

17

Demutualization of the Philippine Stock Exchange

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17.1 Introduction

17.1.1 Background

The Philippine stock market is one of the oldest in Asia. For decades, there were two separate domestic stock exchanges that traded basically the same listed issues: the Manila Stock Exchange (MSE), established on 8 August 1927, and the Makati Stock Exchange (MkSE) founded on 27 May 1963. In 1992, President Fidel V. Ramos declared a government policy of consolidating the operations of both exchanges to develop a more efficient capital market. Thus, on 14 July 1992, the two bourses were unified under the Philippine Stock Exchange, Inc. (PSE).

17.1.2 Legislation and Regulation Affecting the Exchange

The enactment of the Securities Regulation Code (SRC) is a single piece of legislation that affected the structure and operations of PSE (the Exchange). Section 33.2 (a) of the SRC mandated the reorganization of the PSE as a stock corporation by 8 August 2001. Thus, by a stroke of legislative pen, the destiny of the PSE as a demutualized exchange was determined.

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17.2 Ownership Structure of the Stock Exchange Upon Demutualization

17.2.1 Conversion as a Stock Corporation

As a legal concept, demutualization is strictly the conversion of a mutual or member organization into a stock corporation. However, the listing of the exchange via introduction to the market and without the raising of capital consequently expands the ownership structure (i.e., Australian Stock Exchange (ASX) and Hong Kong Stock Exchange (HKEx)) and is widely seen as an effective way of improving corporate governance. The strict timetable and the absence of steady revenue streams constrained the adoption of two steps in demutualization: conversion into a stock corporation and subsequent listing.

17.2.2 Ownership Structure

Under the conversion plan, each of the 184 member-brokers subscribed to and fully paid for 50,000 shares in the PSE. The initial conversion of a mutual company into a stock corporation results in a shareholder-based company owned 100% by brokers. Its subsequent listing is expected to reduce broker ownership significantly, similar to the ASX and HKEx experience. The SRC prohibits shareholders from having more than 5% of the voting rights as well as an “industry group” from owning more than 20% of the shares of the PSE after demutualization.

17.3 Trading Rights

17.3.1 Separation of Ownership of the Exchange from Access to Trading

The ownership of shares in the exchange and access to the trading facilities of the Exchange is separated since 8 August 2001. In recognition of the existing seat ownership by members, one trading right is conferred to each of the 184 members entitled to subscribe to shares.

17.3.2 Policy of Imposing a Moratorium on the Issuance of New Trading Rights

In the light of prevailing market conditions, 184 trading rights are deemed sufficient to meet the business objectives of the Exchange. Thus, on 8 August 2001, the exchange imposed a moratorium on the issuance of new trading rights. The trading right shall be transferable without any time limitation.

17.4 Corporate Governance

17.4.1 Board Structure and Composition

In compliance with the prescribed board structure in Section 33.2 (f) and (g) of the Securities and Regulation Code (SRC), of the 15 members of the board, 8 are non-brokers while 7 are brokers proportionately representing the brokers in terms of volume, value, and paid-up capital. The President of the PSE is also a non-broker.

