DEMUTUALIZATION OF STOCK EXCHANGES

PROBLEMS, SOLUTIONS AND CASE STUDIES

Edited by

SHAMSHAD AKHTAR
Director, Governance, Finance and Trade Division,
East and Central Asia Department,
Asian Development Bank
# CONTENTS

Foreword iii  
Principal Authors xv  
Abbreviations xxi

## PART I: ISSUES INVOLVED IN STOCK EXCHANGE DEMUTUALIZATION

1 **Demutualization of Asian Stock Exchanges—Critical Issues and Challenges**  
   *by Shamshad Akhtar*  
   1.1 Introduction 3  
   1.2 Demutualization: Its Definition, Size and Significance 4  
   1.3 Motivation and Driving Factors for Demutualization 5  
   1.4 From Mutuality to Demutualization of Exchange 8  
   1.5 Benefits of Demutualization of Exchanges 12  
   1.6 Regulatory Oversight: Challenges and Responses for Demutualized Exchange 19  
   1.7 Financial Viability of Demutualized Exchange 25  
   1.8 Conclusion 29

2 **Background Information on Demutualization**  
   *by Pamela S. Hughes*  
   2.1 Introduction 33  
   2.2 What Demutualization Means 33  
   2.3 The Reasons to Demutualize 36  
   2.4 The Models 40  
   2.5 An Update Since Demutualization 43  
   2.6 Conclusion 47
APPENDIX 1: The Models

3 Motivations, Mechanics and Models for Exchange Demutualizations in the United States
by Roberta S. Karmel

3.1 Overview
3.2 Reasons for Demutualization
3.3 How Demutualization is Accomplished
3.4 Post-Demutualization Models

4 The Structure of a Demutualized Exchange—The Critical Issues
by David Holthouse

4.1 Introduction
4.2 Ownership
4.3 Corporate Governance
4.4 Access Rights
4.5 Risk Management
4.6 Financial Management
4.7 Conclusion

5 Demutualization of Exchanges—The Conflicts of Interest (Hong Kong)
by William Pearson

5.1 Structure of Exchanges
5.2 Regulatory Role and Self-Regulation
5.3 Public Policy Objectives of Stock Market Regulation
5.4 Why Should Demutualization Require a Reassessment of SRO Functions?
5.5 What Responses are Being Developed to Deal with These Problems?
5.6 Conclusion
5.7 Hong Kong’s Framework: Listing of HKEx and the Framework for Dealing with Conflicts of Interest
APPENDIX 1: Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong’s Position as a Global Financial Centre—A Policy Paper 105

APPENDIX 2: Memorandum of Understanding for the Listing of HKEx on SEHK 114

APPENDIX 3: Section 13 of the Exchanges and Clearing Houses (Merger) Ordinance 131

APPENDIX 4: Chapter 38 of the Rules Governing the Listing of Securities on the Stock Exchanges of Hong Kong Limited 133

APPENDIX 5: Procedures to Deal with Conflicts of Interest 138

6  Demutualization of Exchanges—The Conflicts of Interest (An Australian Perspective)

by David Holthouse 145

6.1 Introduction 145
6.2 Background to Conflicts 146
6.3 An Exchange’s Listing 148
6.4 Regulation of Other Listings 149
6.5 Supervision of Intermediaries 149
6.6 Profit Motive versus Supervisory Function 150
6.7 Public Interest versus the Exchange’s Commercial Interest 152
6.8 New Business Lines 153
6.9 Conclusion 154

7  Demutualization of Exchanges—The Conflicts of Interest (The Australian Regulator’s Experience)

by Claire Grose 157

7.1 Introduction 157
7.2 Self-Listing 157
7.3 Other Conflicts 160
8  Regulation of a Demutualized Exchange (Canada)
   by Pamela S. Hughes 163
   8.1 Introduction 163
   8.2 Role of an Exchange 165
   8.3 Self-Regulation and Government Oversight 165
   8.4 SRO Conflicts of Interest 169
   8.5 Supervision of Listings 171
   8.6 Self-Listing 171
   8.7 Managing Conflicts of Interest 172
   8.8 Prudential Regulation 172
   8.9 Shareholders 173
   8.10 Directors and Officers 175
   8.11 Memoranda of Understanding 175
   8.12 Conclusion 176

9  Regulation of a Demutualized Exchange (Singapore)
   by Lee Boon Ngiap 177
   9.1 Background 177
   9.2 Regulatory Issues Arising from Demutualization 178
   9.3 The Regulatory Relationship between the Monetary Authority of Singapore and Stock Exchange of Singapore 179
   9.4 Conclusion 183

10 Regulation of a Demutualized Derivatives Exchange (United States)
    by Natalie A. Markman 185
   10.1 Introduction 185
   10.2 A New Framework 186
   10.3 Exchange Oversight 190
   10.4 Regulatory Issues Raised by Demutualization 192
   10.5 Conclusion 195
APPENDIX 1: Designated Contract Markets for Regulated US Derivatives Exchanges 196
APPENDIX 2: Registered Derivatives Transaction Execution Facilities 202
APPENDIX 3: The CFTC Market Surveillance Program 205

11 Regulation of Demutualized Exchanges (Australia) 213
   by Claire Grose

   11.1 Legislative Framework 213
   11.2 Australian Securities and Investment Commission’s (ASIC) Powers 214
   11.3 Supervision by Market Operators 214
   11.4 Memoranda of Understanding (MOUs) 215
   11.5 Changes Due to Demutualization 215
   11.6 New Legislation 217

PART II: DEMUTUALIZATION CASE STUDIES

12 Australian Stock Exchange—The Conversion to a Demutualized Exchange: ASX’s Experience 221
   by David Holthouse

   12.1 Introduction 221
   12.2 Background to Australian Stock Exchange's Demutualization 222
   12.3 Obtaining Member Approval 223
   12.4 Mechanism Used for Conversion 224
   12.5 Changes to the Corporations Law 225
   12.6 The Demutualization Process 226
   12.7 Memorandum of Understanding (MOU) with ASIC 228
   12.8 Demutualization and Listing Outcomes 229
   12.9 Subsequent Supervisory Development: ASX Supervisory Review Pty Limited 230
12.10 Changes in ASX's Focus and Activities 231
12.11 Conclusion 233

13 Hong Kong Exchanges and Clearing Limited—Demutualization, Merger and Listing: The Hong Kong Exchanges' Experience
  by Lawrence Fok 235
  13.1 Introduction 235
  13.2 Pre-Merger Period: Two Exchanges and Three Clearing Houses 236
  13.3 Merger and Proposal 238
  13.4 Reasons For the Merger 239
  13.5 Market Reform 242
  13.6 Conclusion 246

14 Hong Kong Securities and Futures Commission—The Conversion to a Demutualized Exchange: The Hong Kong Regulator's Experience
  by William Pearson 247
  14.1 The Need for Reform 247
  14.2 The Reform Process 250
  14.3 Rationalized Market Regulation 255
  14.4 Implementing Legislation: Exchanges and Clearing Houses (Merger) Ordinance 258
  14.5 Key Issues Arising from Hong Kong's Experience with Demutualization 258

APPENDIX 1: Summary of the Exchanges and Clearing Houses (Merger) Ordinance 261

15 Singapore Stock Exchange—Demutualization and Listing of the Singapore Exchange Limited
  by Alan Shaw 265
  15.1 Introduction 265
15.2 Drivers for Change: The Rationale for Demutualization and Merger 265
15.3 Impact of Demutualization 267
15.4 The Merger Act 269
15.5 The Process of Demutualization 270
15.6 The Singapore Exchange’s Initial Public Offer 271
15.7 The Structure of Singapore Exchange 272
15.8 The Governance of Singapore Exchange 274
15.9 Listing and Conflict of Interest 276
15.10 Conclusion 279

APPENDIX 1: Procedures to Deal with Conflicts of Interest 281

16 Toronto Stock Exchange—From Toronto Stock Exchange to TSE Inc.: Toronto’s Experience with Demutualization
   by Timothy Baikie 283
   16.1 Introduction 283
   16.2 An Overview of the Toronto Stock Exchange (TSE) 283
   16.3 The Development of Mutual Exchanges 286
   16.4 Consolidation, Globalization and New Competition 291
   16.5 The Demutualization Decision 292
   16.6 Market Regulation by a Demutualized Exchange 296
   16.7 Next Steps 298
   16.8 Conclusion 298

17 Demutualization of the Philippine Stock Exchange
   by Maria Larrie Alinsunurin 299
   17.1 Introduction 299
   17.2 Ownership Structure of the Stock Exchange Upon Demutualization 300
   17.3 Trading Rights 300
   17.4 Corporate Governance 301
   17.5 Business of the Exchange 304
   17.6 Statutory Regulatory Role 307
PART III: STRUCTURE OF MUTUAL EXCHANGES

18  The Colombo Stock Exchange (Sri Lanka)
    by Rajeeva Bandaranaike 313

18.1 Ownership Structure 313
18.2 Listing Data 314
18.3 Corporate Governance 314
18.4 Business of the Exchange 315
18.5 The Vision, Mission and Corporate Strategy 316
18.6 Trading Rights 317
18.7 Regulatory Framework 317
18.8 Self-Regulation 317
18.9 Statutory Regulatory Role 319
18.10 Investor Protection 320
18.11 Funding of the Colombo Stock Exchange 321
18.12 Stock Exchange Seeks to Demutualize 321

19  The Kuala Lumpur Stock Exchange (Malaysia)
    by Securities Commission (Malaysia) 323

19.1 Introduction 323
19.2 Ownership Structure of the KLSE 323
19.3 Listing Data 324
19.4 Corporate Governance 324
19.5 Business of the Exchange 325
19.6 Trading Rights 326
19.7 Risk Management and Supervisory Issues 327
19.8 Statutory Regulatory Role 329
19.9 Stock Exchange Seeking to Demutualize 329
## 20 The Shanghai and Shenzen Exchanges: Business Operation, Governance Structure, and Regulatory Function (People's Republic of China)

*by Feng Wei*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>20.1 Overview</td>
<td>331</td>
</tr>
<tr>
<td>20.2 Business Operation</td>
<td>332</td>
</tr>
<tr>
<td>20.3 Governance Structure</td>
<td>333</td>
</tr>
<tr>
<td>20.4 Regulatory Function</td>
<td>335</td>
</tr>
<tr>
<td>20.5 Outlook on Demutualization</td>
<td>337</td>
</tr>
</tbody>
</table>

## 21 The Taiwan Stock Exchange (Taipei, China)

*by Wanpo (Mina) Wang*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>21.1 Ownership Structure of Taiwan Stock Exchange Corporation</td>
<td>341</td>
</tr>
<tr>
<td>21.2 Listing Data</td>
<td>342</td>
</tr>
<tr>
<td>21.3 Corporate Governance</td>
<td>342</td>
</tr>
<tr>
<td>21.4 Business of the Exchange</td>
<td>343</td>
</tr>
<tr>
<td>21.5 Trading Rights</td>
<td>344</td>
</tr>
<tr>
<td>21.6 Risk Management</td>
<td>344</td>
</tr>
<tr>
<td>21.7 Statutory Regulatory Role</td>
<td>347</td>
</tr>
<tr>
<td>21.8 Stock Exchange Seeking to Demutalize</td>
<td>347</td>
</tr>
</tbody>
</table>

## 22 Current Organizational and Regulatory Structure of The Stock Exchange (Thailand)

*by Klao Sanasen*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>22.1 Thai Capital Market Structure</td>
<td>349</td>
</tr>
<tr>
<td>22.2 The Stock Exchange of Thailand</td>
<td>352</td>
</tr>
</tbody>
</table>
FOREWORD

Demutualization of a stock exchange is entire process by which a non-profit member-owned mutual organization is transformed into a for-profit shareholder corporation. Exchanges around the world have been demutualizing because of international competition and technological challenges to traditional modes of trading securities. The change of a stock exchange from a member-owned organization to a for-profit shareholder corporation triggers a number of questions about regulatory oversight. When a demutualized exchange is listed on its own board, some regulatory oversight needs to be transferred to a government regulator. In many countries, demutualization of the major national stock exchange has been accompanied by general securities regulatory reform.

This book grew out of a conference on Demutualization of Stock Exchanges held in Manila on 13-14 August 2001 organized under the APEC Financial Regulators Training Initiative sponsored by the Asian Development Bank. The conference focused on developing greater understanding of demutualization by discussing the general problems it engenders and how these might be solved, developing common themes and lessons from case studies and also seeing how different countries have evolved different approaches to demutualization.

This book is divided into three parts. Part I, consisting of Chapters 1-11, discuss various dimensions and issues involved in the process of stock exchange demutualization. Chapters 1-3 give a broad overview of the reasons for demutualization, the critical issues and challenges, the decision-making process relating to demutualization and the possible models stock exchanges may choose, including that of a privately owned for-profit corporation and that of a publicly held company listed on the exchange's own board. Chapter 4 sets forth the critical issues an exchange and its regulator must confront in connection with the demutualization process from the vantage point of a particular jurisdiction—Australia. Chapters 5-7 discuss the conflicts of interest raised by an exchange's demutualization and then Chapters 8-11 set forth how regulators in Canada, Singapore, the United States and Australia attempted to deal with some of these conflicts through regulation.

Part II of this book is a series of case studies. Chapters 12-17 discuss the demutualization experience in Australia, Hong Kong, Singapore,
Toronto and the Philippines. Part III of this book provides information about jurisdictions that have not demutualized their exchanges. Chapters 18-22 discuss the Colombo, Kuala Lumpur, Shanghai and Shenzen, Taiwan and Thailand exchanges.

Chapters 1-16 were submitted as papers by professionals who presented papers at the conference. Chapters 17-22 were submitted by participants in the conference who were not presenters.

This conference was coordinated by the Finance and Industry Division (East) of ADB under the overall guidance and supervision of Ms. Shamshad Akhtar, Director, Governance, Finance and Trade, East and Central Asia Department. Special thanks are due to the various contributors as well as the organizers. The book has been edited by Ms. Akhtar. Ms. Roberta Karmel, Professor of Law at Brooklyn Law School, was engaged to integrate the conference materials and provide editorial advice. R. Jane Lee, a student at Brooklyn Law School supported the compilation of this book. Mr. Lyle Raquipiso coordinated the publication of this book and Ms. Nancy Bustamante provided administrative support.
PRINCIPAL AUTHORS

SHAMSHAD AKHTAR is Director, Governance, Finance and Trade Division of the Asian Development Bank’s (ADB’s) East and Central Asia Department. She oversees ADB’s financial market operations in the People’s Republic of China, Mongolia and the Central Asian Republics, including SME, microfinance and other rural market financial intermediation; governance and private sector assessment work; and trade liberalization and facilitation. Concurrent to holding other portfolio from 1998-2001, she was head of ADB Secretariat for Asia Pacific Economic Cooperation, leading the policy dialogue and preparation of all papers/documents for this forum, involving interactions with Finance Ministers and Central Bank Governors and their Deputies. Before joining ADB in 1990, she worked as Economist in the World Bank in the 1980’s, and prior to that, in Pakistan’s Planning Agency. She obtained a B.A. in Economics and M.Sc. in Economics from Islamabad, an M.A. in Development Economics from University of Sussex in the United Kingdom (UK), and a Ph.D. in Economics also from UK. She had her post-doctoral fellowship as a Fulbright scholar and was visiting fellow at the Department of Economics, Harvard University in 1987. Ms. Akhtar has presented numerous papers on economics and finance in international conferences.

TIMOTHY BAIKIE is Director, Global Market Initiatives at the Toronto Stock Exchange and is responsible for analyzing market structure issues from a broad, strategic standpoint, including the market model for the Global Equity Market (GEM). Previously, he was Special Counsel, Market Regulation and Director of the Regulatory and Market Policy Division of the Exchange, which is responsible for policy and rule development for the equities and derivatives market. He has spoken at numerous conferences on market regulation, market structure and corporate governance issues and was a member of the Advisory Board for the 1999 Canadian Corporate/Securities Law Moot Court Competition. He received a B.A. from York University (Glendon College), an LL.B. and a B.C.L. from McGill University and an LL.M. from the University of Illinois at Urbana-Champaign. He was called to the Ontario Bar in 1987.

LAWRENCE FOK is the Deputy Chief Operating Officer of Hong Kong Exchanges and Clearing Limited and the Chief Executive of the Stock Exchange. Mr. Fok joined the Stock Exchange in February 1992 and was
appointed Executive Director of the Listing Division in February 1997 and Senior Executive Director of its Regulatory Affairs Group in November 1998. Mr. Fok has over 19 years of experience in financial services and securities regulatory work. Before joining the Stock Exchange he worked for the Securities and Futures Commission, the Office of the Commissioner for Securities and Commodities Trading of the Hong Kong Government and other private organisations in areas of corporate finance advisory work, securities dealing, venture capital investment, mainland China trade and investment management.

CLAIRE GROSE is Special Counsel, Regulatory Policy Branch at the Australian Securities and Investments Commission (ASIC). For two years prior to July 2001, she held the position of ASIC’s Director, National Markets Unit. Before joining ASIC in January 1999, Ms. Grose was a senior partner in the national Australian law firm Freehill Hillingdale & Page, specialising in corporations and securities law. She has more than 20 years experience as a corporate lawyer and played a major part in developing changes to the Corporations Law in Australia in her role as a member of the Corporations Law Simplification Task Force from October 1993 to March 1997.

DAVID HOLTHOUSE is National Manager, International Affairs, at the Australian Stock Exchange (ASX), which he joined in February 1996. His responsibilities include fostering links with governments, businesses and market participants to ensure that ASX has a role in shaping the regional capital market environment, coordinating ASX’s international activities to ensure strategic fit, identifying cross-border listing opportunities where ASX can add value, and providing an effective protocol service on behalf of the Exchange. He has been a member of the Working Committee of the East Asian and Oceanian Stock Exchanges Federation (EAOSEF) since 1997 and is currently the Federation’s Working Committee Chairman. A key activity of the Committee during this time has been the facilitation of cross-border trading. He was formerly a career naval officer, retiring as a Rear Admiral in 1993. He is a member of the governing bodies of a number of professional and charitable organisations, and a Graduate of the Australian Institute of Company Directors. He is a Chartered Professional Engineer, and a Fellow of both the Institute of Engineers Australia and the Institute of Marine Engineers (UK). He was appointed as an Officer in the Order of Australia in 1991.
PAMELA S. HUGHES is a securities law partner at Blake, Cassels & Graydon LLP in Toronto. Her practice focuses on international corporate finance and mergers and acquisitions transactions and advice regarding capital market regulatory reform. Ms. Hughes is a member of the team of lawyers from Blake, Cassels & Graydon involved in the ongoing Ontario Securities Commission (OSC) Policy Reformulation Project which commenced in 1995. Prior to February 1, 1995, Ms. Hughes was Director of the Capital Markets/International Markets Branch of the OSC. Ms. Hughes has also taught international securities regulation in the LL.M. programme at Osgoode Hall and the LL.B. programme at the University of Toronto, and was a contributing editor to North American Corporate Lawyer. Ms. Hughes updated the chapter on Philippines securities law in International Securities Regulation: Pacific Rim, Volumes I and II (New York: Oceana) released in 2000. In 2000, Ms. Hughes was nominated by the federal Department of Finance to the financial services roster for dispute resolution under the North American Free Trade Agreement.

ROBERTA S. KARMEL is a Professor of Law and Co-Director of the Center for the Study of International Business Law at Brooklyn Law School and Of Counsel to the law firm of Kelley Drye & Warren LLP. In addition, she is a director of the Kemper Insurance Companies. She was a Commissioner of the Securities and Exchange Commission from 1977-80, and a public director of the New York Stock Exchange, Inc. from 1983-89. She received a B.A. cum laude from Radcliffe College in 1959 and an LL.B. cum laude from New York University School of Law in 1962. Professor Karmel is the author of over 30 articles in legal journals, and writes a regular column on securities regulation for the New York Law Journal. Her book entitled Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America was published by Simon and Schuster in 1982.

