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Regulation of a Demutualized Exchange (Canada)

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8.1 Introduction

This chapter discusses a number of issues regulators have considered in adapting the securities regulatory framework in response to changes in the ownership structure of exchanges. The chapter is divided into ten parts:

- Role of an Exchange
- Self-Regulation and Government Oversight
- SRO Conflicts of Interest
- Supervision of Listings
- Self-listing
- Managing Conflicts of Interest
- Prudential Regulation
- Shareholders
- Directors and Officers
- Memoranda of Understanding

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Demutualization of an exchange involves the conversion of a not-for-profit member-owned organization to a for-profit shareholder-owned corporation. A regulator of a demutualized stock exchange must balance the interests of the profit motive of the corporation (the demutualized stock exchange) with that of investor protection. In considering how to adapt the regulatory framework to a demutualized exchange, securities regulators consider:

- (i) Whether conflicts of interest are created or increased if a for-profit entity also performs the regulatory functions of an exchange such as primary market regulation (listing of issuers), secondary market regulation and member regulation.
- (ii) A fair and efficient capital market is a public good. Should particular corporate governance arrangements or rules regarding share ownership be imposed to protect the public interest?
- (iii) Will a for profit exchange allocate adequate funding to regulatory functions?²
- (iv) What incentives should a regulatory framework and environment for a demutualized exchange provide? Are the incentives different from those provided by regulation governing a mutual exchange? Arguably not—at the end of the day, regulation is designed to promote the efficient functioning of the capital markets and the protection of the investor.

In a recent speech, Arthur Levitt, former Chairman of the US Securities and Exchange Commission remarked: “[t]he potential for conflicts of interest that may arise if the self-regulatory organization (SRO) is enmeshed within a for-profit corporation must be defused...[a]t the very least, I believe that strict corporate separation of the self-regulatory role from the marketplace it regulates is a minimum for the protection of investors in a for-profit structure.”³

² Technical Committee of the International Organization of Securities Commissions (IOSCO), Issues Paper on Exchange Demutualization, at 4 (June 2001).

³ Lisa Fried, Plans Debated for Stock Markets’ For-profit Conversion, N.Y.L.J. (30 September 1999).

8.2 Role of an Exchange

Stock exchanges are firms that market transaction services to facilitate trading, allowing them to profit from the listing and other transaction fees they impose on listing firms and other customers. Exchanges sell a bundle of services for listed firms, specifically: (a) the provision of liquidity to compensate for temporary imbalances in order flow; (b) monitoring of trading patterns, dispute resolution and corporate governance in exchange-listed securities; (c) the development of standardized contracts to reduce transaction costs for investors in listed stocks; and (d) the provision of reputational capital to listing firms.⁴

Markets do not solve all the problems generated by economic activity within the financial system. As a consequence, regulation is necessary to correct the problems generated by economic activity but the regulation should be responsive to changes in market conditions so as not to stifle innovation. Regulation in the financial markets is necessary for primarily three reasons. First, incomplete contracts can prevent markets from working by increasing to prohibitive levels the costs of transacting in the market. Second, there may be severe problems with enforcement of rules in the absence of some centralized regulation. Third, there may be effects on third parties or externalities that arise in the functioning of markets.⁵

8.3 Self-Regulation and Government Oversight

The three main objectives of securities regulation as expressed by the International Organization of Securities Commissions (IOSCO) are: (i) the protection of investors, (ii) ensuring that markets are fair, efficient and transparent, and (iii) the reduction of systemic risk.⁶ In countries with multiple developed and sophisticated capital markets, another objective of securities regulation is enhanced competition. Competition between exchanges in the delivery of their products is good because the competition forces exchanges to innovate and become more efficient in the delivery of their products.

⁴ Jonathan Macey & Maureen O'Hara, *Regulating Exchanges and Alternate Trading Systems: A Law and Economics Perspective*, 28 *J. Legal Stud.* 17, 22 (January 1999).

⁵ *Id.* at 24.

⁶ International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, at 6 (September 1998).