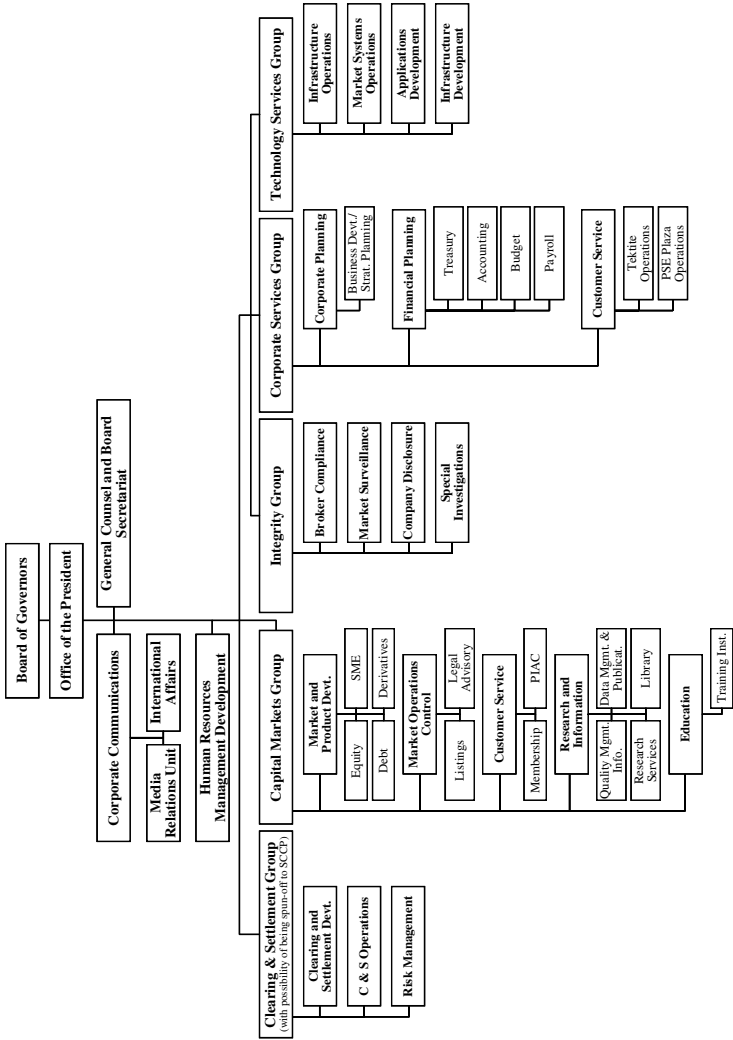
Both the Australian and Hong Kong Exchanges eventually plan to reduce the number of directors pursuant to demutualization. PSE will examine the necessity of reducing the size of its board when it turns public.

17.4.2 Overall Organizational Structure upon Demutualization

A key component of the future success of PSE is dependent on a business structure that reflects its business and strategic plans. PSE will test the efficacy of a new organizational structure it will commence implementing on 8 August 2001.

The overall structure of PSE is shown next page:

Figure 17.1. Overall Structure of the Philippine Stock Exchange



The organizational structure reflects strategic directions aimed at rebuilding integrity, commercializing the organization, providing the best possible resources for the current business and expanding these services to diversify revenue sources. A responsible business unit supports each strand of the strategy, with the Technology Services providing infrastructure for the whole organization.

The Integrity Group is driven by the pursuit of decreasing breaches of rules. At the same time, the Group shall seek to increase its role in the marketplace through better surveillance and follow-up action as well as through involvement in practical policy setting. The Technology Group shall similarly be measured by other means, namely efficiency, reliability, and reusability. The three remaining groups all have core revenue sources: Treasury and Asset Management returns; Listing, Trading and Market data fees and Clearing, Settlement, and Registry fees.

17.4.3 Committees

One of the most significant changes in the governance structure during the transition period is the shift in the committee structure. The primary role of the committees under the new structure will be to provide external audit and appeals mechanisms for exchange customers as well as strategic guidance and advice to the new executive team of the exchange, and eventually to withdraw from all line management decision-making responsibilities.

The tentative committee relationships upon demutualization are in Table 17.1.

Table 17.1. Roles of the Philippine Stock Exchange Committees

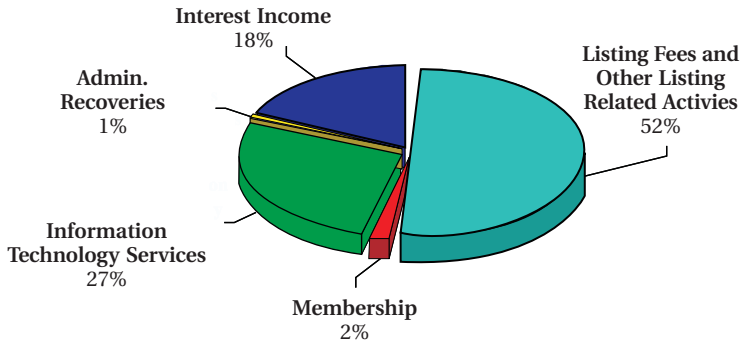
GROUP	COMMITTEE (FUTURE ROLE)
Office of the President	<ul style="list-style-type: none"> • Management Audit & Finance (Audit, Nominations & Remunerations) • Social Committees (Social Club)
Corporate Services	<ul style="list-style-type: none"> • Business Development (Strategic Advisory) • Futures Exchange (Strategic Advisory) • Building (Strategic Advisory)
Integrity Group	<ul style="list-style-type: none"> • Business Conduct & Ethics (Broker Disciplinary) • Floor Trading & Arbitration (Broker Appeals) • Policy Committees (Business Rules)
Capital Markets Group	<ul style="list-style-type: none"> • Membership Committee (Broker Advisory) • Listing Committee (Listing Appeals)
Clearing & Settlement Group	<ul style="list-style-type: none"> • Securities Clearing (Strategic Advisory)
Technology Services	<ul style="list-style-type: none"> • Technology (Strategic Advisory)