LEE BOON NGIAP heads the securities regulatory policy function in Monetary Authority of Singapore (MAS). His division is responsible for regulatory framework development, policy coordination and market analysis of the securities, futures and asset management industries in Singapore. Prior to taking up his responsibility in the Securities and Futures Department, Mr. Lee was the Representative in the MAS office in London, responsible for spearheading the promotion of Singapore as an attractive place for UK and European financial institutions to invest and set up operations. Mr. Lee joined MAS in 1986 and worked in several departments before joining the Markets and Investment Department, where he rose to become a Senior Assistant Director in the Monetary Management Division.
There his responsibilities included the conduct of Singapore's exchange rate and monetary policies, and management and evaluation of the foreign exchange exposures of public sector entities. He holds an honours degree in Civil Engineering from the National University of Singapore and is a Chartered Financial Analyst.

**Natalie A. Markman** is Counsel to Commissioner Thomas J. Erickson of the US Commodity Futures Trading Commission. She provides legal counsel and analyzes such policy issues as those created by derivatives market deregulation, electronic trading, and exchange demutualization. Ms. Markman reviews and evaluates all documents submitted by staff for Commission approval, including exchange designations, contract and rule approvals, rulemakings, opinions, and enforcement actions. Previously, she served as Special Counsel in the Commission's Office of International Affairs, as an Attorney-Advisor in the Office of the Chief Counsel of the Commission's Division of Trading and Markets, and as an Attorney-Advisor to Commission Administrative Law Judge George H. Painter. Ms. Markman also was a Teaching Fellow for the Foundations of American Law and Legal Education program at the Georgetown University Law Center, where she received her J.D. degree in 1993.

**William Pearson** is Director in the Corporate Finance Division of the Securities and Futures Commission (SFC) in Hong Kong. He is responsible for assisting in formulating policies for the effective regulation of listed companies and the securities markets. Daily work involves monitoring and regulating corporate activities of publicly listed companies, overseeing the Stock Exchange in its listing related functions, and approving offerings of shares and debentures to the public by non-listed companies. Mr. Pearson joined the SFC as a Senior Manager in the Corporate Finance Division in 1998. Prior to that he spent nine years as a lawyer with Norton Rose, a London law firm, practicing in the areas of corporate finance and M&A. He graduated as a lawyer from King's College, London in 1987.

**Alan Joseph Shaw** is Executive Vice-President of the Singapore Exchange Limited, Head of Risk Management and Regulation. Previously, from 1991-2000, he was National Manager, Supervision of the Australian Stock Exchange Limited, Melbourne. He was educated at the University of Melbourne, from which he received a Bachelor of Laws in 1979, a Graduate Diploma of Public Policy in 1988, and a Master of Arts in Public Policy in 1994. From 1980-91, he served as a Principal
Legal Officer for the National Companies and Securities Commission, as a Judge's Associate, and as a Barrister. He has authored a number of articles on company law.
## ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amex</td>
<td>American Stock Exchange</td>
</tr>
<tr>
<td>APEC</td>
<td>Asia Pacific Economic Cooperation</td>
</tr>
<tr>
<td>Archipelago</td>
<td>Archipelago Holdings, LLC</td>
</tr>
<tr>
<td>Exchange</td>
<td>Archipelago Exchange, LLC</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
</tr>
<tr>
<td>ASTC</td>
<td>Australian Settlement and Transfer Corporation Pty Ltd</td>
</tr>
<tr>
<td>ASX</td>
<td>Australian Stock Exchange</td>
</tr>
<tr>
<td>ATS</td>
<td>alternative trading system</td>
</tr>
<tr>
<td>BOT</td>
<td>Bank of Thailand</td>
</tr>
<tr>
<td>CATS</td>
<td>computer assisted trading system</td>
</tr>
<tr>
<td>CBA</td>
<td>Colombo Brokers Association</td>
</tr>
<tr>
<td>CBI</td>
<td>Canadian-based interlisted issuer</td>
</tr>
<tr>
<td>CBOT</td>
<td>Chicago Board of Trade</td>
</tr>
<tr>
<td>CCASS</td>
<td>Central Clearing and Settlement System</td>
</tr>
<tr>
<td>CDNX</td>
<td>Canadian Venture Exchange</td>
</tr>
<tr>
<td>CDS</td>
<td>Central Depository System</td>
</tr>
<tr>
<td>CFE</td>
<td>communication front-end system</td>
</tr>
<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>CGE</td>
<td>Committee on the Governance of the Exchanges</td>
</tr>
<tr>
<td>CME</td>
<td>Chicago Mercantile Exchange</td>
</tr>
<tr>
<td>CMP</td>
<td>Capital Market Masterplan</td>
</tr>
<tr>
<td>CNS</td>
<td>Continuous Net Settlement</td>
</tr>
<tr>
<td>CSE</td>
<td>Colombo Stock Exchange</td>
</tr>
<tr>
<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
</tr>
<tr>
<td>DTF</td>
<td>derivatives transaction execution facility</td>
</tr>
<tr>
<td>EBOT</td>
<td>exempt board of trade</td>
</tr>
<tr>
<td>ECM</td>
<td>exempt commercial market</td>
</tr>
<tr>
<td>ECN</td>
<td>electronic communications network</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Form</td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
</tr>
<tr>
<td>ETF</td>
<td>exchange traded fund</td>
</tr>
<tr>
<td>ETP</td>
<td>equity trading permit</td>
</tr>
<tr>
<td>FCM</td>
<td>futures commission merchant</td>
</tr>
<tr>
<td>FIBV</td>
<td>International Federation of Stock Exchanges</td>
</tr>
<tr>
<td>GEM</td>
<td>Growth and Emerging Market</td>
</tr>
<tr>
<td>HIBOR</td>
<td>Hong Kong Interbank Offered Rate</td>
</tr>
<tr>
<td>HKCC</td>
<td>HKFE Clearing Company</td>
</tr>
<tr>
<td>HKEC</td>
<td>Hong Kong Exchanges and Clearing</td>
</tr>
<tr>
<td>HKEx</td>
<td>Hong Kong Exchanges and Clearing Limited</td>
</tr>
<tr>
<td>HKFE</td>
<td>Hong Kong Futures Exchange Limited</td>
</tr>
<tr>
<td>HKFECC</td>
<td>HKFE Clearing Corporation Limited</td>
</tr>
<tr>
<td>HKSCC</td>
<td>Hong Kong Securities Clearing Company</td>
</tr>
<tr>
<td>IDA</td>
<td>Investment Dealers Association</td>
</tr>
<tr>
<td>IISL</td>
<td>India Index Services &amp; Products Limited</td>
</tr>
<tr>
<td>IMM</td>
<td>International Monetary Market</td>
</tr>
<tr>
<td>IOM</td>
<td>Index and Option Market</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offer</td>
</tr>
<tr>
<td>KLSE</td>
<td>Kuala Lumpur Stock Exchange</td>
</tr>
<tr>
<td>KULBER</td>
<td>KLSE-Bernama Real-Time Information Services</td>
</tr>
<tr>
<td>LFX</td>
<td>Labuan International Financial Exchange</td>
</tr>
<tr>
<td>LSE</td>
<td>London Stock Exchange Plc</td>
</tr>
<tr>
<td>MAS</td>
<td>Monetary Authority of Singapore</td>
</tr>
<tr>
<td>MCD</td>
<td>Malaysian Central Depository</td>
</tr>
<tr>
<td>MDEX</td>
<td>Malaysia Derivatives Exchange</td>
</tr>
<tr>
<td>ME</td>
<td>Montreal Exchange</td>
</tr>
<tr>
<td>MESDAQ</td>
<td>Malaysian Exchange of Securities Dealing and Automated Quotation Bhd</td>
</tr>
<tr>
<td>MkSE</td>
<td>Makati Stock Exchange</td>
</tr>
<tr>
<td>MMCD</td>
<td>Mark to Market Collateral Deposit</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MOU</td>
<td>memorandum of understanding</td>
</tr>
<tr>
<td>MSE</td>
<td>Manila Stock Exchange</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
</tr>
<tr>
<td>MSRS</td>
<td>Malaysian Share Registration Services</td>
</tr>
<tr>
<td>NASD</td>
<td>National Association of Securities Dealers, Inc.</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>NASDAQ Stock Market, Inc.</td>
</tr>
<tr>
<td>NASDR</td>
<td>NASD Regulation, Inc.</td>
</tr>
<tr>
<td>NSE</td>
<td>National Stock Exchange of India</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OM</td>
<td>OM Gruppen AB</td>
</tr>
<tr>
<td>OSC</td>
<td>Ontario Securities Commission</td>
</tr>
<tr>
<td>OTC</td>
<td>over-the-counter</td>
</tr>
<tr>
<td>PCX</td>
<td>Pacific Exchange</td>
</tr>
<tr>
<td>PCX Holdings</td>
<td>PCX Holdings, Inc.</td>
</tr>
<tr>
<td>PCXE</td>
<td>PCX Equities, Inc.</td>
</tr>
<tr>
<td>PSE</td>
<td>Philippine Stock Exchange, Inc.</td>
</tr>
<tr>
<td>REC</td>
<td>recognized exchange controller</td>
</tr>
<tr>
<td>RIIAM</td>
<td>Research Institute of Investment Analysts Malaysia</td>
</tr>
<tr>
<td>SAFE</td>
<td>South Asian Federation of Exchanges</td>
</tr>
<tr>
<td>SC</td>
<td>Securities Commission</td>
</tr>
<tr>
<td>SCA</td>
<td>Securities Commission Act 1993</td>
</tr>
<tr>
<td>SCANS</td>
<td>Securities Clearing Automated Network Services Sdn Bhd</td>
</tr>
<tr>
<td>SCCP</td>
<td>Securities Clearing Corporation of the Philippines</td>
</tr>
<tr>
<td>SCORE</td>
<td>System on Computerised Order Routing and Execution</td>
</tr>
<tr>
<td>SCH</td>
<td>Securities Clearing House</td>
</tr>
<tr>
<td>SEA</td>
<td>Securities and Exchange Act of 1992</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SEHK</td>
<td>The Stock Exchange of Hong Kong Limited</td>
</tr>
<tr>
<td>SEL</td>
<td>Taiwanese Securities and Exchange Law</td>
</tr>
<tr>
<td>SEOCH</td>
<td>SEHK Options Clearing House Limited</td>
</tr>
<tr>
<td>SES</td>
<td>Stock Exchange of Singapore</td>
</tr>
<tr>
<td>SET</td>
<td>Stock Exchange of Thailand</td>
</tr>
</tbody>
</table>
SFA  Securities and Futures Act
SFC  Securities and Future Commission
SFE  SFE Corporation Limited (formally known as Sydney Futures Exchange Limited)
SGX  Singapore Exchange Limited
SGX-ST  Singapore Exchange Securities Trading Ltd
SIA  Securities Industry Act 1983
SIIS  Special Isolated Immediate Settlement
SIMEX  Singapore International Monetary Exchange Limited
SIPF  Securities Investors Protection Fund
SME  Small Medium Enterprise Board
SRC  Securities Regulation Code
SRO  Self-regulatory organization
STAMP  standard message protocol
TBDC  Thai Bond Dealing Center
TSD  Thailand Securities Depository Co., Ltd.
TSE  The Toronto Stock Exchange
TSE RS  TSE regulatory services
TSE  Tokyo Stock Exchange
TSEC  Taiwan Stock Exchange Corporation
TSI  Thailand Securities Institute
PART I

Issues Involved in Stock Exchange Demutualization
1.1 Introduction

Stock exchanges offer a host of services to listing companies. These include:

(i) liquidity,
(ii) execution of services,
(iii) signaling function for listed companies,
(iv) monitoring of trading to prevent manipulation and insider trading,
(v) standard rules to reduce transaction costs, and
(vi) clearing of buy and order transactions.

Traditionally, stock exchanges operating as a "club of brokers" offered these services as monopoly operators serving largely under a mutual governance structure. The members of the club enjoyed rights of ownership, decision-making (one member, one vote), and trading. Value enhancement of the exchange was achieved by restricting access.

Stock exchanges are now increasingly changing their business model and restructuring themselves across the world due to the simultaneous convergence of a number of powerful developments. The most notable of these has been the: (i) rapid advancement and innovation...
in technology that has facilitated alternative trading systems (ATS) including electronic communication networks (ECNs); and (ii) growing market competition and integration as well as globalization induced partly by cross-border listing and portfolio flows, etc. Together these developments have eroded the significance of physical national stock exchanges and their trading floors.

Consequently, across the globe stock exchanges are now rethinking their business strategy and model in order to find ways of how best to survive. In the process, exchanges have evolved towards new corporate, legal and business models to strengthen governance and face the competition. This process of transformation from members’ associations into for-profit corporations is referred to as demutualization.

There is a great need to distill lessons from the rapidly evolving experience with demutualization and synthesize both the normative and positive aspects of this exciting and relatively new structure so that developing countries can take advantage of it. This paper, therefore, aims to provide basic perspectives and dimensions of demutualization based on a review of literature and experience. In the process it explains:

(i) What is demutualization and how significant has it been?
(ii) What factors have been driving the demutualization of exchanges?
(iii) What ownership, legal and strategic approaches are being adopted in the process of demutualization?
(iv) What are the principal benefits of demutualization?
(v) What regulatory challenges and responses does a demutualized exchange face?
(vi) Have the demutualized exchanges been financially viable?

1.2 Demutualization: Its Definition, Size and Significance

Demutualization, in the strictest sense, refers to the change in legal status of the exchange from a mutual association with one vote per member (and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making). Demutualization makes sense if it induces a change in the exchange’s objective from managing the interests of a closed
member-based organization with a central focus on providing services for the benefit primarily of the members/brokers and keeping costs and investments limited to financing agreed by members, into a company set up with the objective of maximizing the value of the equity shares by focusing on generating profits from servicing the demands of their customers (brokers and investors) in a competitive manner.

The number of exchanges that have privatized or listed has been increasing since the Stockholm Stock Exchange demutualized in 1993. In 1999, 11 stock exchanges had been privatized or listed and this number rose to 21 by early 2002, with several other exchanges either considering demutualization or already having stated their intent to do so. Of the World Federation of Stock Exchanges-formerly the International Federation of Stock Exchanges (FIBV)-member exchanges, around 52% of stock market capitalization is accounted for by demutualized exchanges. In Asia, demutualized stock exchanges including the Tokyo Stock Exchange now account for 76% of the region’s market capitalization (Figures 1.1 and 1.2).

1.3 Motivation and Driving Factors for Demutualization

Today, exchanges are no longer the sole primary and secondary market makers or the sole service providers of trade execution, signaling or other activities. This is largely because of the widespread proliferation of ATS and ECNs that have been supported by technological revolution and introduction of high capacity hardware, software packages and Internet facilities. ATS/ECNs have allowed efficient and effective matching
of the buy and sell orders of customers at lower transaction costs, while
offering price transparency, trader anonymity and extended trading
hours. Large global brokers are able to price-match within their own
order-stock and only report the net position as a trade to the exchange
(thus avoiding transaction costs).

Given the competitive edge, the market share of the ECNs has grown.
In 2002, ECNs have accounted for 45% of NASDAQ shares traded (compared
to 25.5% in 1999) - although they only accounted for about 5% of the listed
shares traded. Of the several ECNs, Island ECN alone accounted for 32%
of the ECN’s market share. Instinet makes up another 29%, ArcaEx 27.2%
(forming through the merger of Archipelago and REDIBook), Bloomberg
Tradebook 6.3% and Brut ECN 5.3%. The rest is accounted by other
networks.² Having attracted substantial trading, ECNs are also entering
into strategic alliances or tie ups with other exchanges or are offering
services such as quotes and listing shares to further raise revenues.

The growing competitive pressure has also triggered a wave of
restructuring and mergers and alliances among securities markets to
maximize economies of scale, accessibility and market reach, while
providing global trade facilities through around the clock trading. For
instance:

(i) Euronext was established by the merger of former national
exchanges in France, the Netherlands, Belgium and Portugal and
the integrated equity trading markets of the northern-European
countries of Sweden, Finland, Denmark and Norway;

(ii) in the derivatives markets, a/c/e, the trading platform of Eurex
and Chicago Board of Trade (CBOT), and Globex (Chicago
Mercantile Exchange, Liffe, Singapore and others), have already
formed global alliances with participants from all time zones,
thus creating 24 hour trading markets; and

(iii) NASDAQ has developed global alliances/interconnections to
attract more liquidity for the United States and regional securities
markets. NASDAQ has structured agreements with Europe,
Japan, Hong Kong and Canada and is positioned for similar
arrangements with China, Latin America and Middle East. In
Asia, several exchanges have trading links and dual-listing
agreements with the United States-based NASDAQ.

JP Morgan, H&Q.
The market integration has encouraged a process of dis-intermediation. With the emergence of new structures, there is no need for formal floors of stock exchanges or financial market intermediaries and participants, as they do not add value (to match the cost) to trading of securities. Exchanges with low market capitalization and weak trading volumes have had to particularly re-examine their operations and organizations with the view to increasing their competitive offering and price mix to minimize further diversion of trading volumes. Summarizing the emerging issues, a recent World Bank study concluded that:

"Powerful trends of internationalization and migration of order flow are putting pressures on stock exchanges around the world. For some exchanges, already more than half of trading and listing has migrated offshore... Migration makes it difficult for countries to sustain a full-fledged local stock exchange. As trading volumes further decrease, financing the fixed overhead of maintaining market oversight, clearing and settlement systems, ... and generating enough business for local investment banks, accounting firms, and other support services will become even harder, especially for smaller emerging markets. The trend towards increased migration will thus make it more difficult for small exchanges to survive." [page 18]

In order to survive in this environment, exchanges need to diversify and move towards commercially oriented business practices with greater focus on improving efficiency, accessibility and ease of use of their systems. Since exchanges have higher overhead costs (as compared to ECNs) due to (among other things) cost of building and facilities, they need to strive harder to achieve profitability and economies of scale, while offering competitive services and fees compatible to those being provided by the ECNs. These considerations have driven exchanges to consider alliances and consolidation. By merging two exchanges, the exchange can multiply the volume at the same overhead cost (provided cost cutting synergies are fully explored). It can thus offer to the investors and brokers more listed securities for trading on the same platform.

There are forecasts available that indicate that by 2010, there will be fewer than five major stock exchanges; and, perhaps two or three of these will be entirely electronic markets—which have not yet been established.

---

Part I: Issues Involved in Stock Exchange Demutualization

1.4 From Mutuality to Demutualization of Exchange

The transformation of exchanges from mutual to demutualized structure involves two key features: (i) a change in the ownership structure, and (ii) a change in legal as well as organizational form. Both need to be accompanied by adequate safeguards to ensure appropriate governance. Depending on the nature of ownership and legal forms adopted, the demutualized exchange—given their corporate model and facing growing competitive pressures—lends itself to focusing on evolving strategic positioning which, depending on a number of conditions, could involve greater market consolidation, vertical integration and product diversification.

