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The Structure of a Demutualized Exchange—The Critical Issues

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4.1 Introduction

The process of demutualisation raises a number of issues for consideration. This chapter focuses on some of the key issues, which are addressed under the following headings:

- Ownership Issues
- Corporate Governance
- Access Rights
- Risk Management
- Financial Management

4.2 Ownership

The nature of the ownership issues confronting an exchange changes when the exchange is transformed from a mutual to a for-profit company. This chapter will analyze the two situations separately.

4.2.1 Ownership Issues Faced by Mutuals

Mutual stock exchanges arose out of the need for stockbrokers to provide a means of quality assurance for individuals contemplating

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investment in the securities of local companies. Stock exchanges supervised the activities of brokers, and the mutual form of ownership helped to ensure that brokers were judged reasonably—which is to say, by their peers—and that the livelihoods of brokers were protected.

There have been fundamental and universal changes in the environment faced by exchanges that have brought into question the continued desirability of the mutual form of ownership for stock exchanges. In particular:

Competition faced by exchanges has increased markedly in the last decade. Local companies and investors are now able to switch between markets, relatively easily; and there is now a much greater and more urgent need for exchanges to think and act strategically and to adapt quickly to changing circumstances.

There is often a large disparity in the contribution made (as measured by trading volume) by members of a mutual, with the result that principles such as "one vote per member" are brought into question.

Regarding timeliness and flexibility of decision-making, the expectations of exchange customers, arguably, have never been higher. Broker control of operations, as exists in mutual exchanges, means that the expectations of the exchange's non-broker customers—for example, its listed companies—are less likely to be met.

4.2.2 Additional Ownership Issues Faced by For-Profit Exchanges

The introduction of share ownership can help to address the shortcomings associated with a mutual structure noted above: it is a powerful catalyst for change but it is not, of itself, a sufficient condition to ensure that change occurs. It is possible, for example, for brokers to convert the form of ownership of the exchange to shares—to become shareholders—but for there to be no market for the shares. The result, inevitably, would be that little changes other than ownership by shares. Exchanges that are in the process of demutualizing should give careful consideration to:

(i) what are the ownership features which are most likely to address the shortcomings of the mutual structure which are identified under the previous sub-heading; and

(ii) how a market with as much transparency and liquidity as possible can be established?

Specific ownership issues for demutualized exchanges include:

(i) whether an exchange intends to target any particular type of investors specifically and, if so, which ones; and

(ii) whether an exchange intends to impose any form of ownership restriction, such as sectoral distribution, percentage limits or foreign ownership restrictions.

In relation to the first point, exchanges have a certain measure of influence over the types of investors that hold their securities. The types of investors can be influenced, for example, by:

(i) whether the exchange seeks to list on itself;

(ii) the range in which the exchange's shares trade; and

(iii) the dividend policy adopted by the exchange.

It might be argued that for public policy reasons it is desirable to encourage widespread ownership, encompassing both institutional and retail investors. This helps to reduce the likelihood of decisions being made in the interests of any one particular segment, above others. There are, however, a number of factors that could influence an exchange to seek to limit ownership, including:

(i) relatively large shareholder bases are likely to impose significant on-going costs on exchanges arising from the need to service its owners, for example by providing them with annual reports, general meeting venues and so on; and

(ii) where ownership is very widely dispersed, investors are more likely than otherwise to suffer from "rational apathy" in their decision-making, with possible adverse consequences on occasions when a requisite level of extant shareholders is needed, for example where a change to an exchange's constitution is required.[2]

2 The problem is known in the economics literature as a "public goods" problem.

By way of illustration, the Australian Stock Exchange's (ASX's) objective was to target both institutional and retail investors as shareholders, in order to promote as wide a spread of holders as possible. Whereas ASX began as a listed company in October 1998 with 606 shareholders, it has in excess of 17,000 shareholders today—the vast majority of whom are small retail investors.

Ownership restrictions are a contentious issue. In one view, such restrictions serve to fetter the market for corporate control, thereby risking inefficiencies. In another view it can be argued that ownership restrictions are necessary because it is undesirable on public policy grounds to allow an individual, or a small group, to control a stock exchange.