The reasons for each of the three main objectives overlap to some extent, reinforcing the importance of each to the foundation of a sound financial system. For example, the first objective is based on the theory that investors need to be protected from misleading, manipulative and fraudulent practices.⁷ In order to achieve the first objective, the markets should not favour some market users over others and therefore must provide full and timely disclosure of relevant information.⁸ Furthermore, the protection of investors can only be achieved if regulation aims to reduce the risk of failure of a participant in the financial system or seeks to reduce the impact of that failure and isolate the risk to the failing institution.⁹

The need for efficiency and transparency is also driven by market forces. Edward Waitzer, former Chairman of the Ontario Securities Commission noted: "Issuers and investors demand liquid, transparent, well-informed markets with low transaction (including regulatory) costs and high integrity. If our markets (and intermediaries) do not satisfy these requirements, transactions can easily flow elsewhere."¹⁰

IOSCO has noted that it is not necessary that responsibility for all aspects of enforcement of securities law be given to a single body. There are several effective models in which responsibilities are shared between several government or quasi-government agencies or where responsibility is shared with SROs.¹¹

Some of the advantages of a government regulator delegating responsibility for oversight of the market to SROs are the ability to utilize industry expertise; the potential for higher standards than may be imposed by law; potentially greater compliance with mutually agreed rules set by peers than with externally imposed requirements; and greater flexibility and responsiveness.¹²

However, self-regulation also has a number of risks arising from the conflict between the interests of the members and the public. These include:

- (i) operational failures resulting from lack of resources or commitment, such as the application of inconsistent standards or arbitrary penalties or the failure to respond promptly to problems;

⁷ Id. at 6.

⁸ Id. at 7.

⁹ Id. at 8.

¹⁰ Edward Waitzer, *Coordinated Securities Regulation: Getting to a More Effective Regime*, Queen's Annual Business Law Symposium, at 3 (4 November 1994).

¹¹ Supra note 6, at 13.

¹² Simon Romano, *Self-Regulation in the Securities Industry-A Regulatory Perspective*, 95 OSCB.

- (ii) anti-competitive behaviour, such as entry barriers and sub-optimal market structure, which favours the interests of members over those of investors;
- (iii) self-serving regulation generally;
- (iv) heightened possibility of “regulatory capture,” including through control of the information necessary to regulate properly and increased regulatory dependence on the SRO for policy input and expertise; and
- (v) the chilling effect on dissent that may result from a well-organized interest group.¹³

Two reasons frequently cited for the need for government supervision of SROs are that the government must be assured that the SRO actually performs its regulatory functions and that the government must seek to reduce impairment of competition.

Industry members know that unless conduct is effectively policed, investors will incur losses and complain to government about inadequate regulation. Regulatory responsibility is shared between the SRO, as regulator, and the government, as supervisor. Inadequacy of the regulation will generally be the fault of both the SRO and the government and will result in less SRO regulatory power and more government supervision—a situation that industry seeks to avoid.

The key to successful government-SRO regulation is to establish increased competency in each regulator, effective arrangements for information exchange and co-ordination and appropriate oversight of the SRO by the government regulator. The government regulator and SRO must each commit to promote:

- (i) an improved understanding of the roles, powers and responsibilities of each regulator;
- (ii) exchange of expertise;
- (iii) consistent implementation of regulatory standards;
- (iv) access by each regulator to the information necessary to fulfill its responsibilities; and
- (v) communication lines that will maintain and enhance each regulator’s ability to react to market activities in a timely manner.

¹³ Id.

In the US, regulation by stock exchanges of their members and listed companies preceded regulation of securities markets and the securities industry by the Securities and Exchange Commission (SEC) pursuant to the Securities Exchange Act of 1934 (Exchange Act), which required exchanges to register with the SEC. The Exchange Act provided for the SEC to have oversight authority over stock exchanges, but stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies. In 1945, the Ontario Securities Commission was given the explicit authority to regulate the Toronto Stock Exchange (TSE).

The regulatory responsibilities of exchanges may include:

- (i) developing trading rules and enforcing them;
- (ii) setting listing standards and ensuring continuous disclosure of material information by listed companies;
- (iii) adopting and enforcing rules of conduct for members of the exchange;
- (iv) setting qualification and financial standards for industry professionals;
- (v) conducting surveillance of the market and its participants and investigating violations of exchange rules and disciplining violators; and
- (vi) monitoring and regulating daily trading and the operation of the market to ensure its integrity.¹⁴

Not all exchanges are responsible for regulation of the business affairs of members and their dealings with customers. For example, in 1997, the TSE transferred responsibility for most aspects of member regulation to the Investment Dealers Association of Canada. This allows the TSE to focus on market regulation.