1.4.1 Ownership Structure

The transformation from the mutual member-based to demutualized exchange involves issues of transferability of ownership from members to nonmembers. There are various ways that dilution of membership can be achieved. Sequentially, it involves conversion of existing member seats by monetizing these and assigning a certain value per seat. Once the valuation is done, the members can opt to convert their membership to share ownership or to sell off their interest to nonmembers. In most cases of demutualization of exchange, members have opted to retain their share ownership. A listing of equity shares in the exchange facilitates the unlocking of the members’ equity and buy out of the interest of the traders, while leading to the monetization of the value of the members’ seats. An entity with freely transferable shares, rather than membership rights, can form equity-swap-based strategic alliances or mergers with other exchanges, domestically or in other countries or time zones. Such alliances are stronger and offer greater credibility than pure cooperation agreements.

To avoid stock exchanges operating in special or limited interests, securities regulators often place restriction on ownership by one holder or a group of holders to non-controlling stakes of 5-10%. Limits on ownership stakes could affect potential take-over by other exchanges. Such take-overs could have merit in terms of efficiency and economies of scale of the market especially where more efficient participants acquire inefficient ones. Recognizing the synergies of take-overs, most demutualized exchanges have provisions in place to allow other
exchanges, or technology partners, the possibility of acquiring or swapping strategic stakes. The reluctance to relinquish control to strategic partners or owners remains however one reason why non-equity, swap-based cooperative alliances have been more prolific in the exchange industry.\textsuperscript{5} Indeed, several hostile take-over attempts (including OM Gruppen’s moves to acquire the London Stock Exchange in 2000, and the bidding war for Sydney Futures Exchange by Australian Stock Exchange and Computershare in 1999) have failed due to the voting strength still exerted by the brokers (Table 1.1).

1.4.2 Legal and Company Structure

Most stock exchanges are registered as private limited companies with a paid-up capital base, while others operate as member associations or cooperative arrangements. At the end of 2000, FIBV statistics indicates that 90% of its member exchanges, accounting for 60% of market capitalization, were private limited companies. Almost 46% of these were legal company exchanges with inside ownership. Around 25% (accounting for 21% of market capitalization) of the exchanges had been privatized, 13% (accounting for 8% of market capitalization) were registered as listed companies\textsuperscript{6} and the remaining 17% had other types of status—with some being state-owned or semi-public entities (such as the Shenzhen and Shanghai Stock Exchanges (SZSE and SHSE). As evident in Table 1.2, in Asia, with the exception of SZSE and SHSE, most of the exchanges are legal entities registered as private limited companies. So far, five exchanges in Asia have been fully demutualized, with three of these listed on their own exchange, and another two have announced plans to demutualize in 2003.

The legal structure for the demutualized exchange is based on considerations similar to that for any profit-making company including decisions on number of shareholders (partnership vs. corporation), voting procedures, limitation of liability (liability limited to equity invested vs. joint and several liability for all debts), accounting and reporting requirements (based on taxation laws and on partners/shareholders’ access to information of the company) and distribution of dividends (re-investment

\textsuperscript{5} Interestingly, this is similar to another rapidly globalizing industry with national quasi-monopolistic companies—the airline industry—in which global cooperation alliances have proven very important for customer retention.

\textsuperscript{6} Notably half (of six) of the exchanges that have listed themselves are in Asia.
Part I: Issues Involved in Stock Exchange Demutualization

10

Source: Stock Exchanges. Latest Annual Reports

### Table 1.1. Asian Stock Exchanges: Shareholding Structure

<table>
<thead>
<tr>
<th>SHAREHOLDING LIMIT</th>
<th>SHAREHOLDING STRUCTURE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Australian Stock Exchange (ASX)</strong></td>
<td>As of June 2001, issued and paid-up capital of ASX amounted to A$106,282,000. After listing, ASX’s shareholders rose from 606 to 16,313. Besides individual investors, the large domestic and international fund managers subscribed to ASX equity including Chase Manhattan Nominees Ltd. whose holding is 6.9%, National Nominees Ltd. 3.5%, followed by AMP Life Ltd. (2.6%), Westpac Custodian Nominees Pty. Ltd. (2.11%) and Citicorp Nominees Pty. Ltd. (2.07%). The top 20 shareholders account for 27.3% of issued capital.</td>
</tr>
<tr>
<td>Initially maximum shareholding limit was 5%, but the Financial Services Reform Act raised this to 15% in March 2002. Higher shareholding can be allowed if it is in national interest subject to approval of the Minister for Financial Services and Regulation.</td>
<td></td>
</tr>
</tbody>
</table>

| **Singapore Exchange Limited (SGX)** | SGX has authorized share capital of S$1,000,000,000. As of August 2001, its issued and paid-up capital stood at S$10,000,000. The top shareholders include SEL Holdings Pte. Ltd with 25% of total shares (but owing to the restrictions in the exercise of votes attached to shares, SEL is not regarded as a substantial shareholder), Raffles Nominee Pte. Ltd. (9.9%), Overseas-Chinese Bank Nominees Ltd. (5.3%) and HSBC Singapore Ltd. and Citibank Singapore (each over 4.0%), and others with significant stake in the range of 0.60-2%. The top 20 shareholders account for 77.8% of total shares. Out of the shares issued to SEL, the Company made an Initial Public Offer (IPO) and a private placement. The IPO raised S$470 million. Consequently, the issued and fully paid share capital of SGX increased from S$61,670 as at 30 June 2000 to S$10 million as at 16 November 2000. |
| Maximum shareholding limit is 5% and can be higher if approved by the Monetary Authority of Singapore (MAS). In 2001, MAS announced that, with its approval, strategic investors and fund managers who invest pools of consumer funds could acquire up to 10% of share-holding. | |

| **Hong Kong Exchanges and Clearing Limited (HKEx)** | HKEx has authorized share capital of HK$2,000,000,000. As of December 2001, issued and fully paid capital amount to HK$1,040,664,846. As of March 2002, the two Central Clearing and Settlement System (CCASS) Participants held 28.8%, and 12.1% of HKEx’s issued share capital. SFC granted approval to these two entities as minority controllers of HKEx on the basis that the shares are held in custody for their clients. |
| Maximum shareholding limit is 5%. The Securities and Futures Commission (SFC), in consultation with the Finance Secretary, may give approval to a person to hold more than 5% where it can be demonstrated to be in the interest of the public or the investing public. | |

| **Philippine Stock Exchange (PSE)** | The demutualized PSE has an authorized capital stock of P36.8 million, with subscribed and fully paid-up capital base of P9.2 million representing a portion of the members’ total contribution of P286.6 million as of 31 December 2000. Each of the 184 member-brokers was granted 50,000 common shares of the new PSE at a par value of P1.00 per share. The remaining members’ contribution of P277.4 million will be booked under additional paid-in surplus. |
| The Securities Regulation Code imposes a 5% maximum shareholding limit for individuals and individual companies and 20% for industry or business groups. | |

| **Tokyo Stock Exchange (TSE)** | Prior to demutualization, TSE had a capital of Y11,500 million. After demutualization, TSE raised it to Y22,874 million by issuing 2,300,000 shares for equal allotment to its members. The total number of authorized shares after demutualization is 9,200,000. TSE now has 114 shareholders. |
| Under the Securities and Exchange Law, there is a 5% maximum shareholding limit. | |

Source: Stock Exchanges. Latest Annual Reports
Demutualization of Asian Stock Exchanges—Critical Issues and Challenges

Table 1.2. Asian Stock Exchanges: Legal and Corporate Structure

<table>
<thead>
<tr>
<th>STOCK EXCHANGE</th>
<th>LEGAL FORM</th>
<th>LISTING STATUS</th>
</tr>
</thead>
<tbody>
<tr>
<td>TSE</td>
<td>TSE was demutualized on 1 November 2001&lt;br&gt;Legal Status: Company</td>
<td>Not listed (plans to list in FY2005)</td>
</tr>
<tr>
<td>SGX</td>
<td>SGX was demutualized in December 1999&lt;br&gt;Legal Status: Company (for profit)&lt;br&gt;Singapore Exchange Securities Trading Limited (SGX-ST), the stock exchange, is a wholly-owned subsidiary of SGX.</td>
<td>On 23 November 2000, the Company was admitted for listing of SGX-ST. SGX became a public-listed company with 1,000,000,000 ordinary shares outstanding.</td>
</tr>
<tr>
<td>HKEx</td>
<td>HKEx was demutualized in March 2000&lt;br&gt;Legal Status: Company (for profit) with the Stock Exchange of Hong Kong Limited (SEHK) set up as a wholly-owned subsidiary of HKEx.</td>
<td>Listed</td>
</tr>
<tr>
<td>ASX</td>
<td>ASX was demutualized on 13 October 1998&lt;br&gt;Legal Status: Company (for profit)</td>
<td>ASX was listed on its own exchange on 14 October 1998. When ASX shares were quoted on 14 October 1998, they closed at A$4.25; subsequently they rose as high as A$16 by 16 March 1999. By the end of 1999, they traded at a range of A$10 to A$11, valuing the company at between A$1 billion and A$1.1 billion.</td>
</tr>
<tr>
<td>PSE</td>
<td>PSE was demutualized in August 2001&lt;br&gt;Legal Status: Company</td>
<td>Not Listed</td>
</tr>
</tbody>
</table>

Source: Stock Exchanges. Latest Annual Reports

needs vs. distribution to partners, taxation). In most jurisdictions, a limited liability company has been observed to be the traditional and preferred option for profit-making ventures involving more than a close group of partners. The methods for transforming an association into a limited liability company vary between jurisdictions, but in principle, the existing members agree to transfer the assets and operations of their association to a newly formed company, in exchange for shares in that new company.
1.5 Benefits of Demutualization of Exchanges

1.5.1 Improvements in Corporate Governance

Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allow members exclusive rights of access to trading systems and platforms. Operating under this mutual structure, exchanges enjoyed quasi or full monopoly on trading and they derived profits from the intermediation of nonmember transactions. Since members under the mutual structure were owners of the exchange, they imposed rights to trading and disallowed direct access to the trading floor to any outsiders. Brokers inadvertently resisted changes if these entailed additional costs, loss of revenue or competitive threat. This resistance eventually impeded the ability of the company to react quickly to a rapidly changing market environment. Also, in some developing countries if the exchanges enjoyed a legal or decreed national monopoly, government-appointed officials and stakeholder representatives were often represented on the board. While in the short-run such appointments may have proved conducive to mitigating entrenched vested interests, in the long-run these can prove counter productive leading to unhealthy government interference.

With the changing economics of automated auction trading and its easy access electronically, the economics of member-cum-trading floor based exchanges has lost its merit. As a result, it has generated pressures to replace the age-old reliance on one member, one vote and the committee-based decision structure where control is vested with the interest groups that have exclusive rights of intermediation at exchange. Under demutualization, there is increased acceptance to separation of ownership from membership that automatically provides trading rights. This segregation helps introduce effective corporate governance if: (i) there are accompanying improvements in the incentive structure, which allow the exchanges to sell their equity stakes to nonmembers and outsiders, (ii) decision making is based on this new ownership structure (not on rights of intermediation), and (iii) when there is an effective oversight of a governing board and a company structure.

---

Since under demutualization the economic ownership of the exchange is separated from trading membership, it is not appropriate that interest groups (such as the trading members) have exclusive authority over the decisions of exchange. After demutualization, some exchanges have granted less than 50% of the voting rights to the broker members on the board of the exchange (see Table 1.3). To gradually decrease broker influence on the board, the exchanges have appointed independent directors or directors that are nontrading owners.

After demutualization, the appointment of government appointed officials (a common feature of exchanges in developing economies) has by and large been viewed as controversial given that the demutualized exchange is a private sector company operating in a competitive environment. In environments where broker influences are often daunting, the continued role of the representative(s) of the securities regulator can support the transition of exchange till such time as the regulation is changed to allow the exchanges to operate in a fully competitive manner.

Besides appropriate board representation, it is important that the management of the exchange is fully qualified and motivated to act not only in the best interests of the shareholders, but also to conduct the business in a prudent manner so as not to disrupt the orderly and fair trading in the capital markets. To ensure that this public interest is satisfied, "fit-and-proper" screening of the board and management, similar to tests put in place in the banking regulations of many jurisdictions, could be undertaken.

The management should be accountable to the board, which would determine management’s appointment and remuneration, supervise the strategic direction and audit the financial and operational results, including risk management, and if needed, effect the removal of management. To ensure the effective supervision and auditing of management, it would seem prudent to ensure that a majority of board members are truly independent directors.

To remain competitive, a stock exchange must follow international best practices in ethics and procedures. This is necessary in order to ensure that institutional investors do not shift their investments to other alternatives perceived to be more fair or secure. Therefore, it is in the profit-motivated exchange’s best interest to ensure fair and transparent practices; and, as such, good corporate governance needs to be an integral part of the exchange once it is driven by the profit motive.
Table 1.3. Asian Stock Exchanges: Board Representation

<table>
<thead>
<tr>
<th>STOCK EXCHANGE</th>
<th>BOARD REPRESENTATION/COMPOSITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASX</td>
<td>9 member board of directors. Of ASX's 9 directors, 4 are ASX Members/Affiliates.</td>
</tr>
<tr>
<td>SGX</td>
<td>11 member board of directors. Of SGX 11 directors, 4 represent broker interests. SGX plans to broaden membership base by attracting new international members both global and regional securities houses. In addition, SGX will be introducing a new membership structure that allows new and existing members to choose between trading-only membership or clearing-only membership or both trading and clearing membership. Central Depository Pte. (CDP) clearing rules have been revised to incorporate the admission requirements and expect to launch the new membership structure in the third quarter of 2002.</td>
</tr>
<tr>
<td>HKEx</td>
<td>The board comprises 8 Public Interest Directors appointed by the Financial Secretary to represent public and market interests, 6 Directors elected by shareholders, and the Chief Executive of HKEx who is an ex-officio board member. Pursuant to the Exchanges and Clearing Houses (Merger) Ordinance, the number of Public Interest Directors will be reduced to no more than the number of elected Directors immediately following the annual general meeting of HKEx in 2003.</td>
</tr>
<tr>
<td>PSE</td>
<td>51% of the board (8 of 15 directors) should be independent.</td>
</tr>
<tr>
<td>TSE</td>
<td>11 member board of directors, of whom 6 are outside directors.</td>
</tr>
</tbody>
</table>

Source: Stock Exchanges. Latest Annual Reports

1.5.2 Opening Up of Trading Rights of Exchanges

Consistent with the for-profit motive, the demutualized exchanges in Asia have included provisions to admit new trading partners (Table 1.4) and permitted eligible applicants (new customers) unrestricted commercial access to the services of exchange. Some exchanges, however, adopted a moratorium period on the issuance of new trading rights.

If share ownership were a requirement for trading membership, it would be relatively easy for existing members to protect their market share by refusing to sell existing or issue any new shares, thus barring new entrants. If new shares can only be issued to the active trading members, then the public, financial institutions, institutional investors and others would generally not be able to invest. The question of a broader ownership
Table 1.4. Asian Stock Exchanges: Trading Rights and Dividend for Profit-Seeking

<table>
<thead>
<tr>
<th>STOCK EXCHANGE</th>
<th>TRADING RIGHTS</th>
<th>PAYOUT RATIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASX</td>
<td>Trading rights may be acquired through application with ASX or from an existing Participant.</td>
<td>70% of net profit after tax.</td>
</tr>
<tr>
<td>SGX</td>
<td>Trading rights have to be acquired through application with SGX, as these cannot be secured through transfer from an existing member. In July 2000, SGX opened the securities market to new members, and five new member firms joined in 2000. SGX also changed its rules to allow a single legal entity to be a member firm in each of the securities and derivatives markets thereby furthering their members' opportunities to trade in both markets.</td>
<td>85%</td>
</tr>
<tr>
<td>HKEx</td>
<td>Access to the markets may be obtained through acquisition of trading rights from existing members of the exchanges and from HKEx after the expiry of a two-year moratorium on March 2002. Trading rights issued by HKEx (other than those automatically conferred to the exchange shareholders on the effective date) will not be transferable. For a further period of 2 years thereafter, no new trading rights will be issued for less than HK$3.0 million per Stock Exchange Trading Right or for less than HK$1.5 million per Futures Exchange Trading Right.</td>
<td>46%</td>
</tr>
<tr>
<td>TSE</td>
<td>An entity may acquire trading right from an existing trading participant (with approval of TSE), or through application with TSE.</td>
<td>n.a.</td>
</tr>
<tr>
<td>PSE</td>
<td>Trading right can be acquired through purchase from an existing trading participant. PSE temporarily imposed a moratorium on the issuance of new trading rights and limits it to its present number of 184, transferable for an unlimited period of time.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Source: Stock Exchanges. Latest Annual Reports

base of the exchange (as a public listed company) is critical in situations where exchanges need to raise funds for future investments. Broader ownership would help avoid potentially large swings in the value based on the trading of a limited number of shares only.

With share ownership separated from the right to trade, the question of the compensation of existing trading members arises especially since trading rights are granted freely to new members when the existing
members had to acquire their trading memberships. If existing shareholders continue to retain their shares, then they would enjoy the trading rights granted to the shareholders and there would be no need to compensate them for trading rights. This is argued largely because for both the old and new shareholders, the economic value that the shares now represent would always be inclusive of the right to trade provided such rights have been granted.

In order for shares to have economic value, there must be an expectation of dividends, at some point in the future. The introduction of a dividend policy (which does not exist in mutual exchanges), coupled with a listing of the shares, thus transfers the value of stock exchange share ownership from the right to trade, to the right to receive dividends and trade the shares (see Table 1.4). These factors should in theory minimize the resistance to the demutualization of exchanges by the brokers. However, a moratorium (limited in time) on the granting of new trading rights has often been introduced to lessen the competitive impact on smaller brokers.

### 1.5.3 Restructuring and Alliances of Exchanges

After being demutualized, most exchanges have revisited their commercial strategy to improve viability and enhance business prospects. Exchanges have opted to: (i) consolidate, merge and/or integrate their domestic markets; (ii) build alliances by establishing cross-border linkages with other exchanges within or outside the region; and (iii) merge with other exchanges—a phenomena more predominant thus far in Europe. In Asia, the exchanges have by and large opted thus far for (i) and (ii). Emphasis has been largely to re-group businesses to broaden the markets, offer issuers and investors better distribution networks and improved liquidity. Predominant in-country mergers or restructuring have taken place in Singapore, Hong Kong, Australia and Japan, and in early 2002, the Kuala Lumpur Stock Exchange (KLSE) merged with MESDAQ (Table 1.5).

