflicts of interest by two means: (a) an MOU between SFC, HKEx and the Stock Exchange, and (b) new listing rules relating specifically to the listing of HKEx</li> </ul>

## SINGAPORE EXCHANGE (SGX)

Demutualization Status	Demutualization Process	Reasons for Demutualization
<ul style="list-style-type: none"> <li>• is now public, listed on its own exchange</li> <li>• SGX was formed in 1999 by the merger of the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange Limited (SIMEX) (financial futures exchange)</li> <li>• prior to the merger, SES was an incorporated company administered by the Monetary Authority of Singapore (MAS); both SES and SIMEX were “mutuals”—they were legally owned by their members; access to SES was restricted to its 33 members; SIMEX was owned by its 35 clearing members and access was restricted to them, the non-clearing members whose number was restricted to 427 seats, and to the 147 individual non-clearing members with trading permits</li> </ul>	<ul style="list-style-type: none"> <li>• pursuant to legislation adopted to effect the merger, SGX was created to own the exchanges and their related clearinghouses, and the former owners and shareholders were given shares and seats in the exchanges</li> <li>• in 2000, SGX became a public company, with 1,000,000,000 ordinary shares outstanding</li> </ul>	<ul style="list-style-type: none"> <li>• globalization and technology</li> <li>• proliferation of electronic communications networks (ECNs) which are positioning themselves as virtual exchanges and providing a single electronic access to multiple markets</li> <li>• <i>exchanges now need to make strategic choices to serve the broader interests of the financial sector, which interests are not always in line with the interests of brokers</i></li> <li>• demutualization allows SGX to better serve the needs of its customers and the end-users</li> <li>• merger minimizes operating costs and increases value-positioning vis-à-vis other foreign exchanges</li> </ul>

Post-Demutualization	Corporate Governance	Regulatory Framework
<ul style="list-style-type: none"> <li>• agreement with ASX that will allow brokers on each exchange to trade selected stocks listed on the other exchange</li> <li>• signed MOU with Tokyo Stock Exchange for general cooperation, designed to contribute to the development and efficiency of the two markets, as well as to investor protection</li> <li>• in 2000, SGX announced joint venture with American Stock Exchange (Amex) to offer a series of exchange traded funds to investors across Asia</li> <li>• created alliance with the National Stock Exchange of India (NSE) and the India Index Services &amp; Products Limited (IISL) for cooperation in areas relating to derivatives trading, market-information sharing, staff training and technical assistance</li> </ul>	<ul style="list-style-type: none"> <li>• 11 member board of directors</li> </ul>	<ul style="list-style-type: none"> <li>• is an SRO</li> <li>• legislation requires anyone who wishes to acquire 5% or more of SGX to seek prior approval from Monetary Authority of Singapore (MAS)</li> <li>• in 2001, MAS announced that, with its approval, strategic investors and fund managers who invest pools of consumer funds can acquire 5% or more in SGX, up to 10%</li> </ul>

## STOCKHOLM STOCK EXCHANGE (SSE)

Demutualization Status	Demutualization Process	Reasons for Demutualization
<ul style="list-style-type: none"><li>• is now public, listed on its own exchange</li><li>• used to be operated as a not-for-profit mutual organization, with no right to build up capital, as fees charged to members could not exceed costs; members could trade seats, but seats could not be purchased and sold; SSE was regulated by the City Chamber of Commerce and it operated as a legal monopoly</li></ul>	<ul style="list-style-type: none"><li>• 3 step transformation in exchange:<ul style="list-style-type: none"><li>(1) modernization of trading</li><li>(2) privatization of exchange</li><li>(3) internationalization of the market</li></ul></li><li>• 1992 legislation abolished monopoly of SSE and provided the Financial Supervisory Authority with the power to authorize an exchange</li><li>• shares were sold to listed issuers and exchange members, and were only freely tradable after one year, after which time, no restrictions on ownership</li></ul>	<ul style="list-style-type: none"><li>• in the '80s trading on the exchange was low and primary market for key Swedish issuers moved to London due to a 1% turnover tax</li><li>• in late '80s and '90s, political climate changed—more market oriented, aftermath of '87 crash and financial crisis in the Swedish banking system</li><li>• turnover tax and currency controls repealed</li><li>• because of 1992 legislation, the exchange felt that in order to compete internationally it needed “economic incentives and a business attitude”</li></ul>

Post-Demutualization	Corporate Governance	Regulatory Framework
<ul style="list-style-type: none"> <li>• SSE's first act as private company was to allow remote membership and direct execution of orders from other cities</li> <li>• OM Gruppen AB (OM), which began in 1985 as a clearance house and options exchange of Swedish stocks and became authorized and licensed as an exchange following the 1992 legislation, and which was an initial subscriber to shares in SSE because of its status as a listed company, increased its ownership in SSE to 20% and proposed a merger with SSE in 1998</li> <li>• this controversial proposal succeeded because the Ministry of Finance believed a merger of cash and derivatives market was beneficial</li> <li>• in order to satisfy opponents, the government became a shareholder of both OM and SSE</li> <li>• also, new legislation passed giving Financial Supervisory Authority more power</li> <li>• at completion of merger, government owned 6.3% of combined entity and announced its intention of becoming a 10% shareholder in order to block measures</li> <li>• in 1995 a clearing link was created between OM and the Finnish derivatives exchange; in 1997 these derivatives were united by the world's first electronic trading link between independent exchanges</li> <li>• in 1999, Sweden and Denmark launched the first cross-border joint equities trading system, designed to raise liquidity in Baltic markets</li> </ul>	<ul style="list-style-type: none"> <li>• 9 board members elected by shareholders</li> </ul>	<ul style="list-style-type: none"> <li>• Financial Supervisory Authority has power to vet owners (10% stockowners) and managers of exchanges, and has direct supervision of public disclosure by OM and SSE</li> <li>• independent disciplinary committees were created for companies with qualified holdings in an exchange, with a right to initiate disciplinary proceedings in such cases given to the FSA</li> </ul>