In ASX's case, the legislation facilitating demutualization included a provision which limited persons and their associates to owning or controlling a maximum of 5% of the voting power in the exchange. This provision reflected the Australian Parliament's view that it is in the national interest for restrictions to be imposed on the ownership of shares in ASX.

ASX considers that the 5% limit could impede strategic alliances, the need for which may arise in the future. Moreover, in ASX's view, the 5% limit provides little benefit as a means of promoting market integrity. ASX accordingly lobbied for the ownership restriction to be reconsidered, and as a consequence the limit is presently in the process of being lifted in the law to 15%, with the possibility for anyone wanting to buy more than 15% of ASX shares being able to do so, provided that the government is persuaded that the proposed acquisition is in the national interest and agrees to vary the limit. The amendments to the law which will increase the ownership limitation will also introduce a fit and proper person requirement in relation to those involved in an exchange.

4.2.3 Foreign Ownership

Another ownership issue that presents itself is whether, given the important role that exchanges play in capital formation, allocation and redistribution—and hence domestic employment and savings—there should be any restrictions imposed on foreign ownership.

ASX has argued against any special foreign ownership restrictions being applied to it. Rather, ASX believes that only the general foreign ownership considerations applicable to other Australian companies should be applied in its own case. The foreign investment requirements in Australia already provide for government scrutiny of many proposed foreign purchases of Australian businesses and properties. Essentially, the government has the power under the *Foreign Acquisitions and Takeovers Act 1975* to block proposals that it determines are contrary to the national interest.

In order for exchanges to survive, it may be necessary for them to enter into alliances with other exchanges globally. Foreign ownership restrictions may impede an exchange's ability to achieve such alliances, with the result that an exchange could find itself unable to compete realistically for listings and investment capital. Such an eventuality could in turn have a deleterious effect on the exchange's local economy.

4.3 Corporate Governance

In all issues concerning corporate governance, a stock exchange, as the body that supervises listed company behaviour, may be viewed as a 'standard setter' for other listed companies—and this is so whether an exchange is demutualized or not. It is, therefore, appropriate that an exchange board embody what are generally accepted to be sound principles of corporate governance. In this regard, reference should be made to local corporate governance guidelines if they exist, and in any case to the Organisation for Economic Co-operation and Development's (OECD's) corporate governance principles, which provide common elements of good corporate governance. The latter principles can be adapted to reflect local economic, social, legal and cultural circumstances.[3]

4.3.1 Board Appointments

Demutualization will typically involve a fundamental change in the way that board members are appointed. When ASX was a mutual, its constitution required that a majority of directors comprise broker-appointed "member directors" and that:

(i) member directors be elected by a ballot of members on the basis of one vote per member; and

(ii) the board include Member Directors from each State within the Commonwealth of Australia.

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[3] The OECD Principles of Corporate Governance were adopted by OECD Ministers in May 1999 by member governments of OECD. These principles are non-binding and are intended to serve as a reference point for countries' efforts to evaluate and improve their own legal, institutional and regulatory framework.

When ASX became a company limited by shares, control of the composition of the board passed to the shareholders, and the requirement for member directors and geographical restrictions regarding appointment of directors were removed. The board was also downsized.

4.3.2 Board Representation

It has been suggested by some commentators that an exchange's board should include representatives from major interest groups, such as investor and company director associations. ASX considers this to be undesirable; moreover, it could significantly impede the decision-making processes of a board. Company directors should act in the interests of their company; not in the individual interests of the groups that may have nominated them. In Australia this view is reinforced in law. Where directors are acting solely in the individual interests of their constituents, there is a risk that boards can become like Parliaments. Being comprised of representatives of diverse constituencies they may come to debate issues rather than to make decisions.