In-country restructuring of exchanges has involved:

- Merger of two or more exchanges into a single viable national-level company, which would be of sufficient scale to be an interesting partner for other (foreign) exchanges, and as a listed company for investors to consider. While these mergers lead to
# Table 1.5. Asian Exchanges: Mergers and Alliances

<table>
<thead>
<tr>
<th>STOCK EXCHANGE</th>
<th>MERGERS PRIOR TO DEMUTUALIZATION</th>
<th>ALLIANCES WITH OTHER EXCHANGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>TSE</td>
<td>Hiroshima and Niigata Stock Exchanges merged with the TSE in March 2000.</td>
<td>NYSE, CME, American Stock Exchange (Amex), Korea Stock Exchange, Stock Exchange of Thailand (SET), ASX, PSE, SGX, KLSE, HKEx, Taiwan Stock Exchange (TSEC)</td>
</tr>
<tr>
<td>SGX</td>
<td>Stock Exchange of Singapore and SIMEX merged under a holding company, SGX.</td>
<td>ASX, TSE, Amex, CME/Globex, National Stock Exchanges of India</td>
</tr>
<tr>
<td>HKEx</td>
<td>Consolidation of the Hong Kong Stock Exchange, Hong Kong Futures Exchange and Hong Kong Securities Clearing to form a holding company structure.</td>
<td>NASDAQ, Sydney Futures Exchange, MOU with ASX, SET, KLSE, Luxembourg Stock Exchange</td>
</tr>
<tr>
<td>ASX</td>
<td>ASX has evolved from amalgamation of six regional stock exchanges.</td>
<td>NASDAQ, MOU with HKEx, JSX, Korea Stock Exchange, KLSE, PSE, TSEC, TSE, SET and SGX</td>
</tr>
<tr>
<td>PSE</td>
<td>PSE was established by the merger of Manila Stock Exchange and Makati Stock Exchange in 1992.</td>
<td>MOU with TSE and ASX</td>
</tr>
<tr>
<td>TSEC</td>
<td>&quot;Transferred&quot; 55 listed companies of ROC over-the-counter Securities Exchange (ROSE) to TSEC in 2001.</td>
<td>MOU with ASX, SET, Korea Stock Exchange and TSE</td>
</tr>
<tr>
<td>SHSE</td>
<td>Plans exist to merge the Shanghai Stock Exchange and Shenzhen Stock Exchange.</td>
<td>Talks with Euronext started</td>
</tr>
<tr>
<td>SET</td>
<td>—</td>
<td>Stock Exchange of Mauritius, Stock Exchange of Mumbai</td>
</tr>
</tbody>
</table>

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

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

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

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

After demutualization, some regional exchanges such as the SGX and HKEx have taken a wide range of initiatives. For instance, SGX has developed cross linkages with Japan, NASDAQ and Australia, and SGX has provided global access to Singapore Exchange Derivatives Trading Ltd. (SGX-DT) electronic trading system to provide on-line access for both trading of domestic and international securities, offered Exchange Trade Funds and effectively integrated the settlement infrastructure to the central depository to facilitate straight through processing. On 1 July 2002, SGX offered a new real-time multi-level data system that allows investors to access full order book information on the SGX securities market, on a subscription basis. The greater transparency and the enhanced price discovery process offered by the system will enable investors to make better-informed decisions.
In order to remain competitive, exchanges need to continually restructure and upgrade themselves based on the latest technological advancements in trading and information dissemination technology. Members of mutual exchanges have been unable or unwilling to commit to such investments. A profit-making exchange with transferable (and listed) shares would be able to access a broader investor base for such funds.

1.6 Regulatory Oversight: Challenges and Responses for Demutualized Exchange

1.6.1 Regulatory Framework for Exchanges

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

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

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

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

1.6.2 Conflicts of Interest Under Demutualized Exchange

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

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

(i) Less incentive to commit resources for self-enforcement or to take enforcement action against its customers or users who are a source of income.
(ii) Temptation to commercialize services and charge fees for selling of data and trade information that traditionally has been offered free in interest of continuous disclosure that is central to market integrity. ASX came under severe criticism in its inquiry over selling of the range of all ordinaries index that tracked market movements. Standard and Poor’s (S&P) has sought license to use this information. While demutualized exchange sees market information as an asset to generate return, the investors perceive it as critical for public interest.

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

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

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

Finally, demutualization triggered extensive debate on the merits of self-regulation. Questions have been raised on inherent conflicts of interest that self-regulatory organizations (SROs)—which in some cases could be stock exchanges—face in their dual roles as market operators and regulators. On the part of exchanges, there have been concerns as required by the securities regulators for admission, suspension or removal of listing on stock exchange, put in place procedures to deal with the conflicts of interests that may arise, and ensure complete disclosure of listing.

Box 1: Self-Listing Arrangement for Demutualized Exchange

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

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

ASX is obligated to pay listing fees to ASIC. ASC provides its licensed software to ASIC for surveillance of the quoted securities of ASX as self-listing exchange. ASTC is obligated to supervise and provide an audit report to ASIC on the conformity of ASX with the SCH Business Rules.
regarding the direct costs to the exchange of implementing the supervisory framework and indirect costs associated with a perceived lack of flexibility and management of authorization and approval process. Critics outside exchanges raise doubts regarding the ability of SROs to regulate members with which they compete and there are perceptions that SROs might abuse its regulatory authority, e.g. through rule making processes, disciplinary actions, use of in proprietary information and unfair practices vis-à-vis competitors it regulates. In the United States, market participants have also complained of regulatory inefficiencies that have emerged because the broker-dealers are subject to the multiple SROs that have different rules and examination standards.

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

1.6.3 Regulatory Oversight of Demutualized Exchange

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

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

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

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

The regulation provides that a competitor may lodge with ASIC an application asking ASIC, instead of ASX, to make decisions and take action (or require ASX to take action on ASIC's behalf) in relation to the competitor's listing application, or the compliance by the competitor (if already listed) with the applicable listing rules.
ASIC’s role and function and its oversight of ASX is defined in an MOU signed between ASIC and ASX. ASIC monitors ASX’s compliance with its role and functions and is mandated to audit supervisory arrangements of market operators. ASX supervises the exchange on a day-to-day basis through contractual arrangements with market participants whereby they agree to comply with the rules for admission to and continued participation in trading activity. Besides these rules, ASX and its market participants are subject to legislative requirements of the Corporation Law, Contract Law and the Trade Practices Act that prevent the abuse of market power.

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

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

1.7 Financial Viability of Demutualized Exchange

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

Over the last five years, given the exchanges’ move towards for-profit structures there has been a steady rise in revenues of FIBV member
Part I: Issues Involved in Stock Exchange Demutualization

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

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

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

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

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

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

---

8 However, if demutualized exchanges function as monopolies, the increase in profitability could arise from their ability to impose high transaction fees.
### Table 1.6. FIBV Member Stock Exchanges Analysis of Costs and Revenues, 2000

<table>
<thead>
<tr>
<th>LEGAL STATUS OF EXCHANGE</th>
<th>TOTAL COSTS</th>
<th>TOTAL REVENUES</th>
<th>RETURN ON SHAREHOLDERS’ EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(US$M)</td>
<td>(US$M)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td></td>
</tr>
<tr>
<td>Legal companies</td>
<td>2,492</td>
<td>3,220</td>
<td>13%</td>
</tr>
<tr>
<td>Others</td>
<td>649</td>
<td>950</td>
<td>13%</td>
</tr>
<tr>
<td>Sub-total for non-demutualized</td>
<td>3,141</td>
<td>4,170</td>
<td>13% (average)</td>
</tr>
<tr>
<td>Privatized exchanges</td>
<td>1,413</td>
<td>1,951</td>
<td>26%</td>
</tr>
<tr>
<td>Listed exchanges</td>
<td>300</td>
<td>632</td>
<td>56%</td>
</tr>
<tr>
<td>Sub-total for demutualized exchanges</td>
<td>1,713</td>
<td>2,583</td>
<td>41% (average)</td>
</tr>
<tr>
<td>Total</td>
<td>4,854</td>
<td>6,753</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: International Federation of Stock Exchanges (FIBV)

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

<table>
<thead>
<tr>
<th>EXCHANGE/DEMUTUALIZATION</th>
<th>OPERATING PROFIT</th>
<th>NET INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BEFORE DEMUTUALIZATION</td>
<td>AFTER DEMUTUALIZATION</td>
</tr>
<tr>
<td>ASX (13 Oct 1998)</td>
<td>A$26.4</td>
<td>A$77.9</td>
</tr>
<tr>
<td>SGX (1 Dec 1999)</td>
<td>S$37.0</td>
<td>S$64.0</td>
</tr>
<tr>
<td>HKEx (6 Mar 2000)</td>
<td>HK$557</td>
<td>HK$822</td>
</tr>
<tr>
<td>TSE (1 Nov 2001)</td>
<td>Y3,250</td>
<td>Y1,308</td>
</tr>
<tr>
<td>PSE (8 Aug 2001)</td>
<td>P72.9</td>
<td>P17.3</td>
</tr>
</tbody>
</table>

Note: For the years ending 30 Jun for ASX and SGX, 31 Dec for HKEx and PSE, 31 Mar for TSE.
Source: Stock Exchanges.
growing competition and technology that drives charges and fees lower, and loss of some sources of income because of ongoing exchanges transformation and migration of businesses.

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

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

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

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

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

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

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

---

Part I: Issues Involved in Stock Exchange Demutualization

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

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

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


Securities and Futures Commission (SFC), Hong Kong Exchanges and Clearing Limited (HKEx) and the Stock Exchange of Hong Kong Limited (SEHK). 2001. Memorandum of Understanding for the Listing of HKEx on SEHK, Between SFC, HKEx and SEHK, 22 August.

Part I: Issues Involved in Stock Exchange Demutualization


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

---

1 Partner, Blake, Cassels & Graydon LLP, Toronto, Canada. The author thanks Daniel Bernstein, associate, and Alisa Ruvinsky, student-at-law, Blake, Cassels & Graydon LLP for their assistance in the preparation of this paper.
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.\(^2\) 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.\(^3\) 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

\(^2\) 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).

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.4

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.5

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.

---

4 Id. at 4.
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.6

2.3.3 Competition from ATSs and Upstairs Trading

The threat of competition from alternative trading systems (ATSs) has forced traditional exchanges to examine their role as trading arenas and to take measures that facilitate more competitive future strategies. An ATS 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.7

Although some ATSs 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 ATSs would impair the fair and orderly functioning of markets. In December 1998, SEC implemented the Regulation ATS that permitted ATSs 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 ATSs.

---

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

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 ATSs 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. 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 ATSs. However, it is unlikely that traditional exchange business models, offering more integrated services than ATSs, 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. 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

8 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.”

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.

9 Timothy Baikie, From Toronto Stock Exchange to TSE Inc.: Toronto’s Experience with Demutualization, at 6, 11.
10 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.\textsuperscript{11}

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.\textsuperscript{12}

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.

\textsuperscript{11} Supra note 2, at 2.
\textsuperscript{12} 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.13

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.14 In addition to developing new trading platforms and mechanisms, the exchange

---

13 G. Marr, TSE to Go Public in Next 6 to 12 Months, National Post, 30 May 2001.
14 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.\(^\text{15}\) 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 \textit{Corporations Law Amendment (ASX) Act} in record time. The new legislation also

\begin{itemize}
  \item[(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);
  \item[(ii)] separated stockbrokers’ rights to trade on an exchange from shareholders’ rights;
  \item[(iii)] imposed a 5% limit on shareholdings in the ASX;
  \item[(iv)] allowed a securities exchange to self-list on its own exchange; and
  \item[(v)] provided for the supervision of any such self-listing by ASIC.\(^\text{16}\)
\end{itemize}

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 \textit{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.\(^\text{17}\) Either way,


\(^{16}\) Supra note 2, at 24, 31.

\(^{17}\) Supra note 2, at n.89.
Background Information on Demutualization

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.18

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 ATSs 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.19

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

19 Supra note 6, at 15-20.
that impose burdensome listing requirements on issuers, or drive brokers or dealers to execute their trades elsewhere.\textsuperscript{20}

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.

\textbf{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

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.21

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.22

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.”23

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

---

21 Rod Stone, Swedish, Danish Bourse Link Starts Well; More Links Seen, Dow Jones International (21 June 1999).
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.24

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.25

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.26 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.27

26 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).  
27 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."28

---

28 Doris C. Dumlao, Demutualization Not a Cure to All of the PSE’s Problems, *Philippine Daily Inquirer* (9 May 2000).
### APPENDIX 1: The Models

**TORONTO STOCK EXCHANGE (TSE)**

<table>
<thead>
<tr>
<th>Demutualization Status</th>
<th>Demutualization Process</th>
<th>Reasons for Demutualization</th>
</tr>
</thead>
<tbody>
<tr>
<td>• became a private, for-profit company in 2000</td>
<td>• 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</td>
<td>• to improve responsiveness to a fluctuating marketplace</td>
</tr>
<tr>
<td>• was a not-for-profit organization incorporated without share capital</td>
<td>• each member or person owning a TSE seat received 20 common shares of TSE Inc. and will no longer have rights as a seatholder</td>
<td>• deconstruction—traditional integrated financial services businesses are being disaggregated; specialized players offering low-cost order routing and matching have emerged</td>
</tr>
<tr>
<td></td>
<td>• each common share carries one vote</td>
<td>• alliances and consolidations between exchanges are becoming wave of future—scale and greater product variety are key</td>
</tr>
<tr>
<td></td>
<td>• 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</td>
<td>• liquidity of TSE threatened as institutional investors “trade upstairs” for anonymity</td>
</tr>
<tr>
<td></td>
<td>• 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</td>
<td>• US competitive threat</td>
</tr>
<tr>
<td></td>
<td>• at time of continuance, any revenue in excess of expenses is internally restricted and may not be distributed to shareholders except upon winding-up</td>
<td>• Alternative Trading Systems (ATSs)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• see “A Blueprint for Success”</td>
</tr>
</tbody>
</table>
Background Information on Demutualization

APPENDIX 1: The Models

<table>
<thead>
<tr>
<th>Post-Demutualization</th>
<th>Corporate Governance</th>
<th>Regulatory Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>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</td>
<td>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</td>
<td>the basic rules applicable to all markets are subject to ongoing oversight by the OSC</td>
</tr>
<tr>
<td></td>
<td></td>
<td>TSE rules are to be approved by the OSC</td>
</tr>
<tr>
<td></td>
<td></td>
<td>the TSE is an SRO; it develops its own rules over and above the rules administered by the OSC</td>
</tr>
<tr>
<td></td>
<td></td>
<td>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</td>
</tr>
</tbody>
</table>
## AUSTRALIAN STOCK EXCHANGE (ASX)

<table>
<thead>
<tr>
<th>Demutualization Status</th>
<th>Demutualization Process</th>
<th>Reasons for Demutualization</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUSTRALIAN STOCK EXCHANGE (ASX)</td>
<td>is now public, listed on its own exchange</td>
<td>• deregulation, open competition and technological advances</td>
</tr>
<tr>
<td>exchange formed in ‘87 through amalgamation of six independent stock exchanges</td>
<td>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</td>
<td></td>
</tr>
<tr>
<td>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</td>
<td>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</td>
<td></td>
</tr>
</tbody>
</table>

- deregulation, open competition and technological advances
Background Information on Demutualization

APPENDIX 1: The Models

<table>
<thead>
<tr>
<th>Post-Demutualization</th>
<th>Corporate Governance</th>
<th>Regulatory Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>• when ASX, Ltd. parent of the exchange proposed to take over the Sydney Futures</td>
<td>• 9 member board of directors</td>
<td>• ASX develops and implements business and listing rules and supervises trading</td>
</tr>
<tr>
<td>Exchange, it found itself in a bidding war;</td>
<td></td>
<td>activity, markets participants such as stockbrokers and broker firms, including</td>
</tr>
<tr>
<td>• also the Australian Competition and Consumer Commission (ACCC) considered ASX’s</td>
<td></td>
<td>surveillance, investigation, discipline of stockbrokers and broker firms, and</td>
</tr>
<tr>
<td>merger plan to be anti-competitive</td>
<td></td>
<td>notification of Australian Securities &amp; Investments Commission (ASIC) of certain</td>
</tr>
<tr>
<td>• “key issue before the ACCC was whether a securities exchange should be protected</td>
<td></td>
<td>supervisory matters</td>
</tr>
<tr>
<td>and fostered as a national capital markets champion or just another entity</td>
<td></td>
<td>• ASIC supervises ASX’s listing and undertakes the day-to-day supervision of its</td>
</tr>
<tr>
<td>competing in the marketplace like the companies that use it to raise capital”</td>
<td></td>
<td>compliance with the listing rules to ensure ASX subject to independent scrutiny</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• MOUs between ASX and ASIC: (1) Markets MOU covering the referral to ASIC of</td>
</tr>
<tr>
<td></td>
<td></td>
<td>matters detected by ASX in its supervision;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2) Membership matters MOU covering ASX’s responsibility for supervision of</td>
</tr>
<tr>
<td></td>
<td></td>
<td>stockbrokers and broking firms; (3) Companies matters MOU covering ASX’s supervision</td>
</tr>
<tr>
<td></td>
<td></td>
<td>of listed entities; (4) Transfer of information MOU relating to arrangements for</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ASX to provide documents released to the market by listed entities; (5) Self-listing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>MOU detailing arrangements for ASX to be listed on its own market and supervised</td>
</tr>
<tr>
<td></td>
<td></td>
<td>as a listed entity by ASIC</td>
</tr>
</tbody>
</table>
HONG KONG EXCHANGES AND CLEARING LIMITED (HKEx)

<table>
<thead>
<tr>
<th>Demutualization Status</th>
<th>Demutualization Process</th>
<th>Reasons for Demutualization</th>
</tr>
</thead>
<tbody>
<tr>
<td>• is now public, listed on its own exchange</td>
<td>• 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</td>
<td>• to compete vigorously for opportunities in the region and around the world</td>
</tr>
<tr>
<td></td>
<td>• 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</td>
<td>• “it is a market-driven business, operating business-driven markets”</td>
</tr>
<tr>
<td></td>
<td>• 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</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• later in 2000, HKEx listed its shares</td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX 1: The Models

<table>
<thead>
<tr>
<th>Post-Demutualization</th>
<th>Corporate Governance</th>
<th>Regulatory Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 5 different business units have been set-up within HKEx to pursue different business goals and implement various business strategies</td>
<td>• 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</td>
<td>• Securities and Futures Commission (SFC) is the principal regulator of HK’s securities and futures markets</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• the making of, and changes to, the rules of HKEx, the Exchanges and the Clearing Houses requires the approval of the SFC.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• there is a prohibition on holding 5% or more of the voting power at any general meeting of HKEx in the Merger Ordinance 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</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• pursuant to the Merger Ordinance, 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:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(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</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 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</td>
</tr>
</tbody>
</table>
## SINGAPORE EXCHANGE (SGX)

<table>
<thead>
<tr>
<th>Demutualization Status</th>
<th>Demutualization Process</th>
<th>Reasons for Demutualization</th>
</tr>
</thead>
<tbody>
<tr>
<td>is now public, listed on its own exchange</td>
<td>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</td>
<td>globalization and technology</td>
</tr>
<tr>
<td>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)</td>
<td>in 2000, SGX became a public company, with 1,000,000,000 ordinary shares outstanding</td>
<td>proliferation of electronic communications networks (ECNs) which are positioning themselves as virtual exchanges and providing a single electronic access to multiple markets</td>
</tr>
<tr>
<td>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</td>
<td>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</td>
<td>demutualization allows SGX to better serve the needs of its customers and the end-users</td>
</tr>
<tr>
<td></td>
<td></td>
<td>merger minimizes operating costs and increases value-positioning vis-à-vis other foreign exchanges</td>
</tr>
</tbody>
</table>
Background Information on Demutualization

**APPENDIX 1: The Models**

<table>
<thead>
<tr>
<th>Post-Demutualization</th>
<th>Corporate Governance</th>
<th>Regulatory Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>• agreement with ASX that will allow brokers on each exchange to trade selected</td>
<td>• 11 member board of directors</td>
<td>• is an SRO</td>
</tr>
<tr>
<td>stocks listed on the other exchange</td>
<td></td>
<td>• legislation requires anyone who wishes to acquire 5%</td>
</tr>
<tr>
<td>• signed MOU with Tokyo Stock Exchange for general cooperation, designed to</td>
<td></td>
<td>or more of SGX to seek prior approval from Monetary</td>
</tr>
<tr>
<td>contribute to the development and efficiency of the two markets, as well as to</td>
<td></td>
<td>Authority of Singapore (MAS)</td>
</tr>
<tr>
<td>investor protection</td>
<td></td>
<td>• in 2001, MAS announced that, with its approval,</td>
</tr>
<tr>
<td>• in 2000, SGX announced joint venture with American Stock Exchange (Amex) to</td>
<td></td>
<td>strategic investors and fund managers who invest pools</td>
</tr>
<tr>
<td>offer a series of exchange traded funds to investors across Asia</td>
<td></td>
<td>of consumer funds can acquire 5% or more in SGX, up to</td>
</tr>
<tr>
<td>• created alliance with the National Stock Exchange of India (NSE) and the India</td>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>Index Services &amp; Products Limited (IISL) for cooperation in areas relating to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>derivatives trading, market-information sharing, staff training and technical</td>
<td></td>
<td></td>
</tr>
<tr>
<td>assistance</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### STOCKHOLM STOCK EXCHANGE (SSE)