Further, Timothy Baikie, Director, Global Market Initiatives of the TSE points out that listed company regulation is not, strictly speaking, self-regulation as exchanges are not organizations of public companies. An exchange's jurisdiction over listed companies is contractual, based in

¹⁴ Frank Donnan, *Self-regulation and the Demutualization of the Australian Stock Exchange*, 10 Australian J. Corp. L., at 12 (1999) cited in IOSCO Issues Paper, supra note 2, at 6.

the listed agreement pursuant to which the company agrees to comply with exchange rules.¹⁵

8.4 SRO Conflicts of Interest

The demutualization of stock exchanges raises a number of contentious issues. First, commentators have argued that conflicts of interests arise between shareholders and members that could lessen the ability of exchanges to engage in effective self-regulation. A potentially more serious conflict is the regulation of an Alternative Trading System (ATS) market by an exchange. Second, securities firms are concerned about increased costs if several ATSs become exchanges and begin to engage in self-regulation. Therefore, some financial services industry participants argue in favour of a single SRO for exchanges and member firms. Third, there are ongoing power struggles between the SROs and between the SROs and the government regulator.¹⁶

Conflicts arise because exchanges set rules in the public interest that may negatively affect the commercial interest of members and monitor and enforce rules against members.¹⁷

Commentators have argued that demutualization may reduce SRO conflicts. The interests of owners in a demutualized exchange may act as a constraint on actions that benefit only member firms. A reputation as a fair and efficient market is a competitive advantage for an exchange and a for-profit exchange may have more resources to devote to regulation that enhances the reputation.¹⁸

However, the more commonly expressed concern is that the for-profit structure increases the scope and intensity of conflicts because revenues must meet expenses and generate a rate of return for investors. Both the NYSE and NASD subsidize their regulatory arms today.¹⁹ The benefits of good regulation are hard to quantify and therefore a for-profit exchange may be unwilling to devote sufficient resources to enforcement. Further, since a regulatory function imposes additional costs, having a regulatory arm makes a corporation a less attractive candidate for an

¹⁵ Timothy Baikie, *From Toronto Stock Exchange to TSE Inc.: Toronto's Experience with Demutualization*, at 9.

¹⁶ Roberta Karmel, *Turning Seats into Shares: Implications of Demutualization for the Regulation of Stock and Futures Exchanges*, at 57 (December 2000).

¹⁷ *Supra* note 2, at 6.

¹⁸ *Id.* at 7.

¹⁹ J. Coffee Jr., *Privatization and Self-Regulation of Stock Exchanges*, at 23.

initial public offering (IPO). In preparing for an IPO an exchange will seek to minimize costs and emphasize its potential for earnings. Spinning off the regulatory arm does that.²⁰

A for profit exchange may enter new businesses, increasing the opportunities for conflict. If a dealer that operates an ATS is also a member of the exchange, conflicts of interest may arise in the exchange regulating the dealer providing a competing service. Conflicts include denial of access to particular activities or failure to make changes to accommodate an entity providing a competing service.

Under the Australian SRO model, the Australian Stock Exchange (ASX) assumes the role of co-regulator with the designated regulatory authority to ensure that the stock market is fair, well-informed and efficient.²¹ The Australian Government passed the *Corporations Law Amendment Act (ASX Act)* in 1997 to facilitate the conversion of ASX to a public company. The *ASX Act* clarifies the responsibilities of ASX as a SRO, and its accountability to ASIC and the government in carrying out its SRO responsibilities. The *ASX Act* imposes a duty on ASX to do everything necessary to ensure that the market it conducts is an orderly and fair market and that the self-regulatory functions are carried out on an ongoing basis.²²

The *ASX Act* obliges ASX to notify ASIC of the particulars of the situation in a variety of circumstances. For example, ASX must notify ASIC when it fines or disciplines a stockbroker. Moreover, if ASX believes that a person has committed or is about to commit a serious contravention of its business or listing rules or the law, again, it must notify ASIC. When ASX makes available to the market information about a listed company, it must also provide that information to the ASIC. And further, if ASX becomes aware of any matter which adversely affects a stockbroker's ability to meet its obligations under the law, it must notify ASIC of the details.²³

In summary, then, ASIC and the Minister have statutory regulator roles and ASX is an SRO which has responsibility for the day-to-day running of the stock market. Among these responsibilities are the maintenance of market integrity, fair trading systems, guarantees of trade completion, clearing, settlement and transfer systems and information about stocks that are traded.²⁴

²⁰ Id. at 24.

²¹ Donnan, *supra* note 14, at 3.

²² Id.

²³ Id at 33-34.

²⁴ Id at 34.

8.5 Supervision of Listings

Another concern is that conversion of an exchange to a for-profit corporation would precipitate a “race to the bottom” in which to compete successfully with each other for listings, exchanges would lower their listing and reporting standards in order to allow more companies to list in order to obtain more listing fees and transaction fees for the exchanges. While competition among exchanges would probably result in a lowering of fees and other costs related to listing for companies, the competition would be accompanied by a loosening of listing standards which would undoubtedly undermine the investing public’s confidence in the strength and quality of the capital markets in general.