ASX currently has nine Directors, only one of whom is an executive director, namely, the Chief Executive Officer. Board members whose backgrounds are predominantly stock broking no longer constitute a majority. Currently , the board comprises persons with complementary and diverse skills including information systems, accounting and auditing, legal, funds management, stock broking and business administration. Members of the board bring both a global and regional perspective to the board's deliberations as well as an understanding of the external political and public policy environment. There is also a depth of experience in company directorships. Nonexecutive directors retire by rotation and the usual term of appointment for all nonexecutives, before they must nominate for re-election should they wish to continue as directors, is three years. There is no maximum term for directors.

4.3.3 Board Committees

In Australia it is normally regarded as good corporate governance practice for boards to establish audit, nomination and remuneration committees,[4] and for such committees to:

[4] ASX has an audit committee and a combined nomination and remuneration committee.

(i) be comprised of a majority of independent directors;

(ii) have an independent director as a chairperson; and

(iii) have clearly defined terms of reference.

Typically, mutual exchanges have many committees and, as suggested elsewhere, it is within these committees that many day-to-day management decisions are made. Achieving a timely and orderly transfer of management responsibilities from the committees to the executive is a critical issue in the demutualization of a stock exchange.

4.3.4 Share Dealing Rules for Directors and Managers

Given an exchange's market position and the role that it plays in the community, even a suggestion of insider-trading by a director or staff member can do great harm to the individual as well as to the exchange, irrespective of whether insider-trading actually took place or is proven. It is therefore essential that a demutualized exchange put in place arrangements for directors, management and committee members where relevant, which govern transactions by them in the exchange's own securities. These arrangements should be made public, in order to enhance confidence in the governance of the exchange.

A cornerstone of such an arrangement would be for directors and other relevant people to be allowed to effect transactions in the exchange's securities only during certain time periods when material information has been released to and absorbed by the market, for example for a period of four weeks commencing two trading days after the exchange has released its financial results. ASX has introduced such share dealing rules for ASX directors and staff. The share dealing rules of ASX also prohibit active trading in ASX securities by ASX directors and staff.

4.3.5 Continuous Disclosure Procedures

It is also very important for an exchange to lead best practice in the continuous disclosure of information relevant to the making of investment decisions in its securities. It is accordingly beneficial to put in place procedures to ensure that material information is released to the market in a coordinated and efficient way. ASX appointed a Continuous Disclosure Officer and introduced formal procedures setting out the obligations of directors and staff relative to the disclosure of information to the market and to protect against unauthorized disclosure to the media or sections of the public.

4.3.6 Accountability and Transparency of Supervisory Decision-Making

Demutualization places a spotlight on the ability of the exchange to quarantine and protect regulatory or supervisory information, to discharge its supervisory responsibilities with integrity and impartiality and to effectively manage conflicts which arise between its supervisory responsibilities and commercial aspirations.

This requires an exchange to review its policies and procedures for supervisory decision-making and ensure that they best promote transparency and accountability. ASX has taken a number of initiatives designed to do this including public consultation on rule amendments, publication of waiver and disciplinary determinations, issue of *Guidance Notes* and materials designed to enhance public understanding and awareness of our processes and our compliance expectations, improved mechanisms (including via our website) for public access to supervisory outcomes and more recently, establishment of ASX Supervisory Review Pty Limited to audit and report on our supervisory activities.

4.4 Access Rights

Demutualization involves the separation of ownership rights from customer or access to market facility rights. Complexities arise where:

- there is more than one class of member in existence; and
- the trading rights are in the form of seats.

Where there is more than one class of member in a demutualizing exchange it will be necessary to value the exchange's business and determine an equitable split of shares in the demutualized entity, between classes. Where there is only one class of member in a demutualizing exchange, valuation is normally less of an issue as members can be offered equal shares in the demutualized entity.

Where seats exist, an exchange in the process of demutualizing will need to decide whether these should continue to exist after demutualization; and if it should be decided that seats are not to continue,[5] what (if any) compensation should be paid to holders. Where there is recent experience of trading participants paying large amounts for seats in the home market, it may be necessary, in order for demutualization to be approved by exchange members, either to continue to allow seats to exist[6] or for the exchange to pay compensation to brokers for loss of transferability of their trading rights.[7]

4.5 Risk Management

Risk is an unavoidable aspect of all organizational activity and therefore the characterization of organizational risks should be a key annual activity for an exchange. An exchange's board should set the framework for the management of organizational risk including the level of risk allowable in certain activities or projects. To assist it in fulfilling its responsibilities, a board should consider establishing a risk management committee.