<table>
<thead>
<tr>
<th>Demutualization Status</th>
<th>Demutualization Process</th>
<th>Reasons for Demutualization</th>
</tr>
</thead>
<tbody>
<tr>
<td>- is now public, listed on its own exchange</td>
<td>- 3 step transformation in exchange: (1) modernization of trading (2) privatization of exchange (3) internationalization of the market</td>
<td>- 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</td>
</tr>
<tr>
<td>- 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</td>
<td>- 1992 legislation abolished monopoly of SSE and provided the Financial Supervisory Authority with the power to authorize an exchange</td>
<td>- in late ‘80s and ‘90s, political climate changed—more market oriented, aftermath of ‘87 crash and financial crisis in the Swedish banking system</td>
</tr>
<tr>
<td></td>
<td>- shares were sold to listed issuers and exchange members, and were only freely tradable after one year, after which time, no restrictions on ownership</td>
<td>- turnover tax and currency controls repealed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- because of 1992 legislation, the exchange felt that in order to compete internationally it needed “economic incentives and a business attitude”</td>
</tr>
</tbody>
</table>
### APPENDIX 1: The Models

<table>
<thead>
<tr>
<th>Post-Demutualization</th>
<th>Corporate Governance</th>
<th>Regulatory Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSE’s first act as private company was to allow remote membership and direct execution of orders from other cities</td>
<td>9 board members elected by shareholders</td>
<td>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</td>
</tr>
<tr>
<td>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</td>
<td></td>
<td>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</td>
</tr>
<tr>
<td>this controversial proposal succeeded because the Ministry of Finance believed a merger of cash and derivatives market was beneficial</td>
<td></td>
<td></td>
</tr>
<tr>
<td>in order to satisfy opponents, the government became a shareholder of both OM and SSE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>also, new legislation passed giving Financial Supervisory Authority more power</td>
<td></td>
<td></td>
</tr>
<tr>
<td>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</td>
<td></td>
<td></td>
</tr>
<tr>
<td>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</td>
<td></td>
<td></td>
</tr>
<tr>
<td>in 1999, Sweden and Denmark launched the first cross-border joint equities trading system, designed to raise liquidity in Baltic markets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
3.1 Overview

Stock and commodities exchanges traditionally operated in the form of non-profit mutual or membership organizations. To the extent market power was not curtailed by competition or regulation, mutual governance gave specialist or market maker members of an exchange control of the price, quality and range of services produced by the exchange. Exchange profits were returned to members in the form of lower access fees or trading profits. Also, exchanges operated as self-regulatory organizations (SROs) to enforce discipline upon members. Initially, this discipline included the fixing of commission rates.

Today some exchanges have been transformed into for-profit shareholder-owned companies and many more are considering such a demutualization. Some demutualized exchanges have become public companies and listed on their own or other boards. Others have remained privately held companies but intend to go public in the future. This chapter will discuss the United States experience and perspective with regard to why exchanges and similar entities have demutualized, how seats are transformed into shares and post demutualization models.

In many countries exchanges were created by state decree. In other countries they were organized as membership organizations from loosely connected traders who met in coffee houses or street corners. In the United States, exchanges pre-dated corporation and securities laws. The
New York Stock Exchange (NYSE) was organized as a private membership organization in 1792 prior to the adoption of general incorporation statutes. Later NYSE became a not-for-profit corporation under existing New York law, but continued to be a membership organization. Before 1934, no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed a statute to establish a framework for an over-the-counter SRO.\(^2\)

Only one such association, the National Association of Securities Dealers, Inc. (NASD) exists for over-the-counter (OTC) brokers and dealers. The NASD was organized as a not-for-profit membership corporation under Delaware law in 1939. Although NASD is for all intents and purposes a stock exchange, it continues to be called and regulated as an association under the securities laws, but the NASD’s subsidiary, the NASDAQ Stock Market, Inc. (NASDAQ) is in the process of registering as a stock exchange. All broker-dealers registered with the Securities and Exchange Commission (SEC), except those doing business exclusively on a securities exchange, are required to join NASD. The Pacific Exchange (PCX), a regional stock exchange, was formed in 1957 as a merger of the San Francisco Stock and Bond Exchange (founded in 1882) and the Los Angeles Stock and Oil Exchange (founded in 1899). It began trading stock options in 1976.

In the United States, securities and commodities exchanges are separate and they are regulated for the most part by separate regulators. The Chicago Board of Trade (CBOT) is the oldest US futures exchange, established in 1848. The State of Illinois passed a special law in 1859 to facilitate incorporation by CBOT. The Chicago Mercantile Exchange (CME) is an outgrowth of the Chicago Produce Exchange, established in 1874 to provide a systematic market for butter, eggs, poultry and other farm products. It was incorporated under the not-for-profit law of the State of Illinois and was transformed into a financial futures exchange in the 1970s.

On 13 November 2000, the Chicago Mercantile Exchange (CME) became the first US exchange to demutualize. It is a registered and reporting company under the Exchange Act but it has not yet conducted a public offering. In May 2000 the SEC approved PCX Equities, Inc. (PCX) as the first US stock exchange to become a for profit stock corporation. NASD has transformed NASDAQ into a for profit stock corporation and sold a portion of its shares in a private placement. A future public offering of NASDAQ shares is contemplated. The CBOT is in the process of

obtaining membership approval for a demutualization and public offering. NYSE announced it would demutualize in 1999, but thus far it has not taken steps to do so.

Demutualization of exchanges is a response to global competition and technological innovation that is restructuring the securities markets. When an exchange changes from a mutual membership organization to a for-profit stock corporation, its corporate governance is transformed and it is in a better position to raise capital needed for technological improvement or business expansion. Demutualization requires the approval of an exchange's membership and its Government Regulator, so the process of turning seats into shares is complicated. Demutualization without a public offering generally is a transitional phase on the road to an exchange becoming a publicly-owned and traded corporation. Nevertheless, because of the key role that exchanges play in a capitalist economy with regard to capital formation, price discovery and allocation of capital, exchanges may not develop into ordinary public corporations.

### 3.2 Reasons for Demutualization

The primary driver for demutualization has been to meet competition from other exchanges, including non-traditional trading markets such as electronic communications networks (ECNs), or alternative trading markets (ATSs). This competition has put pressure on trading profits at a time when trading volumes have increased, but technology has made trading more efficient. In order to compete with ECNs, traditional exchanges have had to better align their governance and business strategies to satisfy institutional and retail customers rather than the short term interests of their members. One aspect of this realignment has been to give clearing members more influence than trading members.

Exchanges have set forth various reasons for their demutualization initiatives, and these statements are informative. CME identified five objectives\(^3\) of its demutualization as follows:

- **Improved governance and managerial structure.** In the view of CME, the traditional distinctions between the exchange's activities and the

---

\(^3\) See Amendment No. 5 to Form S-4 Registration Statement, 25 April 2000, available at <http://www.sec.gov/Archives/edgar/data/1103945/0000950131-00-002795.txt>.
activities of its members and clearing members were becoming increasingly blurred. Members and clearing members decided its affairs, but some of them competed directly with CME by developing off-exchange products and businesses and by joining alternative market initiatives. The board of CME believed that demutualization would enable management to reduce the impact of these conflicts, by creating a governance and management structure that is more agile and swift in its ability to respond to competition. Also, CME’s enterprise value will be increased for the benefit of its equity owners. Management of the demutualized entity will be free to make decisions regarding listing contracts electronically, changing clearing and transaction fees when appropriate, or expanding existing product and service offerings.

- **Improved financial decision-making model.** Commercial decision-making will diminish member political influences. Commercial pricing of services and a profit-making objective will ensure that resources are allocated to those business initiatives and ventures that enhance, or have the potential to enhance, stockholder value. The CME’s ability to obtain financing at favorable rates will depend on whether lenders believe it is investing prudently.

- **Create a catalyst for pursuing new business strategies.** Continuing financial innovation and demand for new risk management and derivative products are fueling global growth in exchange-traded and over-the-counter products. To capitalize on this potential, a demutualized CME will be able to attract outside investment, further expand its current technology platforms, and broaden its product and service offerings.

- **Unlock members’ equity values.** Over the years, many retired CME owners experienced substantial declines in their seat values and turned to income from leasing. These owners have become generally less interested in member opportunity on the floor and more interested in maintaining their asset values and deriving income from their assets. They have become more like traditional stockholders than exchange members. Demutualization will unlock the equity value in CME memberships, and provide shareholder returns to them. Many of the members are interested in selling only a portion of their interest in the exchange, but these members have been unable to do so because they cannot sell less than an entire membership or seat.
Motivations, Mechanics and Models for Exchange Demutualizations in the United States

- **Provide a signal and a currency for working with strategic partners.** Technology firms, as well as firms interested in acquiring an equity stake in CME, are likely to prefer to work with a demutualized corporation, rather than a member-owned mutual organization. Demutualization and conversion of memberships into shares will create a valuable currency for strategic alliances.

The Pacific Exchange (PCX) has expressed itself similarly. It has asserted that the traditional structure is not readily adaptable to an emerging competitive environment. It is difficult to implement new policies and new strategic directions because members, acting through committees or voting on constitutional amendments, must bless each significant change. In addition, the cost of capital to member organizations is high. As a result, members, through fees, dues, and transaction charges, or through special assessments, become the primary source of working capital. Therefore, demutualization is a necessary step in modernizing governance and management for achieving growth in the future. Demutualization will allow PCX to unlock its equity value, enhance its business and partnership opportunities, and position the exchange to become more responsive to customer needs.

The demutualization plan is thought to provide the best opportunity for both members and seat owners to maximize value going forward. The goal of the proposed structure is to streamline decision-making, provide a more flexible capital structure, and separate the regulatory functions from other businesses. This structure will provide PCX with the ability to enter into strategic transactions by using its capital stock as a new form of currency, and enhance its ability to raise outside capital for technology innovation, product development and other critical initiatives.

The Board of Directors of NASDAQ believed that it was in the interest of both its shareholders and the investing public for NASDAQ shares to be publicly traded and widely held through an IPO. As a for-profit, stock-based company governed by the market’s leading participants, NASDAQ would be more agile, flexible, and effective in responding to industry and

---


market conditions. The advantages noted for a public ownership included the following:

- An IPO and the capital it provides will allow NASDAQ to continue to improve its market by allowing NASDAQ to compete effectively with domestic and international competitors, facilitating the NASD’s sale of its remaining equity ownership, and creating a liquid acquisition currency for NASDAQ.

- An IPO will provide a valuation benchmark and liquidity for current investors. An IPO will allow NASDAQ to control the development of the trading market for its stock. NASDAQ’s interest will be aligned with the interests of key participants. NASDAQ will have both an initial infusion of capital and easier ongoing access to capital.

The CBOT’s demutualization is intended to modernize its corporate governance structure, improve the efficiency of its corporate decision-making process and position CBOT to compete more effectively in the evolving futures marketplace. As a for-profit stock corporation, CBOT will have the ability to issue capital stock, the flexibility to continue to evaluate the CBOT ownership structure and to consider value enhancing transactions in the future.\(^7\)

The NYSE Chairman has explained that the diversity of interest among NYSE members is a continuous source of tension and conflict. Members are only able to realize economic value from their right to trade on the NYSE floor, but member firms compete with one another in a variety of businesses, including OTC market-making in listed securities. Demutualization offers greater commonality among equity owners and avoids concentration of ownership power in a particular group of exchange participants. Also, a demutualized exchange can raise capital for strategic affiliations, technological improvements or new systems.\(^8\)

---

\(^7\) See Amendment No. 4, Form S-4, CBOT Registration Statement, available at <http://www.sec.gov/Archives/edgar/edgar/data/11174631000095013101501062/ds4a.txt>.

3.3 How Demutualization is Accomplished

Pursuant to demutualization plans, members are given trading rights that generally are coextensive with the rights held before demutualization. In addition, members and outsiders are given the opportunity to purchase capital shares. The complexity of any exchange’s demutualization depends in part on how complex its membership structure was before demutualization, and what objectives the demutualization is designed to achieve. At the commodity exchanges, for example, different trading rights exist for different contracts. At some exchanges many seats are leased, and there are different economic interests between lessors, lessees and other members. The demutualizations of NASDAQ and PCX accomplished a separation of trading facilities and member self-regulation.

3.3.1 The Chicago Mercantile Exchange Demutualization

The CME converted itself into a publicly held, for-profit corporation in several steps. The original Illinois not-for-profit corporation initially was merged into a new Delaware non-stock corporation and immediately thereafter into a stockholder-owned, for-profit Delaware corporation. In a final step, CME then issued Class A and Class B shares. Both classes of stock have the traditional features of common stock; however, the primary purpose of the Class B stock is to confer trading privileges associated with exchange membership. The transaction did not represent an Initial Public Offering (IPO).

As a result of the demutualization, 25,855,200 shares of Class A common stock were allocated on a 3-2-1 basis to members of CME, International Monetary Market (IMM) and Index and Option Market (IOM) divisions. In addition, 4,722 shares of Class B common stock were issued to exchange members in series corresponding to the former membership divisions. Each CME member received a B-1 share, each IMM member received a B-2 share, each IOM member received a B-3 share, each member of the Growth and Emerging Market (GEM) division received a B-4 share, and those holding a fractional interest in a GEM seat received a B-5 share. Each B series share confers the trading privileges associated with the membership interests that are converted into that series, along with the traditional features of common stock.

---

Class B shares are traded much the way memberships or “seats” on the exchange were traditionally bought and sold. CME’s Membership Department posts bids and offers. The value of Class B shares, as determined by the market, are based on the value of the trading right and of the A share equivalents bundled with the trading right. Class A shares are subject to trading restrictions which will be lifted gradually over a period of 15 months after the demutualization transaction. For example, after six months, shareholders can trade 25% of their initially allocated Class A shares. For the first six months following demutualization, Class A shares can be sold only in conjunction with a sale of the related Class B share. Such sales will occur through a process substantially the same as the process for selling existing membership interests (i.e., through the Membership Department). After six months, increasing portions of the Class A shares can be transferred independently of the associated Class B shares.

The CME demutualization proceeded with over 98% of the membership in favor under the direction of a new CEO. It accomplished the transformation of CME into a for-profit corporation headed in the direction of becoming a public company.

### 3.3.2 The Pacific Exchange Restructuring and Transaction with Archipelago

The restructuring of the PCX proceeded differently with respect to its options trading and equities trading.10 Regarding options trading, PCX’s demutualization provided that PCX seat owners would retain an equity interest in the Exchange as well as the trading access privileges that each seat carried before. Specifically, seat owners received shares of voting common stock in a new company, PCX Holdings, Inc., (PCX Holdings) and a trading permit allowing them to trade on the PCX options floor. The existing PCX became a subsidiary of PCX Holdings, and it continues to operate the options trading floor and conduct associated regulatory functions.

The restructuring of equities trading is more complicated, involving both creation of equity trading permits (ETPs) to replace exchange seats and a merger transaction with Archipelago Holdings, LLC (Archipelago). First, a Delaware stock corporation, PCX Equities, Inc. (PCXE) was created

---

as a wholly-owned subsidiary of PCX to take over the equities trading and clearing business of the PCX. The PCX members received ETPs in the PCXE, in exchange for their seats on the PCX.

In addition, a merger transaction took place between the PCX and Archipelago. Archipelago was formed in December 1996 by a software developer and was one of the original four ECNs approved in January 1997 by SEC. In July 2000, Archipelago and the PCX closed a transaction creating the Archipelago Exchange (ArcaEx), the first totally open, electronic stock market in the United States.

The PCX and PCXE have entered into various agreements with Archipelago regarding the operation and regulation of its subsidiary, the Archipelago Exchange, LLC (Archipelago Exchange). Pursuant to these agreements, the Archipelago Exchange operates ArcaEx, which has replaced the PCXE’s equity trading floor on 22 March 2002. ArcaEx is an electronic securities communications and trading facility allowing the ETP holders and their customers to trade stocks listed on the NYSE, American Stock Exchange (Amex) and NASDAQ.

Under the agreements, PCX and PCXE maintain responsibility for all regulatory functions related to the ArcaEx facility while Archipelago Exchange is responsible for the business of the facility to the extent those activities are not inconsistent with the regulatory and oversight functions of PCX and PCXE. As part of the transaction, PCX received an equity stake in Archipelago and an Archipelago representative went on the board of the demutualized PCX.\(^{11}\)

The PCX’s demutualization was primarily for the purpose of changing its business model and becoming an ECN.

### 3.3.3 The National Association of Securities Dealers Restructuring and NASDAQ Offering

In 1996, the NASD reorganized to create a parent holding company and two operating subsidiaries—NASDAQ and NASD Regulation, Inc. (NASDR). Thereafter, the holding company purchased the Amex. At a special meeting of NASD members held on 14 April 2000, more than a majority of NASD members approved a plan to restructure and broaden NASDAQ’s ownership through a two-phase private placement of:

(i) newly-issued shares of common stock, and (ii) warrants issued by NASD to purchase shares of common stock owned by NASD.\textsuperscript{12}

In connection with the first phase of the restructuring, the NASD separated Amex from the NASDAQ-Amex Market Group, a holding company that was a wholly-owned subsidiary of the NASD, and the Group was then merged with and into NASDAQ. NASDAQ then effected a 49,999-for-one stock dividend creating 100 million shares of Common Stock outstanding (all of which were initially owned by the NASD), and authorized the issuance of an additional 30.9 million in new shares of Common Stock to be offered for sale by NASDAQ as part of the Restructuring. On 28 June 2000, NASDAQ sold an aggregate of 23,663,746 shares of common stock for an aggregate consideration of US$260,301,206. The NASD sold an aggregate of 6,415,049 Warrants to purchase an aggregate amount of 25,660,196 shares of common stock and an aggregate of 323,196 shares of Common Stock owned by NASD for an aggregate consideration of US$74,120,695.

In the second phase of the restructuring, on 18 January 2001, NASDAQ sold an aggregate of 5,028,797 shares of Common Stock for an aggregate consideration of US$65,374,361. The NASD sold an aggregate of 4,392,345 Warrants to purchase an aggregate amount of 17,569,380 shares of Common Stock and an aggregate of 4,222,295 shares of Common Stock owned by NASD for an aggregate consideration of US$116,382,665. Investors in both phases of this restructuring consisted of NASD members, NASDAQ market participants, issuers with securities quoted on NASDAQ, and other strategic partners.

On 3 May 2001, NASDAQ issued and sold US$240,000,000 in aggregate principal amount of its 4% convertible subordinated debentures due 2006 to Hellman & Friedman Capital Partners IV, L.P. and certain of its affiliated limited partnerships (collectively, Hellman & Friedman). The subordinated Debentures are convertible at any time into an aggregate of 12,000,000 shares of Common Stock, subject to adjustment. Hellman & Friedman owns approximately 9.8% of NASDAQ on an as-converted basis. In connection with the transaction, NASDAQ has agreed to use its best efforts to seek stockholder approval of a charter amendment that would provide for voting debt in order to permit Hellman & Friedman to vote on an as-converted basis on all matters on which common stockholders have the right to vote, subject to a 5% voting limitation in NASDAQ’s Restated Certificate of Incorporation.