17.5 Business of the Exchange

17.5.1 Current Revenues

As of 31 December 2000, PSE obtains revenues from a range of services covering listing fees and other listing related activities (52%), information technology services (27%), membership services (2%), administration recoveries (1%), and interest income (18%). Revenues generated from listing is largely made up of initial, annual, and subsequent listing fees while income derived from membership comprises of filing fees and lounge membership fees.

The revenues from the information technology services came from the charges for the hire of terminals, the Communication Front-End system (CFE), and the data feed connections Figure 17.2.

Figure 17.2. The Current Revenues of PSE

In its efforts to enhance productivity and profitability, PSE is currently seeking opportunities to improve returns and minimize costs in the short term and studying the long-term strategic directions it will need to take. This is pursuant to the advice of JP Morgan dated 14 February 2001, which states that:

«...the demutualization process should aim to create, before listing, structures that will in due course establish the exchange as a viable and profitable listed entity where ownership is separated from market access. Importantly, it is vital for a newly-listed exchange not to disappoint its shareholders soon after listing. This is because investor confidence, once shaken, is often difficult to re-establish in the short term.»

17.5.2 Data on Listed Companies

Listed companies are a significant client base of the PSE. As of 31 July 2001, there are two hundred 229 companies listed on the First and Second board of the Exchange with a total market capitalization of approximately US\$47.89B and one company listed on the Small Medium Enterprise Board (SME). These companies came from different key sectors which include commercial-industrial, property, mining, and oil sectors.

Total number of listed companies is shown in Table 17.2.

ASX and HKEx derive the bulk of their revenues from clearing and settlement. One avenue open for PSE to increase its revenues significantly

Table 17.2. Listed Companies of PSE

INDUSTRY CLASSIFICATION	NUMBER OF LISTED COMPANIES
Banks	18
Financial Services	7
Communication	15
Power and Energy	3
Transportation Services	6
Construction & Other Related Products	12
Food, Beverage, & Tobacco	13
Holding Firms	62
Manufacturing, Distribution, and Trading	26
Hotel, Recreation, and other Services	9
Bonds	4
Property	26
Mining	16
Oil	10
Others	2
Total	229

is to increase market activity. The development of new services could include clearing and settling sales and purchases of retail managed funds, commodity contracts, and short-term money market instruments. At present, the Exchange owns 51% of Securities Clearing Corporation of the Philippines (SCCP), a private institution organized primarily as a clearance and settlement agency for eligible trades executed in the Exchange.

Although the PSE will not fully own SCCP as part of the strategic direction of PSE, a clearing and settlement system will be purchased. The system to be acquired shall be a unified system designed to meet the needs of the Philippine equities market and shall support any model of settlement with fully integrated risk monitoring capabilities. It shall have direct links with the transfer agents and shall allow interface with the systems of all market participants.