However, a reply to this argument is that while some exchanges may choose to lower their listing standards in order to be more profitable for their shareholders, other exchanges will in fact put in place more stringent and rigorous standards in order to distinguish themselves and the service they are offering from other exchanges. The New York Stock Exchange (NYSE) has, in fact, adopted such a strategy to distinguish itself from other exchanges. In fact, companies seek to list on the NYSE because of the reputational capital that comes with listing on the world’s premier exchange.²⁵

8.6 Self-Listing

An exchange listing on itself presents a more fundamental conflict of interest than those inherent in an SRO. In addition to the issue of whether an exchange can function as its own regulator is the issue of whether self-listing increases the conflicts of overseeing competing entities that are also listed on the exchange. IOSCO cites two factors that act as controls against discriminatory treatment of competitors: (a) competition for listings among exchanges; and (b) the risk to the exchange’s reputation.²⁶ Potential conflicts are lessened by the government regulator assuming regulation of the exchange as issuer.

When the Stockholm and the Australian exchanges went public, the government was assigned the task of overseeing exchange disclosure to

²⁵ Exchanges supply reputational capital to the firms that list on them. *Supra* note 4, at 26.

²⁶ *Supra* note 2, at 8.

shareholders. ASIC supervises ASX's listing and undertakes the day-to-day supervision of its compliance with the listing rules to ensure that ASX is subject to independent scrutiny.

8.7 Managing Conflicts of Interest

IOSCO commented that the challenge for exchanges is to create an environment in which conflicts are recognized, minimized and managed. This environment involves:

- (i) corporate governance requirements such as requirements for public directors;
- (ii) a clear statutory statement of the obligation to provide a fair and efficient public trading market;
- (iii) rigorous regulatory oversight;
- (iv) enhanced transparency through requirements to publish rules and decisions;
- (v) mechanisms to enhance exchange accountability to the government regulator and the public; and
- (vi) separation of the commercial activities of the exchange from regulatory functions—from dividing lines of authority and accountability within a single firm to establishing a separate legal entity or transferring some regulatory responsibilities (such as regulation of the exchange as listed corporation) to the government regulator.²⁷

8.8 Prudential Regulation

A member-owned exchange usually has the right to assess members and request a capital contribution. A demutualized exchange usually loses the right to demand that shareholders contribute additional capital, but gains the flexibility to raise capital from public or private sources. Capital and solvency requirements serve to reduce the risk of failure of a

²⁷ Id. at 9.

financial firm by requiring a capital cushion to absorb losses. Capital also provides liquidity to permit a firm to operate during an orderly wind down. Regulators have raised the issue of whether capital requirements should be imposed on a demutualized exchange. Other alternatives raised are to require a demutualized exchange to establish a reserve to address shortfalls in capital, or for the regulator to monitor the financial condition of an exchange and take remedial action, if appropriate. New business lines of exchanges may reduce financial risks by diversifying the exchange's sources of income. A regulator could require segregation of core and non-core activities, firewalls to protect the resources necessary to run the exchange's core activities or impose a requirement for prior regulatory approval.²⁸

8.9 Shareholders

A mutual exchange is governed by consensus, so no one member exerts control over the decisions of the exchange. With demutualization, ownership is broadened to include non-member investors. Concerns may arise if an exchange is controlled by one or more persons. An issue arises whether the public interest requires a limit on share ownership or prior regulatory approval for ownership above a threshold percentage.

The corporate structure that the demutualized TSE has adopted is similar to that adopted by several of the other demutualized stock exchanges around the world.

In 1999, Canada's four major stock exchanges were streamlined into three specialized markets, with the TSE becoming the sole senior equity market. Each person owning a TSE seat received 20 common shares of TSE Inc. Each common share carries one vote. No person or combination of persons acting jointly or in concert may beneficially own or control more than 5% of the outstanding shares without the prior approval of the Ontario Securities Commission. Moreover, persons who held more than 5% immediately following demutualization were "grandfathered" from these provisions, meaning that persons who do own more than 5% of TSE Inc. may not vote in excess of 5% without the prior approval of the Ontario Securities Commission.

In the first two years following the continuance of the TSE as a for-profit corporation, the transfer of shares is restricted—any transfer

²⁸ Id. at 13-14.

requires either the majority consent of the Board or the majority vote at a meeting of shareholders.