\textsuperscript{12} See NASDAQ 10-12G/A Registration Statement, June 29, 2001, available at \textltt{<http://www.sec.gov/Archives/edgar/data/1120193/000095017201500449/0000950172-01-500449.txt>}. 

---

68
On 3 May 2001, NASDAQ used the net proceeds from the sale of the subordinated debentures to purchase 18,461,538 shares of Common Stock from NASD for US$13 per share for an aggregate purchase price of US$239,999,994. These repurchased shares have been cancelled and are no longer outstanding. As of 4 May 2001, NASD owns 31% of NASDAQ assuming all warrants are fully exercised.

The restructuring of the NASD is extremely complex because it involves a separation of NASD’s regulatory functions from NASDAQ at a time when the US markets shifted to decimal trading and the over-the-counter market has been very volatile. The SEC’s approval of various kinds have been required for the restructuring. This restructuring was a response to the challenges of ECN trading, and NASDAQ envisions that ECNs will become members of the new NASDAQ. The future of the Amex has yet to be determined.

3.3.4 The Chicago Board of Trade’s Plans for Restructuring

Pursuant to its demutualization, the CBOT will be converted from a non-stock, not-for-profit corporation into a stock, for-profit corporation. Each member will receive shares of Class A common stock in accordance with an allocation methodology of a share of one of the five series of Class B common stock in the for-profit corporation in respect of each membership held by such member. The shares of Class A common stock will represent an equity interest in the for-profit corporation. Each share of Class B common stock will represent an equity interest in the for-profit corporation and a membership in the demutualized exchange, which, subject to satisfaction of applicable membership and eligibility requirements, will entitle the holder to trading rights and privileges that correspond to the trading rights and privileges currently associated with that holder’s class of membership.

In connection with the restructuring transactions, the membership petition process will be substantially eliminated and a more modern mechanism for initiating and voting on stockholder proposals will be adopted. The board of directors will be streamlined and modernized. In addition, the electronic trading business will be reorganized and consolidated into a wholly-owned subsidiary, Electronic Chicago Board of Trade, Inc. Full members and associate members will be entitled to vote on the restructuring transactions. Full members will be entitled to

---

one vote for each full membership owned and associate members will be entitled to one-sixth of one vote for each associate membership owned. No other class of membership will be entitled to vote on the restructuring transactions.

The restructuring of CBOT is still on the drawing boards and it is another effort by this exchange to deal with the challenges of electronic trading and the globalization of the markets.

### 3.4 Post-Demutualization Models

One of the primary motivations for demutualization of an exchange is to change its governance. In the United States, both securities and commodities exchanges are required by law to have public directors. In 1975, the Exchange Act was amended to provide that the rules of an exchange or association must assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. The *Commodities Futures Act* was similarly amended in 1992 to require exchange boards to provide for a meaningful representation of a diversity of interests. As a result of these legal requirements and for historical and political reasons, exchanges and the NASD have for some time had large boards which are comprised of 20% to 50% public members and the remainder of the board are members of the securities or commodities industries. Further, various constituency groups such as specialists, wire houses, floor brokers, institutional firms and commodities producers are represented on these boards. Independent nominating committees select board members. In addition, industry committees play a large role in exchange decision making.

After exchanges demutualize, they become more like other for-profit corporations where large investors may select board members and professional managers become the key decision makers. It is planned that their boards will become smaller and more focused on the profitability of the exchange, rather than the interests of members. Under CME’s new governance, the board has been reduced from 39 to 19 members and will be further reduced to 10 members. Class B shareholders, representing the interests of members rather than owners, will have voting rights to elect only about 10% of the new board. Another example of governance change is at NASDAQ, where Warren Hellman of
Hellman & Friedman LLC, a private equity investment firm that made a significant investment in NASDAQ, was elected to the board in May 2001.

Most exchanges have conducted their demutualizations as private placements, but plan to make public offerings when such an offering is feasible as a regulatory matter and when market conditions permit. NASD, for example, has stated that it will sell by 30 June 2002 those shares of common stock it owns (other than shares underlying its warrants), subject to market conditions and its ability to obtain a fair price. But NASDAQ cannot become an independent public corporation until its registration as an exchange is approved by the SEC.

Whether exchanges can be transformed into ordinary public companies is an interesting question. Exchanges are much more than marketplaces for trading securities and commodities. They are quasi-public bodies that function as SROs. In the United States and elsewhere, they are treated as national champions.

If an exchange becomes an ordinary public company it will become subject not only to the advantages of public ownership, but also to the perils and burdens of such a business, and this is an unaccustomed mode of operation. Publicly-owned exchanges will have to make fuller disclosure of their financial condition and business operations than they do today and they will become subject to the pressures of investors to realize shareholder value. They will have to learn to deal with security analysts. Executives might become overly focused on stock price and begin to follow short term instead of long term strategies. They could become the targets of a hostile takeover initiative or a bidder in a losing acquisition effort. This already happened with respect to the OM Gruppen bid for the London Stock Exchange. If there is a market break and the stock price of an exchange falls this could accelerate investor loss of confidence in the market generally. Many exchanges have a smaller capitalization than some of their members and listed companies, but they have a mystique that places their trading activities on the newsscreens every day. As public companies struggling for profits and market share exchanges could lose that mystique. However, that may be the price of survival in the stock markets of the future.
The Structure of a Demutualized Exchange—The Critical Issues

David Holthouse

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

---

1 National Manager, International Affairs, Australian Stock Exchange.
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.

---

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, and for such committees to:

---

4 ASX has an audit committee and a combined nomination and remuneration committee.
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, 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 or for the exchange to pay compensation to brokers for loss of transferability of their trading rights.

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.

---

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.
5.1 Structure of Exchanges

5.1.1 Mutuals and Share Companies

The legal forms that traditional exchanges have commonly adopted is that of a company limited by guarantee or company limited by shares. Even in those cases where the legal form of an exchange is that of a company limited by shares, the essential character of the organization and operation of the exchange typically resembles that of a cooperative or mutual enterprise.

The distinguishing feature of a mutually-owned exchange is its cooperative structure of governance. The owners of the enterprise, its decision-makers and the direct users of its trading services are the same persons: the member broking firms. Decisions are usually made on a one-member, one-vote basis, and often are made by committees representing the interests of member firms. In a true mutual, ownership rights are not freely transferable and may terminate with cessation of membership. Where a shareholding structure is used, the company is typically nonpublic and share ownership is confined to a small group, usually brokers. Often, a number of independent or public representatives are appointed to the board to offset the self interest of the members.

Within these traditional structures, the exchange is expected to perform regulatory functions such as listing and prudential and conduct

---

1 Director, Corporate Finance, Securities and Futures Commission, Hong Kong, China.
regulation of its broker members. The exchange is in turn regulated or overseen by a statutory regulator or an arm of government.

In contrast, most for-profit enterprises are organized as corporations with share capital under which the owners of the company, its decision-makers and its principal customers may well be three separate groups. The shareholders vest decision-making power for the company in a board of directors who are subject to election and removal by shareholders. Day-to-day decisions are made by the management of the corporation. The voting rights of shareholders are generally commensurate with their economic interest in the company: one share, one vote. Companies limited by shares may raise new capital in a variety of ways and from various sources.2

5.1.2 Demutualization of Exchanges

In recent years there has been a trend for exchanges to convert from not-for-profit member-owned organizations into for-profit shareholder-owned organizations. This process has become known as “demutualization” without strict regard to whether prior to conversion the exchange was truly “mutual” or “cooperative” in nature, or a company limited by shares. The restructuring involves moving from an entity in which ownership of a share or “seat” in the exchange confers a right to trade on, and have some influence over the management of, the exchange, into an entity where ownership rights and trading rights are separate, and where the right to trade confers no ownership or management right.

The trend to demutualize is being driven largely by changes in technology and increased competition. Trading technology is developing rapidly and is expensive to install and maintain. Competition from electronic communication networks (ECNs) and other alternative trading systems offering anonymity and alternative or lower cost structures is drawing volume away from traditional exchanges. These developments are forcing traditional exchanges to become more efficient in all activities, including in their decision-making processes.

The conventional rationale for public companies limited by shares is profit maximization. It has been said that the single overriding objective shared by all listed public companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders’ investment. A public company is able,

---

2 Part 5.1 is based on an extract from the Issues Paper on Stock Exchange Demutualization prepared by the IOSCO Technical Committee, June 2001.
and under some pressure, to distribute profits to its owners. For-profit enterprises are said to respond to a changing environment quickly, and engender a proprietorial sense in shareholders and holders of stock options (e.g. management).

Public companies are disciplined by competition from other companies and it is this competition which forces the creation of mechanisms to efficiently monitor the performance of management. Ownership is seen as a key factor in determining the ability of a company to respond to market and regulatory developments. Under a mutual governance structure the exchange is focused primarily on how its operations affect the personal or business interests of each member stockbroker. External ownership of a public company enables it to focus on the requirements of the exchange as a business and increase its capacity to make the difficult business decisions required by changing markets, technology and international and domestic competition.

Demutualization is seen as facilitating a response to market and regulatory developments by:

(i) separating rights of ownership from rights to trade and rights to manage;
(ii) removing certain inefficiencies and conflicts of interest which impaired the decision-making process; and
(iii) facilitating capital raising and alliances or mergers between exchanges.

The decision to demutualize has far-reaching consequences both for the exchange and the traditional manner of its operation, and for the regulatory framework for securities and futures markets.

5.1.3 Multiple Roles of an Exchange

An exchange, demutualized or not, has a number of roles. On the one hand, it is a commercial entity carrying on the business of running an exchange and seeking to protect and promote its business. On the other hand, it plays a critical role in ensuring the integrity and efficiency of capital markets by setting and enforcing rules to regulate its market.

The commercial role of an exchange is to provide services and generate revenues. Exchanges generate revenues from listings, trading services, settlement fees, market data fees, and membership fees. This
revenue is derived directly from those who use or purchase services or information from the exchange: the brokers, intermediaries, listed issuers and information vendors, and indirectly from the investing public.

In performing their role in the capital markets, exchanges are usually viewed as performing public functions and are subject to oversight by the statutory regulator or government. Many are further vested with self-regulatory functions involving regulation of listed companies and member brokers.

5.2 Regulatory Role and Self-Regulation

The typical self-regulatory functions of exchanges are the regulation of trading and listing on the exchange and the regulation of member brokers. Regulation of trading includes admitting new users to the exchange trading system, devising rules for trading and enforcing them. Regulation of member brokers includes monitoring financial resources and conduct. Regulation of listing includes determining qualifications for listing, approving new applicants and monitoring listed issuers ongoing compliance with the listing rules (including continuous disclosure of material information to the market).

5.2.1 Advantages of Self-Regulation

Proponents assert that self-regulation offers a number of benefits.

Self-regulation is best suited to monitor conduct, which lies beyond the practical reach of the law. Trading is a fluid activity and rule books need to deal with matters and concepts which do not lend themselves to statutory language and formal principles of statutory interpretation. Furthermore, self-regulatory rules can be more effective because of the self-regulatory organization’s (SRO) intimate knowledge of the trading environment and market practices compared to government officials and the judiciary. Exchange management and
regulatory staff are closer to the market activity and likely to be better placed to understand what may be going on.³

Market participants may have a strong interest in maintaining the integrity of the markets on which they trade. They stand to lose most if market misconduct leads to lower turnover and causes a migration of liquidity and trading activity.

Presence of market practitioners as self-regulators enhances knowledge, expertise and experience of regulatory authorities and the relevance of regulation. Also, market practitioners learn about the regulatory process by participating in it and thereby enhancing their firms’ internal compliance with their regulatory duties.

Rules imposed by industry peers carry more legitimacy with market participants than those imposed by an external regulator. Self-regulation results in better compliance because self-enforcement is more effective and more readily accepted by the regulated entities. Industry participants bring to the task expertise and intimate knowledge of the complexities of the industry and can respond more quickly to regulatory problems. The rules are likely to be tailored to the conditions of the regulated industry and accepted as being more reasonable compared with prescriptive rules issued by a government agency.

It is more difficult for statutory regulators or governments funded by public revenue to pay the same wages or attract the same calibre of people as private sector regulators funded by the market.

Self-regulation seeks to avoid prescriptive methods of regulation. Prescriptive and legalistic rules limit discretion and are criticized as being largely ineffective particularly when compared with their costs. Also, policies determined by self-regulation may be less susceptible to political influences than those determined by a government regulator.

Self-regulation may result in cost savings for government if supervision of the regulated industry requires fewer resources than direct regulation and less costly regulation overall. It is often more efficient for government to rely on the SRO’s knowledge and expertise than try to reproduce it at a governmental level.

³ Under self-regulation, as the U.S. Securities and Exchange Commission (SEC) pointed out in its report on the National Association of Securities Dealers, Inc. (NASD) (see note 4, infra), it is not sufficient merely for an SRO to have a knowledge of the regulated activity. It must be prepared to act on its superior knowledge in the public interest: “The benefits of self-regulation, however, can be realized only if, among other things, the SRO fully informs itself of the nature and purposes of the full range of activities occurring in the market. The SRO must vigilantly surveil and investigate the activities of market participants and take appropriate action as warranted under the facts and as required by law.”
Finally, self-regulatory organizations are able to modify their rules quickly in response to developments in the business environment. The bureaucratic structures of government agencies and rigid, formal requirements for rule making and enforcement inhibit innovation and quick responses to sudden changes in the environment. Under the pressure of competition, SROs have a strong incentive to keep their rules current and cost effective.

5.2.2 Disadvantages of Self-Regulation

The following reasons are seen as being disadvantages of self-regulation.

Self-regulatory organizations do not have adequate statutory enforcement powers—which may be reserved to the statutory regulator—and therefore lose some credibility in exercising enforcement powers. They may be ineffective altogether for cross-border activities.

Self-regulatory organizations have to serve the interests of various constituencies (members, customers and the general public) and reconciling their often conflicting interests can be difficult and lead to inefficiency. Furthermore, the composition of the membership itself, and their role in the governance of the exchange may give particular constituencies undue influence over critical aspects of the exchange operations, such as oversight of trading and enforcement of rules and regulations, and lead to deficiencies in the performance of these functions.

Self-regulatory organizations are often in a monopoly position and may seek to preserve and enhance that position to the detriment of members, customers and the general public. Alternatively, as membership organisations they may regulate the market they operate to their own advantage and contrary to the public interest. An SRO may use its regulatory power to impose purely anti-competitive restraints as opposed to those justified by regulatory needs. Similarly, the SRO may resist change in the regulatory pattern because of vested economic interests in its preservation or insufficient knowledge of newly developing market conventions or investor needs.

Self-regulatory organizations may be required to supervise intermediaries who have no interest in the markets the SRO operates (such as investment advisers who are not licensed to trade on the exchange), again resulting in conflicts of interest between those persons and intermediaries who are members of the exchange. This may also give rise to arguments as to the proper apportionment of costs between different classes of intermediaries.
The structure of government regulation plus SRO is duplicative and costly. If there are several SROs with overlapping jurisdictions, their independent licensing, market surveillance and enforcement activities may further duplicate each other and force market participants to incur unnecessary time and costs in complying with different regulatory regimes.

Competition and innovation may be stifled if every exchange SRO is expected to perform the full range of SRO functions. Performance of all functions may be uneconomic and irrelevant for smaller niche markets. However, not to require full SRO functions in every case creates inequality and increases the administrative burden of the statutory regulator in discharging its monitoring and supervisory functions.

The combination of fulfilling self-regulatory and commercial goals splits the SRO focus such that it excels at neither. The potentially conflicting goals also inhibit the SRO ability to raise capital.

5.3 Public Policy Objectives of Stock Market Regulation

The public policy objectives of securities regulation are generally common to most jurisdictions. The Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions (IOSCO) succinctly state these objectives to be the protection of investors, ensuring that markets are fair, efficient and transparent, and the reduction of systemic risk.

Arguably, the underlying objective of stock market regulation is ensuring market integrity such that users will have confidence in using the markets. This means adopting processes that result in markets being transparent, users being treated fairly, the price formation process being reliable and markets being free of misleading, manipulative or abusive conduct.

In the report of its investigation of NASD and the NASDAQ Stock Market (NASDAQ) in 1996, the SEC’s view of the standard for a self-regulatory organisation is clearly expressed: “While self-regulation benefits from the knowledge, insight and expertise brought by industry participants it must give primacy to the fundamental purpose of regulation of the securities markets: the protection of investors and the public interest.”

---

4 Report pursuant to Section 21(a) of the Securities Act of 1934 regarding the NASD and the NASDAQ Market, Securities and Exchange Commission, CCH, at 88, 292-362 (6 August 1996).
Part I: Issues Involved in Stock Exchange Demutualization

As a regulatory body NASD’s most important constituency was the investing public, not listed companies or broker-dealers. The report states that there is a tendency for a regulated industry to influence its regulator to protect the industry’s proprietary interests. It must guard against the efforts of any one segment of its membership to assert undue influence over its regulatory functions and processes. The public interest must be the predominant concern. Failure of an exchange to take appropriate action in circumstances where some action is dictated by the facts must constitute a failure by an SRO to meet its statutory obligations and its public interest mandate as an SRO.

The characteristic mode of the regulation of securities and futures markets that has emerged to overcome the weaknesses of self-regulation is a system of co-regulation. Under this system SROs generally assume the role of co-regulator with the government regulatory authority to protect investors and the public interest, promote just and equitable principles of trade and prevent fraud and manipulation. The government regulatory authority oversees the SRO and exercises statutory powers, often including among others its own rule making, powers to compel testimony and production of documents, and sometimes prosecution.

5.4 Why Should Demutualization Require a Reassessment of SRO Functions?

It is recognized that exchanges, which have historically operated as self-regulatory organizations, are subject to conflicts of interest. Conflicts arise because the members are being asked to set rules in the public interest that may negatively affect their own commercial interests and monitor and enforce rules against each other.

A major weakness of self-regulation is the inherent potential for it to favour the interests of the broker members over those of the investing public. Because SROs are left directly in charge of the implementation of a program of government and public policy, and are themselves owned or controlled by the industry participants who are the objects of regulation, self-regulation raises the distinct possibility of inadequate enforcement of rules and standards, and concerted anti-competitive conduct in opposition to the public policy goals. The SRO may, in ways that are not readily apparent to outsiders, subvert the regulatory goals to its own business goals and, by establishing a façade of self-regulation, give the impression of a properly regulated industry.
Demutualization may lessen some of the SRO conflicts. Where demutualization leads to a separation of the owners of an exchange from its users, the interests of the owners may act as a constraint on actions that would benefit the interests of the member firms. The more the shareholder base looks like the public as a whole, the greater this effect is likely to be, as the shareholder interest and the public interest will arguably tend to converge. Furthermore, where a reputation as a fair and efficient market is seen as a competitive advantage (or the lack of one as a significant disadvantage), a for profit exchange may have a greater incentive to devote more resources to activities that enhance that reputation.

More commonly expressed is the concern that a demutualized exchange experiences greater conflicts of interest. Becoming a listed company permits the raising of capital from the public, but brings with it enhanced duties and obligations enshrined in the *Company Law* and listing rules and greater responsibilities to shareholders. These influences combine to accentuate the competitive and profit-making motive. The risk is that a fair and orderly market can remain a goal only if it can pass a commercial cost/benefit analysis. These possibilities are arguably greater still where the SRO is a monopoly with little or no domestic competition.

Conflicts of interest are generally created or increased where the for-profit entity also performs regulatory functions. This is especially the case where the regulatory functions are a cost center rather than a profit center. While not all such possible conflicts will be new, demutualization may exacerbate some of them and this warrants re-examination of issues and regulatory responses. It is necessary to consider carefully whether the commercial pressures and corporate structure of a for-profit entity will undermine the commitment of resources and capabilities of the exchange to fulfill its regulatory and public interest responsibilities to an appropriate standard.