A key risk that ASX monitors in its own risk management is "business risk" or threats to the achievement of its goals and to the successful execution of its strategies. ASX compiles an inventory of business risks and then conducts workshops to consider these risks. The objective is to identify all significant business risks arising from current operations, new business initiatives and projects. The risks identified are then combined with risk data from previous years that continue to be relevant. Risks are grouped and ranked, and containment measures regarding them, identified.

ASX does not have a risk management committee per se; instead an audit committee monitors the risk management and control structure implemented by management. The committee advises on the need for significant changes to that structure in order to obtain reasonable assurance that ASX assets are safeguarded and that reliable financial records are maintained.[8]

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5 The existence of seats implies that there is a restriction on the issue of new trading rights. Depending on the circumstances, this may well be detrimental to market liquidity and to the commercial interests of an exchange.

6 Some demutualized exchanges have put a sunset restriction on seats.

7 Compensation will probably not be a possibility for exchanges in emerging markets.

8 ASX reports annually on its risk management processes.

4.6 Financial Management

4.6.1 Sources of Funds

A mutual exchange may have the power to levy assessments upon its members in order to obtain debt finance. A demutualized exchange has broader avenues open to it for raising capital, notwithstanding that, unlike the levying of mutual members, shareholders have no financial liabilities beyond their fully paid-up shares.

A demutualized exchange may raise additional capital by issuing shares externally and it may be perceived as having a greater capacity to obtain debt finance. However, the availability of new equity and loan capital at a reasonable price, if required, would depend more on sustainable profits than on the current value of the exchange's net assets.

4.6.2 Investor Expectations

The process of demutualization and listing brings with it investor expectations concerning financial management and performance. These expectations will have a major impact on the financial policies adopted by an exchange. In this context, exchanges will need to consider:

(i) what is an appropriate hurdle rate, i.e., rate of return, for new activities;

(ii) the extent to which activities should be diversified, in order to maintain a steady income despite variations in market conditions; and

(iii) what is an appropriate dividend policy.

Investor expectations and therefore the most appropriate mix of financial policies are likely to vary from country to country.

4.6.3 Financial Governance

An exchange's board is directly responsible for financial governance of the entity. The board sets the financial policies that guide the Chief Executive Officer in his/her financial management. These policies address matters such as budgeting criteria, day-to-day financial management, protection of assets, employee remuneration and benefits, investment practices and financial reserves.

In the course of discharging its financial governance responsibilities, the board of an exchange should:

(i) seek to ensure the ongoing financial viability of the exchange and the fiscal integrity of CEO actions by monitoring actual performance against criteria set by the board;

(ii) ensure that it receives reports that provide assurance of the integrity of the financial processes, systems and reporting; an audit committee could assist in this area; and

(iii) establish and manage the exchange's relationship with its external auditor; an audit committee could assist here also.

4.7 Conclusion

This chapter has commented on the main issues that present themselves when exchanges consider what is to be the exchange's most appropriate structure post-demutualization, including:

(i) ownership issues, such as whether an exchange should target any particular type of investors, and/or have any ownership restrictions such as percentage limits or foreign ownership caps;

(ii) corporate governance issues, such as what should be the composition of the board, whether the board should establish committees, and what share-dealing rules and policies should be introduced for the exchange's own directors and managers;

(iii) access issues, such as how to treat different classes of members and seats, as part of the demutualization process;

(iv) risk management issues, such as how should an exchange board monitor risk management, and what types of risks should an exchange be focusing on; and

(v) financial management issues, such as how to meet investor expectations regarding rates of return, and what role an exchange board should play in financial governance.

The discussion highlights a variety of issues that need to be addressed in order to maximize the benefits to be gained from demutualization. It is unlikely that one set of solutions will suit all exchanges. Each exchange will need to consider these and other issues in the light of its own particular environment.