17.5.4 Risk Management

Although primarily seen as a regulatory function, risk management is a business function as well. As the entity conducting risk management, SCCP must ensure that it manages risks to protect its own financial

position and that of the investors and brokers who use the market. To improve the efficacy of risks, SCCP implemented the following the following vital steps:

- (i) Reduction of settlement date from T+4 to T+3;
- (ii) Continuous evaluation of the Comprehensive Trade Guaranty Fund to achieve the ideal level;
- (iii) Imposition of Mark to Market Collateral Deposit (MMCD); and
- (iv) Establishment of Guidelines for Cash Payment or Early Delivery/ Early Payment and for Special Isolated Immediate Settlement (SIIS)

In addition, daily monitoring of trading activity (Volume/Value) per broker and per issue is in place. Actively traded issues are monitored based on the following categories:

- (i) Price band 40% - 50%
- (ii) 50% increase in volume
- (iii) Trade Value exceeds the 25% current level of CTGF
- (iv) EQTRADES

17.6 Statutory Regulatory Role

The regulatory responsibilities of PSE are established under the SRC and its *Implementing Rules and Regulation*. It is within a framework of a self-regulatory organization that the responsibilities are imposed. Admittedly, however, there is a need to define the roles and functions of the Securities and Exchange Commission (SEC) to allow a demutualized PSE to operate independently pursuant to its role as a self-regulatory organization without compromising the oversight function of the SEC. To this end, the development and publication of a policy statement from the SEC setting out its oversight objectives with a view of strengthening its cooperation with PSE is necessary.

17.6.1 Front-Line Market Regulator

The responsibility of monitoring market conditions and trading activity as prescribed in the SRC and its implementing rules provide the PSE with regulatory status and obligations. Pursuant to such regulatory responsibilities, the exchange is enhancing its surveillance system by incorporating alerts in the system by November 2001. Among those to be introduced to the system are:

- *Cumulative Price Alert.* Will list all issues deviating beyond a variance limit of cumulative price;
- *Cumulative Volume Alert.* Will list all issues deviating beyond a variance limit of cumulative volume;
- *Cross Transaction Alert.* Will list all brokers significantly involved in heavy cross transactions, compared to their regular floor transactions;
- *Run-off Alert.* Will list all significant trading activity conducted proximately prior to the run-off period (end of trading day);
- *Significant Shares Concentration Alert.* Will list all brokers, issuers who have had unusual concentration of traded shares activity; and
- *Significant Trading Alert.* Will list all issues with unusually significant market activity based on the issue's statistical average trading volume.

17.6.2 Power Over Listed Companies

Under the *Implementing Rules and Regulations* of the SRC, the exchange shall be solely «responsible for processing and approving or rejecting applications for new listing of shares, suspension and delisting of listed issues and impositions of sanctions on listed companies for violation of SRO rules.» The exchange is also empowered to monitor compliance by listed companies with continuing listing obligations. With its demutualization, PSE segregated its supervisory and commercial activities to ensure that both functions receive sufficient attention.

As a commercial entity, the PSE will treat listed entities as customers and will enhance its service to the listed companies without prejudice to its duty to monitor them. Pursuant to its dichotomous roles and within the framework of full disclosure, the Exchange is introducing an Electronic Disclosure System.

The implementation of the electronic disclosure system will allow listed companies to send their respective company disclosures (unstructured and structured) electronically. Upon the release of disclosures from the listed companies and review by the Listings and Disclosure Group, it will be simultaneously disseminated to all market participants, data vendors and media via electronic data feed and posted on the PSE Website. Implementation of the electronic disclosure system is scheduled on January 2002.

17.6.3 Enhancing Organizational Structure for Regulatory Role

The organizational structure is based upon the key consideration of resolving potential conflicts of interest. Thus, the separation of regulatory activities from commercial ones while centralizing regulatory activities with independent oversight is desirable. The PSE seeks to enhance its brand image to impart investors' confidence in the integrity of the market. To this end, PSE will add one or two high level executives on the operational and policy level or both.

17.6.4 Delineation of Responsibilities Between PSE and SEC Through Memoranda of Understanding

The success of the self-regulatory structure relies on a mutual recognition by the front-line regulator (Exchange) and by the market overseer (SEC) of their shared responsibilities and a delineation of these shared responsibilities. There are overlaps in the responsibilities over listed companies, market surveillance and investigation of members or trading participants.

During the Joint PSE-SEC Seminar on Market Regulation held on 27 April 2001, the PSE and SEC agreed to develop a framework for co-regulation by delineating boundaries between the responsibilities of the Exchange and those of SEC. Thus, memoranda of understanding on listed companies, market surveillance and member regulation as well as on parallel investigations involving both persons who are and who are not subject of SRO jurisdiction will be explored by the SEC and PSE.