It must, however, also be accepted that commercial considerations are proper considerations for an exchange. Self-regulation is an expensive undertaking, which has considerable public benefits and an exchange must be able to fund the costs of this activity.

5.4.1. Regulatory Concerns with Demutualization

Demutualization may raise regulatory concerns in a number of areas.

Cost cutting on regulatory functions affects the ability to properly perform the relevant function. The exchange competes with other operators providing similar services but who may not carry regulatory
functions. These pressures may affect the proper performance of self-regulatory functions, to the detriment of the market and public interest. In the cost versus benefit equation of “good regulation”, the costs are easier to determine than the benefits. It is not difficult to envisage an exchange being confronted with decisions involving a choice between expenditure on regulatory infrastructure (such as market surveillance or enforcing disclosure of price sensitive information) and financial returns to shareholders.

Lowering of standards to increase business and revenue leads to a race to the bottom. Specifically, a for-profit exchange may wish to lower listing standards in order to attract more companies and increase its fee income; or it may be less willing to take enforcement action against users who are a source of revenue for the exchange.

Conversely, the exchange may seek to use its regulatory powers more vigorously to increase its competitive position (that is, a race to the top), or its revenue. This may arguably include a tendency to apply higher standards or take greater enforcement action than before to generate revenue from fines.

There is an increase in possible conflicts of interest, including those arising between:

(i) The interests of the exchange and the interests of users, which are regulated by it, particularly where the user may be in competition with the exchange business. There is a risk that the exchange will seek to use its regulatory powers against business competitors which are listed companies or trading members in a way which adversely affects the competitors’ business interests. Conversely, the exchange may be tempted to treat more leniently a regulated user, which is a business associate. Competition laws may not adequately address these situations.

(ii) The interests of the exchange and the public interest. In the context of exchanges listing on their own markets, it is widely acknowledged that the public interest is not well served by allowing the exchange to supervise itself. The exchange is likely to face conflicts of interest in admitting itself to listing, monitoring its on-going compliance with listing rules, monitoring the trading in its securities and taking necessary enforcement action. Also, an exchange which is successful in attracting new listings may find its own market capitalization increasing. The exchange may try to increase the value of its
securities by seeking to be included in one or more index funds on the basis of its market capitalization. This is especially problematic if the exchange creates its own index fund and becomes a constituent member.

(iii) The interests of the exchange and the interests of board members, which are associated with regulated users. In the past, concerns have arisen from the fact that representatives of market participants or listed issuers are elected to the board of the exchange. There is a risk that these officers take action on behalf of the exchange which serve their own business interests. These conflicts may be greater where the exchange is a profit-making company, which competes with those business interests.

(iv) The duties of board members who are representatives of the public interest and their duties to shareholders. Public interest board members may find that they face a conflict between actions, which are in the public interest but may not be in the interests of shareholders.

5.5 What Responses are Being Developed to Deal with These Problems?

The regulatory responses to the issues, which arise upon a demutualization have varied from one jurisdiction to another since they depend upon the prevailing legal framework and regulatory philosophy. However, there has been some consistency in dealing with the issues which arise, and the general approach has tended towards retaining the self-regulatory function for the time being and transferring some regulatory functions to the government regulator. While there are no examples where demutualization has led to the removal of all self-regulatory functions, perhaps the United Kingdom is moving closest to doing so.

The regulatory responses can be divided into three headings: first, changes to the governance structure to ensure that the public interest is safeguarded and prevails over commercial interests; second, changes to the corporate structure to ensure that the regulatory function specifically continues to be performed and is adequately resourced; and finally, changes to the regulatory framework to address the conflicts of interest which arise between the exchange upon its listing and between the exchange and persons dealing with it.
5.5.1 Changes to the Governance Structure

The governance structure of an exchange—whether it is a mutual or a for-profit entity—has an important bearing on its regulatory and commercial performance and on its ability to reconcile the competing interests of its managers, owners and the various users and potential users of its services. The structure may affect the delivery of the self-regulatory functions. A failure in this respect may have an adverse impact on the market as a whole and on the capacity of exchanges to deliver the public policy objectives set for them by governments.

Given the additional pressures that arise upon demutualization, the statutory regulator and/or government may provide for one or more of the following rules:

Persons to represent the public interest may be appointed to the board of directors. In some cases, such as in Hong Kong, the government is empowered under legislation to appoint a majority (in Hong Kong, 8 out of 15) of directors. Furthermore, to overcome the potential conflict such directors may face between reconciling the interests of the public and their duties to shareholders, it may be appropriate to provide a statutory remedy.

In Hong Kong, the demutualization legislation imposes an express duty on the exchange to ensure, so far as reasonably practicable, an orderly and fair market in securities or futures contracts traded on or through the exchange. In discharging this obligation it is required to act in the interests of the public, having particular regard to the interests of the investing public. Where these interests conflict with any other interests that the company is required to serve under any other law, the former must prevail. Since this obligation applies to the exchange, all directors (and not only those appointed by government) are placed in the same position. Furthermore, a statutory indemnity has been provided for the exchange and its officers to remove any potential liability they may have as a result of giving priority to the public interest.

Methods to control the abuse of any monopoly position, including the requirement that changes to fees imposed in the exchange capacity as an exchange should be subject to approval. In Hong Kong, the legislation requires that in considering any such increase, the Securities and Futures Commission (SFC) must have regard to the level of competition, if any, in Hong Kong for the matter for which the fee is imposed, and the level of fees imposed by any similar body in or outside Hong Kong for the same or similar matter.
Oversight by a statutory regulator (as in Hong Kong) or a parliamentary committee (as in Australia) may be provided. Australian legislation requires the Australian Stock Exchange (ASX) to file a report each year and to answer questions in relation to its operations.

Share ownership may be limited (with or without scope for a waiver of those limitations by the statutory regulator or government). In Hong Kong, the legislation provides that no person and his associates may exercise or control the exercise of 5% or more of the voting rights in the exchange unless authorized by SFC. Authorisation is likely to be given in the context of share issues for the purpose of entering into alliances. To ensure that any holding company of an exchange does not dispose of some or all of its shareholding to a third party, it may also be appropriate to require that prior regulatory approval be obtained.

Appendix 1 contains Chapters 4 and 5 of *Hong Kong Exchanges and Clearing Limited (HKEx): Reinforcing Hong Kong's Position as a Global Financial Centre*, a policy paper written by the Financial Services Bureau of the Government of Hong Kong Special Administrative Region of the People's Republic of China in July 1999, which outlines the business and regulatory framework proposed for HKEx following demutualization. These chapters describe in more detail some of the checks and balances put in place Hong Kong to address the conflicts of interest, which were seen to arise.

### 5.5.2 Changes to the Corporate Structure

Changes may be made to the corporate structure of a group to ensure that the regulatory function continues to be properly performed (i.e., is carried out independently from, and is not compromised by, its commercial operations) and is adequately financed.

These actions often involve transferring some or all of the regulatory function to a separate entity\(^5\) such as:

\[
\begin{align*}
(i) \ & \text{another group company with an independent governance structure and budget (as in the NASDR/NASDAQ and ASX models);} \\
(ii) \ & \text{another self-regulatory organization (or giving the choice to}
\end{align*}
\]

\(^5\) For a detailed analysis of the advantages and disadvantages of a number of options in this area, see *Reinventing Self-Regulation*, White Paper for the Securities Industry Association’s Ad Hoc Committee on Regulatory Implications of Demutualization, 4 January 2000.
contract out the performance of the functions to another SRO or retaining it in-house but securing its performance in various ways); or

(iii) the statutory regulator.

In the second case, an assessment must be made of the capacity of the company and its officers to which the functions are transferred to properly perform them. This may require an assessment of various factors, including: whether the applicant has adequate arrangements in place to operate the market and settle and clear trades, supervise the market, protect retail investors (including compensation funds), and has sufficient resources generally to adequately carry on each of these functions.

Even in jurisdictions where the commitment to self-regulation is strong enough to ensure that there is presently no urge to transfer the regulatory functions to the statutory regulator, it is important to ensure that any restructuring is seen to achieve true independence. Unless the public perception is one of genuine independence then the solution is unlikely to last and pressure will mount for a complete transfer of responsibility to the statutory regulator.

Ensuring adequate resourcing of the regulatory function may also involve imposing capital adequacy requirements or requiring the establishment of reserves, much as for financial intermediaries. There is commonly no requirement for an exchange simply to have sufficient financial resources to conduct its regulatory functions in an efficient manner. Arguably such a requirement is desirable. In the NASD case, the SEC was able to direct the expenditure of sufficient resources to particular areas of regulation.

5.5.3 Conflicts of Interest Upon Listing and Over-Regulation of Users

It is now widely accepted that because of the obvious conflicts of interest involved it is not appropriate for a self-regulatory exchange to be responsible for its own listing or supervising its own compliance with the listing rules and the trading in its securities. It is less obvious what should be done with conflicts arising between the exchange and other users of the exchange. However, these may involve treating a business competitor—to give an obvious example, a listed company or broker setting up a new trading or clearing system—more harshly or a business
associate more leniently than would otherwise be the case. In such cases,
powers may be needed to step into the shoes of the exchange and
discharge the relevant regulatory function.

In Hong Kong, the demutualization legislation provides that
whenever the SFC is satisfied that a conflict of interest exists or may arise,
or has existed and may be repeated, between the interests of the exchange
and the interests of the proper performance of a regulatory function, the
SFC may by notice direct the exchange to take steps specified in the notice
(including steps in relation to any of its affairs, business and property) for
the purposes of remedying the conflict or the matters occasioning the
conflict. The exchange may appeal to the Chief Executive in Council but
the notice takes effect immediately.6

It can be presumed that in such instances of conflict any third party,
which feels it is being prejudiced, will make this known to the statutory
regulator. However, it can also be assumed that a business associate of
the exchange being given a sweet deal by the exchange will not be so quick
to announce it. Furthermore, there may be some concern that users of
the exchange will be tempted to complain too readily that conflicts of
interests arise and that the exchange becomes increasingly unable to
exercise its normal regulatory and disciplinary functions.

While responsibility for stepping into the shoes of the self-regulatory
organizations and exercising relevant functions may be assumed by the
statutory regulator, it would be possible for the regulator to appoint
another person to undertake this function on its behalf.

5.6 Conclusion

A number of new regulatory issues arise when a stock exchange
demutualizes. Among other things, it is necessary to review the self-
regulatory functions, which are performed. There are good reasons for
exchanges to continue as SROs, but some changes will usually need to be
made to the corporate and governance structure of the organization to
ensure that the self-regulatory function continues to be properly
performed and that the public interest is safeguarded.

While self-regulation is firmly accepted as a primary mechanism
for the regulation of the securities industry, it needs to be recognized that

6 Section 14, Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555).
it also poses risks for the implementation of public policy objectives in the industry: the risk of uneven enforcement, capture of the regulators by the regulated industry and the creation of barriers to entry or competition. These concerns are not necessarily resolved where a demutualized exchange decides that it is no longer willing to continue to perform all or some of the SRO functions. If nobody is qualified to assume the functions in its place, the government may have to refuse such a transfer. This would no doubt call into question the exchange’s commitment to perform the functions to the same standard as before.

The demutualization of an exchange is not incompatible with self-regulation. The ability of the exchange to meet the standards set for it and deliver key regulatory and public interest objectives depends on a range of factors including the overall regulatory framework, the exchange’s obligations under the law, the formulation, administration and enforcement of its listing and trading rules, its formal and informal arrangements with the statutory regulator, its management structure, the transparency of its decision making processes, its allocation of resources for particular regulatory functions and the experience and quality of its staff.

Arguably, the capacity and the willingness of the statutory regulator to perform its supervisory role is key to the success of the regulatory framework.

5.7 Hong Kong’s Framework: Listing of HKEx and the Framework for Dealing with Conflicts of Interest

Section 13 of the Exchanges and Clearing Houses (Merger) Ordinance sets out the framework for HKEx to become a listed company. The section requires that prior to listing rules and arrangements be put in place to deal with possible conflicts of interest which might arise if HKEx were to be a listed company and to adequately ensure the integrity of the securities and futures markets.

The requirements of Section 13 of the Merger Ordinance were satisfied by drafting a new Chapter 38 of the Stock Exchange of Hong Kong Limited’s (SEHK’s) listing rules and a new Memorandum of Understanding between the SFC, HKEx and SEHK (the Pre-listing MOU). The current version of Pre-listing MOU—which includes, in appendices, Section 13 of the Merger Ordinance and Chapter 38—is set out in full in Appendices 2, 3 and 4 of this chapter. As contemplated by the new
Chapter 38, the SFC established a framework within which to exercise its new listing related powers and functions (including the establishment of two new listing related committees, namely the SFC (HKEC Listing) Committee and SFC (HKEC Listing) Appeals Committee, which are designed to mirror similar committees within SEHK. At the same time, the SFC put in place a framework to exercise new powers and functions given to it by the Pre-listing MOU to deal with conflicts of interest, which may arise between the commercial interests of HKEx and the performance of regulatory functions generally by any HKEx group company—not limited specifically to the listing related functions. These arrangements all entered into effect on 19 June 2000. The Pre-listing MOU—to which is annexed Section 13 of the Merger Ordinance and Chapter 38—is available on the SFC’s, SEHK’s and HKEx’s websites.

The new Chapter 38 deals with a number of matters, which can be divided broadly into three heads.

The first one consists of the powers and functions, rights and obligations of the SFC, SEHK and HKEx in relation to the listing of HKEx. Provisions seek to deal with the most obvious conflict of interest which arises as a result of the listing of HKEx, namely its regulation as an applicant for listing and listed issuer by SEHK, a member of its own group. The approach taken is to provide that the SFC effectively steps into SEHK’s shoes and exercises SEHK’s listing powers and functions in relation to HKEx in place of and to the exclusion of SEHK.

Furthermore, the new chapter focuses on the powers and functions, rights and obligations of the SFC, SEHK and, where SEHK is prevented from acting in relation to other applicants and listed issuers by reason of a conflict of interest, such other applicants and listed issuers. It is possible

---

7 The above framework was intended to cover all circumstances where conflicts of interest prevent SEHK from acting with respect to an applicant or listed issuer. However, at the time of drafting staff of the SFC and HKEx were focused specifically on HKEx and its pending application for listing on SEHK’s Main Board. Unfortunately, the documents, which establish the framework are drafted in a way, which makes it hard to argue that SEHK’s Growth Enterprise Market (GEM) is covered by the framework: no express reference to the framework was made in the Rules Governing the Securities on GEM (GEM Listing Rules); and definitions in Chapter 38 of the Main Board Listing Rules and the Pre-listing MOU make reference expressly to the Main Board Listing Rules and not to GEM. As Chapter 38 of the Main Board Listing Rules and the Pre-listing MOU are the source of SFC’s powers and functions as a front line regulator in the event of SEHK facing a conflict of interest, it is arguable that technically the SFC cannot deal with GEM without equivalent provision being made for that Board. The Pre-listing MOU has therefore recently been amended to cover GEM and a new Chapter 36 has been inserted in the GEM Listing Rules which is substantially similar to Chapter 38 of the Main Board Listing Rules. While for reasons of simplicity the rest of this section refers to Chapter 38, readers are asked to have in mind that similar rules will also now appear in Chapter 36 of the GEM Listing Rules.
that conflicts between business interests of the HKEx group and regulatory functions performed by SEHK will arise whenever SEHK is dealing with a listed issuer which is either a business competitor or a business associate of HKEx. The aim is to try to avoid a situation where SEHK treats a regulatee which is a business competitor of HKEx more stringently than usual, or a regulatee which is a business associate of HKEx less stringently than usual. In any case of conflict or potential conflict of this kind, agreed procedures contained in the Pre-listing MOU will take effect.

Finally, the Chapter 38 provides the framework within which SFC will exercise the listing functions and powers. For reasons of fairness to HKEx and to be seen to be exercising listing powers and functions in a way similar to that which applies to other applicants for listing and listed issuers, the SFC’s listing framework mirrors as closely as possible that set out in the SEHK listing rules. The appropriateness of this approach is confirmed when one recognises that SFC may have to deal with applicants for listing and listed issuers other than HKEx—when SEHK would have a conflict of interest in exercising its regulatory powers and functions which makes it inappropriate for SEHK to exercise those functions—and that to provide different listing structures would be confusing for the market and increase the chance of potentially different outcomes. The framework therefore provides for the establishment of the new Committees mentioned above, and the delegation to them and other persons of powers and functions of the SFC equivalent to those delegated by SEHK to the SEHK Listing Committee, SEHK Listing Appeals Committee, SEHK Listing Division and the Chief Executive of SEHK.

The Pre-Listing MOU contains arrangements designed to ensure the integrity of the securities and futures market and the compliance by HKEx with its obligations as a listed company. In relation to the first category, the MOU includes provisions to address, among others, conflicts of interests and preferential treatment of HKEx. In contrast to relevant provisions of Chapter 38 of the listing rules described above, which deal with conflicts of interest or potential conflicts of interest in listing matters only, the intention here is to catch conflicts of interest and potential conflicts of interest between business interests and regulatory interests affecting the performance of regulatory functions by HKEx group companies in all regulatory areas. This would include the exercise of regulatory functions by SEHK and HKFE (or their respective subsidiaries) in relation to their Exchange Participants, and by HKSCC (or its subsidiaries) in relation to Clearing Participants.
The procedures for dealing with conflicts of interest require HKEx to put in place a system to ensure that staff discharging regulatory functions can identify conflicts or potential conflicts between business interests and regulatory interests and refer them to a Conflict Committee comprising senior executives of the HKEx group. The Conflict Committee will then refer to the SFC all cases except those which they consider give rise to no conflict or potential conflict of interest. The first point of contact and decision taking level within the SFC will be with the so called “SFC Representatives,” being persons granted delegated powers by the Commission for this purpose. One or more SFC Representative(s) will make a decision as to whether any HKEx proposal for ensuring the proper discharge of regulatory functions is acceptable (in which case HKEx may proceed to handle the matter) or, where appropriate, may determine that the SFC should intervene and exercise the powers given to it under those procedures. If HKEx disagrees with any determination resulting in the latter outcome, it may appeal to the Commission, who will be asked to hear argument from both HKEx and the relevant SFC Representative(s), and then make a determination and issue a written decision which will be binding on both parties.

In all circumstances involving the exercise of a regulatory function where the SFC Representatives or the Commission have determined that it is inappropriate for any HKEx group regulator to act, the SFC may ask for information, give a direction to the regulator concerned or step in and exercise the relevant regulatory powers and functions itself in relation to that matter.

The Pre-listing MOU also sets out administrative and other procedural arrangements to assist SFC to deal with HKEx as a listed company. A number of points are worth noting. First, in order to ensure HKEx is treated no differently from other listed issuers it is intended that the SFC will maintain a dialogue with staff of the Listing Division in order to obtain relevant information regarding SEHK’s normal practices and procedures. Secondly, it is not intended that SFC shall necessarily assume all SEHK’s listing functions in relation to HKEx.

With respect to listed issuers, SEHK exercises listing-related powers and functions both as a regulator and as a securities exchange. It is intended that only the former powers and functions will be exercised by the Commission, and that SEHK will continue to exercise the role of an exchange (which involves, for example, SEHK being the primary source of public information regarding HKEx as a listed company—thus HKEx will continue to file multiple copies of annual and interim financial statements with SEHK, and the SEHK SDI Unit will continue to be the
recipient of returns under the *Securities (Disclosure of Interests) Ordinance*) notification regarding HKEx. Furthermore, the Pre-listing MOU provides that SEHK shall exercise its normal regulatory functions with respect to HKEx in relation to any particular matter or decision that the Commission confirms in writing gives rise to no conflict of interest.