In 2000, the Stock Exchange of Hong Kong Limited (SEHK) and the Hong Kong Futures Exchange Limited (HKFE) demutualized and, together with the Hong Kong Securities Clearing Company Limited, merged under a single holding company (HKEx). As a result of this merger, ownership in shares of the exchanges were separated from access to trading facilities. Shareholders of the new exchanges became holders of trading rights and trading members before the merger were deemed exchange participants. Lastly, holders of trading rights for an exchange are eligible to trade on that exchange subject to requirements.

As with the shareholding limits in place with regard to the TSE, in the *Merger Ordinance* and in the articles of association of HKEx, there is a prohibition on holding 5% or more of the voting power of HKEx at any general meeting of the shareholders of HKEx. However, the Securities and Futures Commission (SFC), the principal regulator of the Hong Kong capital markets, in consultation with the Financial Secretary, may give approval to a person to hold more than 5% if it can be demonstrated to be in the interest of the investing public. The *ASX Act* in Australia limits persons to owning or controlling no more than 5% of the shares in the ASX. This 5% limit applies to both Australian and foreign persons.²⁹ A memorandum issued to explain these restrictions in Australia justified the shareholding limits by offering two reasons: (a) ASX has a critical role to play in the national economy and thus it is in the national public interest not to allow any one party to gain control of the Exchange, and (b) such a limitation encourages diverse ownership of the ASX.³⁰

The 5% shareholding limit results in a prohibition on hostile take-overs of stock exchanges thereby removing a disciplinary tool on management. Economists argue that a healthy take-over market works efficiently and effectively to control costs imposed by the managers on the owners of the firm. The threat of take-overs forces management to use capital efficiently and focus on performance.³¹

²⁹ Donnan, *supra* note 14 at 86.

³⁰ *Id.* at 23 (citing Explanatory Memorandum).

³¹ *Id.* at 87.

8.10 Directors and Officers

The fair and efficient functioning of an exchange is of significant benefit to the public. An exchange provides liquidity and price discovery that facilitates efficient raising of capital for businesses, benefiting the wider corporate sector and the economy as a whole.

In recognition of the role of an exchange and the degree of conflict of interest in a member-owned exchange, exchanges are commonly required to have public directors on the board to represent the interests of the community. Public directors monitor conflicts of interest in a SRO and promote integrity in decision making. IOSCO raises the issues of whether a demutualized exchange still needs to have public directors and if so, whether they should be given specific public interest responsibilities.³² I would argue that given that the public interest in a fair and efficient exchange continues in a demutualized exchange, the need for public directors continues. The directors of a for-profit exchange must take into account the interests of all of its stakeholders if the exchange is to function effectively. These stakeholders are its customers (the companies that list on the exchange and the securities information processors), its members that have trading privileges (the broker-dealers), its owners (the shareholders) and the investing public. Thus, while a corporation exists to make profits for its owners, it is imperative that the investing public not lose confidence in the integrity of the stock exchange.

In a demutualized exchange, the senior management of the exchange are likely to be the decision makers on a day-to-day basis. Market demands will push the exchange to hire as competent people as possible. IOSCO³³ raises the issue of whether there is a need for direct involvement of the government regulator in hiring decisions.

8.11 Memoranda of Understanding

Memoranda of understanding (MOUs) are used to define the regulatory relationship between institutions. For example ASIC and ASX put in place a number of MOUs, such as:

³² Supra note 2, at 11.

³³ Id.

- (i) the Markets MOU covering the referral to ASIC by the ASX of matters detected by ASX in its supervision;
- (ii) the Membership Matters MOU covering ASX's responsibility for supervision of brokers and broking firms;
- (iii) the Companies Matters MOU covering ASX's supervision of listed entities;
- (iv) the Transfer of Information MOU relating to arrangements for ASX to provide documents released to the market by listed entities; and
- (v) the Self-listing MOU detailing arrangements for ASX to be listed on its own market and supervised as a listed entity by ASIC.

The Hong Kong Stock Exchange also uses an MOU between the SFC, HKEx and the Stock Exchange to regulate conflicts of interest.

8.12 Conclusion

The characteristic mode of regulation of stock exchanges is co-regulation.³⁴ A stock exchange acts as a co-regulator with the government regulator to ensure that the markets are working fairly and efficiently, to protect investors and prevent fraud. The conversion of an exchange from a mutual association to a for-profit corporation does not necessitate a fundamental change in this regulatory relationship.

Undoubtedly, an exchange will experience some internal tension between its roles as a for-profit corporation and as an SRO. However, in many instances, industry self-regulation has functioned well despite inherent conflicts of interest. Moreover, co-regulation is a flexible concept and a for-profit SRO is one of many factors for a government to take into account when designing a regulatory framework.³⁵

³⁴ Donnan, *supra* note 14, at 32.

³⁵ *Id.* at 60.