Where the SFC exercises listing-related functions in place of SEHK under *Chapter 38* of the listing rules and the Pre-listing MOU, the proposed SFC listing framework contemplates that the SFC’s Executive director of Corporate Finance and certain other staff of the Corporate Finance Division—to be known as the SFC (HKEC Listing) Executive—will take the majority of day-to-day actions and decisions that would otherwise be taken by the SEHK Listing Division. The actions and decisions of the SFC (HKEC Listing) Executive will be subject to review by the SFC (HKEC Listing) Committee and SFC (HKEC Listing) Appeals Committee, in much the same way as actions and decisions of the SEHK Listing Division are subject to review by the SEHK Listing Committee and SEHK Listing Appeals Committee.

The SFC (HKEC Listing) Committee consists of four Executive directors of the Commission (namely those other than the Chairman of the Commission and the Executive director of CF) and four market participants namely. The SFC (HKEC Listing) Appeals Committee consists of the Chairman of the Commission and the nonexecutive directors of the Commission.

The Appendix 1 below contains Chapters 4 and 5 of *Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong’s Position as a Global Financial Centre—A Policy Paper* written by the Government of the Hong Kong Special Administrative Region of the People’s Republic of China in July 1999, which outlines the business and regulatory framework proposed for HKEx following demutualization.
APPENDIX 1:
Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong’s Position as a Global Financial Centre—A Policy Paper

CHECKS AND BALANCES FOR PUBLIC INTERESTS

Public Functions of Hong Kong Exchanges and Clearing (HKEC)

While the HKEC will be a profit-driven commercial entity, it will also be a key strategic economic asset of Hong Kong. The trading and clearing functions of the securities and futures markets will be centralized in HKEC. Its stock market will inherit from the SEHK the monopoly to operate an exchange-based primary market in Hong Kong. It will also own the only futures exchange and all the clearing operators in Hong Kong. HKEC’s performance will have a direct bearing on the success of Hong Kong as a global financial centre.

The role of HKEC in safeguarding the integrity and stability of the financial system of Hong Kong will be crucial. The integrated clearing and settlement unit under HKEC will be one of the most important components of the financial infrastructure of Hong Kong. HKEC has the responsibility to ensure that the risks of the market are properly managed and reduced as far as possible. As witnessed in other markets, the clearing unit is becoming an increasingly technology-intensive operation, making important contributions to the further enhancement of the overall efficiency and stability of the market. Traders, investors and market operators have been increasingly demanding as to the performance of the clearing unit in terms of integrity, reliability and efficiency. Any material failure of the clearing unit would be detrimental to any market, its reputation as well as the confidence of the market users and investors.

The Framework of Checks and Balances

All in all, it is important that the commercial and public objectives of HKEC are properly balanced and that its clearing unit operates in a prudent manner taking risk management and infrastructure
development as its prime objectives. To ensure that HKEC will be able to live up to this important mandate, strike an appropriate balance between its different objectives and functions, and not abuse its monopoly status to the detriment of the market and investors, a comprehensive framework of checks and balances needs to be put in place.

This will be built on the basis of the current regulation over exchanges and clearing houses provided for under the various securities-related ordinances including the Securities and Futures Commission Ordinance, the Securities Ordinance, the Stock Exchanges Unification Ordinance, the Commodities Trading Ordinance, the Commodities Exchanges (Prohibition) Ordinance and the Securities and Futures (Clearing Houses) Ordinance. In addition, a number of specific measures are proposed to address issues that arise primarily from the proposed demutualization and merger.

Corporate Governance

As HKEC will be a commercial entity, its board will have a fiduciary duty to its shareholders to promote the interests of the company. It is neither appropriate nor practicable to maintain supervision over HKEC at a micro-level. It is therefore important that there is an appropriate corporate governance structure for HKEC to ensure that HKEC will be run properly from both the public and commercial perspectives and be able to strike a right balance where these two objectives conflict with each other. Some of the more salient features include the composition of the board, the designation and removal of the Chairman and directors as well as the function and responsibilities of its senior executives. Chapter 5 gives more details in this area.

Prevention of Abuse of Monopoly Status

As a commercial service provider, HKEC is entitled to charge for its services at a profit. Such charges and fees include, inter alia, listing fees, trader admission fees, annual/monthly trading fees (i.e., fees collected from traders for access to the trading facilities of HKEC), transaction fees, clearing fees and charges for trade data and other market information. For some of these fees and charges which concern services or products which HKEC provides in a monopolistic environment, the absence of local
competition may create the possibility of abuse by HKEC by charging unreasonable and excessive fees, which if left unaddressed will not only be unfair to the market users and investors and lead to market inefficiencies but will also reduce Hong Kong’s competitiveness internationally.

At the moment, fees and charges of the two Exchanges and HKSCC are set out in their respective rules. The making of or changes to these rules require the approval of the SFC. We believe this system will provide a reasonable safeguard against abuse and at the same time allow sufficient flexibility in implementation which is essential given the diversified business and product base of HKEC. In exercising such approval power, the SFC will develop non-statutory guidelines setting out the factors to be taken into account in considering the level of fees and charges proposed by HKEC. These factors will include, among other things, the comparative transaction costs of Hong Kong and other markets. As a matter of general principle, the level of control should be inversely proportional to the degree of competition available in the local market in respect of the particular services provided by HKEC. For services which are already subject to adequate market competition, there would appear to be no apparent need for SFC supervision as the risk of abuse is most unlikely.

It should also be noted that with the removal of the membership structure following demutualization of the exchanges, the level of commission charged by traders should be a matter essentially between traders and their clients.

**Risk Management for the Market**

As noted above, risk management of the clearing unit is an important function of HKEC that will have profound implications for the rest of the financial system. To ensure that HKEC will perform such function in a prudent manner and that risk management-related decisions will not be unduly affected by profit-related considerations, the policy-making function for the clearing unit will be entrusted to a high-power, independent governance committee within HKEC. The committee should be chaired by the Chairman of HKEC personally and comprise a majority of external board members of HKEC, including representatives of market regulators including the SFC and the Hong Kong
Monetary Authority, relevant market experts and public interest representatives. The decision of the committee will prevail unless overruled by, say, a two-third majority of the Board of HKEC. On matters of fundamental importance to the risk management function, the decisions of the committee will require the consent of the SFC. The power and constitution of this committee will be spelt out clearly under the law and repeated in the constitution of HKEC.

**Shareholding Limit**

A shareholding limit of 5% will be put down in the law to prevent control of HKEC by any individual parties or parties acting in concert. The limit can be waived by the SFC in consultation with the Financial Secretary where it can be demonstrated that an exemption is in the interest of the public and the market, such as under an equity alliance with an overseas exchange. Conditions may be attached to such exemptions where deemed appropriate. In addition, any changes in the corporate structure involving changes in the equity ownership of the HKEC’s subsidiaries will require the approval of the SFC in consultation with the Financial Secretary.

**HKEC as a Listed Company**

HKEC as a listed company on its own stock market will be regulated by the SFC to avoid conflict of interest and to ensure a level playing field between HKEC and other listed companies which will be subject to the listing rules administered by HKEC.

**A Streamlined Governance Model**

The Principle

HKEC has both commercial and public interests. The primary consideration in designing its corporate governance structure is to ensure that these interests are properly balanced. It should afford sufficient protection for the public interest vested in HKEC on the one hand and provide the necessary flexibility and incentive for HKEC to pursue its commercial interest on the other.
In arriving at the proposed model below, it is recognised that as the ownership of HKEC becomes more diversified through listing and trading of its shares on the market, a higher proportion of the members of the board of HKEC should be representatives of the shareholders of HKEC, whose interests should be consistent with the interests of HKEC as a whole. This means that the board composition of HKEC has to be adjusted as its ownership diversifies.

The Business Structure of HKEC

After the merger, HKEC will become a public holding company and the Exchanges and the Clearing Houses will become its wholly-owned subsidiaries. Chapter 3 sets out the business and operation structures of HKEC, including the functions of the Board and the main BUs and administrative and functional departments under HKEC. This Chapter focuses on the structure of the board of HKEC and the various governance committees and consultative panels.

Formation of HKEC

As a party to the merger, HKEC is required under the law to exist prior to the circulation of the scheme of arrangement documents, which is expected to take place around mid-August 1999. At its inception, HKEC will have no substantive business. In fact, there are limited functions that need to be performed by the HKEC board at this particular stage, apart from the legal functions required under the law and the Takeovers Code to complete the merger process and the preparatory work for the transitional phase after voting by members of the two exchanges but before the merger actually takes place (which is subject to the enactment of the enabling legislation). As perhaps the natural and obvious guardian of the interest of HKEC at this stage, it is considered appropriate that HKEC will be incorporated as a private company under the Financial Secretary Incorporation. After the merger, the government will cease to hold any shares of HKEC, or at most maintain only a deminimized shareholding.
The HKEC Board

The HKEC board must balance two main interests, namely the shareholders’ interests, and the market and public interests. The design in the evolution of the board structure as detailed below also takes into account the consideration that as the ownership of HKEC diversifies over time, the representation of the shareholders’ interests in the board can also be expected to increase. In addition, such evolution also reflects the four distinct phases in the early years of HKEC that require corresponding adjustments in the composition of its board.

The following sets out the preferred composition of the board of HKEC at four different stages (a summarized version can be found as follows).

<table>
<thead>
<tr>
<th>Groups</th>
<th>Preparatory Board</th>
<th>Inaugural Board</th>
<th>Second Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>0 0</td>
<td>6 6</td>
<td></td>
</tr>
<tr>
<td>Public/market</td>
<td>4 7</td>
<td>8 5–8**</td>
<td></td>
</tr>
<tr>
<td>representatives*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CEO</td>
<td>0 0</td>
<td>1 1</td>
<td></td>
</tr>
<tr>
<td>Total board members</td>
<td>4 7</td>
<td>15 12–15</td>
<td></td>
</tr>
</tbody>
</table>

* Market representatives include traders, fund managers and other groups of intermediaries and market-related professionals.

** Depending on commercial and operational needs of HKEC as well as the diversification of shareholding, subject to review in 2001/2002.

** Preparatory board. As noted above, HKEC is legally required to be formally established prior to the circulation of the scheme of arrangement documents. At this stage, the board should be relatively small—comprising four members, including the Chairman, all of whom would be appointed by the government, representing in essence the public and market interests.

** October 1999  Assuming that members of both SEHK and HKFE vote for the merger, three additional directors will be appointed by the government to the preparatory board, one from each of the two exchanges and the HKSCC as representatives of their respective interests in HKEC during the transitional period prior to completion of the merger. Appointment of these directors prior to the voting is considered inappropriate as it may give rise to potential conflict of interests.

continued next page
Appendix 1: Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong’s Position as a Global Financial Centre—A Policy Paper

continued

**March 2000**  
*Inaugural board.* When the merger is completed, the board will be enlarged to include six additional directors to be returned by shareholders of HKEC (i.e., members of the two exchanges). The number of directors to be appointed by the government to the HKEC board representing public and market interests will be increased from seven to eight. The CEO of HKEC would be an ex-officio member of the board, giving a total of 15 directors on the inaugural board.

**2003**  
*Second board.* It is believed that as HKEC matures, the size of its board could be reduced. In addition, as the ownership of HKEC becomes more diversified over time, it is appropriate to increase the representation of shareholder interests on the board, while still maintaining a reasonable representation of public and market interests through directors appointed by the government. Consequently, when the term of the inaugural board expires, the size of the board could be reduced from fifteen to, say, twelve. The number of directors to be returned by shareholders would remain at six (hence accounting for 50% of the board size) and the number of directors to be appointed by the government could be reduced. The CEO of HKEC would remain an ex-officio member of the board. However, depending on the actual commercial and operational needs of HKEC at the time and the pace of diversification of shareholding in HKEC, there may be grounds to maintain the board on a similar scale beyond 2003. The matter should be reviewed in say, 2002, by the board of HKEC before a final decision is made.

**Chairman**

The chairman of HKEC assumes key responsibilities not only for HKEC but also for the wider public interests vested in HKEC. He/she will focus on chairing the board, supervising the CEO and the COO and optimizing relationships with external constituencies at the policy level. The chairman should be nonexecutive to ensure that he/she is best placed to balance the interests of HKEC, its shareholders and the public.

The chairman of the preparatory board will be appointed by the government. For the inaugural board and thereafter, the chairman will be elected by the directors of the board, subject to endorsement by the Chief Executive of the HKSAR. The board will be empowered to remove the chairman on a two-thirds majority. The Chief Executive of the HKSAR may also remove the chairman on grounds of public interest or interest of the investing public. Each term of the chairmanship will last for three years. The serving chairman is eligible for re-election for the
Appendix 1: Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong’s Position as a Global Financial Centre—A Policy Paper

chairmanship next term. The chairman must not stand for election immediately after having served two consecutive terms.

Directors of HKEC Board

The HKEC board will comprise directors to be returned by shareholders, directors appointed by the government and the CEO as an ex-officio director. The preparatory board will also act as the nominating committee, which will be responsible for returning no less than nine candidates for election by shareholders of HKEC as directors of its inaugural board. For the second board and thereafter, both the incumbent board and shareholders of HKEC may nominate candidates for election by shareholders as directors. In the case of nomination by shareholders, such nomination must receive a reasonable level of support from the shareholders either expressed as a percentage of shareholding or number of shareholders.

The four governance committees consist of the Audit, Risk Management, Listing Matters and Users Appeal Committees. The Audit Committee performs the corporate supervision and checking function for the HKEC group of companies as a whole including its subsidiaries. It would be composed of three board members (one of whom would chair the committee) and a number of external experts and market participant representatives. Listing Matters and Users Appeal Committees would be composed purely of external members together with two to three public interest representatives. All governance committees report directly to the board. The Risk Management Committee is distinct in its independent nature commensurate with the important tasks it will perform.

Three consultative panels represent the market participants, one for each of HKEC’s main activities: Cash Market, Futures and Derivatives, and Clearing. Each of these panels would be composed of three board members (one of whom would chair the panel) and a number of external experts and market participant representatives. The consultative panels would also report directly to the board.
### BOARD COMMITTEES AND PANELS

<table>
<thead>
<tr>
<th>Committees</th>
<th>Key Tasks</th>
<th>Composition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance Committees</td>
<td>• review financial statements before board.</td>
<td>• 3 board members (including 1 as chairman).</td>
</tr>
<tr>
<td></td>
<td>• nominate external auditors.</td>
<td>• 3 to 5 external members (appointed by board).</td>
</tr>
<tr>
<td></td>
<td>• monitor the structure of internal controls.</td>
<td></td>
</tr>
<tr>
<td>Risk Management</td>
<td>• review risk management procedures.</td>
<td>• 3 board members (including 1 as chairman).</td>
</tr>
<tr>
<td></td>
<td>• assess changes on minimum capital reserve requirement,</td>
<td>• 3 to 5 external members including cross-market government experts and</td>
</tr>
<tr>
<td></td>
<td>margining levels, counter party risk limit.</td>
<td>public interest representatives (appointed by the board).</td>
</tr>
<tr>
<td>User Appeal</td>
<td>• adjudicate disciplinary matters concerning participants and listed</td>
<td>• 1 board member.</td>
</tr>
<tr>
<td></td>
<td>companies.</td>
<td>• 5 to 6 external market professionals (e.g., lawyers, accountants).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 2 to 3 public interest representatives.</td>
</tr>
<tr>
<td>Listing Matters</td>
<td>• adjudicate appeals on listing decisions and other listing matters.</td>
<td>• 1 board member.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 5 to 6 external market professionals (e.g., lawyers, accountants).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 2 to 3 public interest representatives.</td>
</tr>
<tr>
<td>Consultative Panels</td>
<td>• provide market expertise on: international trends; intermediary/issuer/</td>
<td>• 10 members for each committee of which 2 are board members.</td>
</tr>
<tr>
<td>Cash Market</td>
<td>investors needs; technology challenges; new product opportunities.</td>
<td>• selected from representatives of market participants and industry experts,</td>
</tr>
<tr>
<td>Derivatives Market</td>
<td>• act as sounding board for: policy decisions; strategic initiatives;</td>
<td>• selection process to be determined.</td>
</tr>
<tr>
<td>Clearing</td>
<td>major investments.</td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX 2:
Memorandum of Understanding for the Listing of Hong Kong Exchanges and Clearing Limited on the Stock Exchange of Hong Kong Limited

between

Securities and Futures Commission
Hong Kong Exchanges and Clearing Limited

and

The Stock Exchange of Hong Kong Limited

19th June 2000
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

Memorandum of Understanding for the Listing of HKEx on SEHK between:

(1) Securities and Futures Commission of 12th Floor, Edinburgh Tower, The Landmark, 15 Queen’s Road Central, Hong Kong (SFC);

(2) Hong Kong Exchanges and Clearing Limited of 12th Floor, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong (HKEx); and

(3) The Stock Exchange of Hong Kong Limited of 1st Floor, One and Two Exchange Square, Central, Hong Kong (SEHK).

1. INTERPRETATION

1.1 Definitions

1.1.1 Unless the context otherwise requires, the following expressions shall have the following respective meanings:

<table>
<thead>
<tr>
<th>Expression</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listing rules</td>
<td>Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited</td>
</tr>
<tr>
<td>Merger Ordinance</td>
<td>The Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555)</td>
</tr>
<tr>
<td>MOU</td>
<td>This Memorandum of Understanding</td>
</tr>
<tr>
<td>Relevant Ordinances</td>
<td>The Securities and Futures Commission Ordinance (Cap. 24), Part II of the Companies Ordinance (Cap. 32) (insofar as that part relates, whether directly or indirectly, to the performance of functions by the SFC in relation to prospectuses and purchase by a company of its own shares) and part XII of that ordinance (insofar as that part relates, whether directly or indirectly, to the performance of functions by the SFC in relation to prospectuses), the Securities Ordinance (Cap. 333), the Commodity Exchanges (Prohibition) Ordinance (Cap. 82), the Commodities Trading Ordinance (Cap. 250), the Merger Ordinance, the Protection of Investors Ordinance (Cap. 335), the Stock Exchanges Unification Ordinance (Cap. 361), the Securities and Futures (Clearing Houses) Ordinance (Cap. 420), the Securities (Disclosure of Interests) Ordinance (Cap. 396) and the Securities (Insider Dealing) Ordinance (Cap. 395)</td>
</tr>
</tbody>
</table>
1.2 Construction

1.2.1 In this MOU, where the context admits:

(a) words and expressions, the definitions of which are contained or referred to in the Merger Ordinance or the listing rules, shall be construed as having the meanings so attributed to them;

(b) references to statutory provisions shall be construed as references to those provisions as respectively amended or re-enacted or as their application is modified by other provisions (whether before or after the date hereof) from time to time and shall include any provisions of which they are a re-enactment (whether with or without modification); and

(c) words importing the singular meaning include the plural meaning and vice versa and words of one gender include both other genders, and words denoting natural persons include corporations and firms and vice versa.

2. STATUS OF THE PARTIES AND THIS MOU

2.1 Status of the Parties

2.1.1 The SFC is the statutory regulator of the securities and futures markets in Hong Kong. The relevant ordinances include provisions allowing the SFC to oversee the operations of HKEx and SEHK. The Merger Ordinance provides, inter alia, for the SFC to perform certain functions and exercise certain powers in the event of HKEx's listing.

2.1.2 HKEx is a recognized exchange controller and SEHK is a company of which HKEx is the controller.

2.1.3 SEHK is a wholly owned subsidiary of HKEx. It is a recognized exchange company which operates the Stock Exchange of Hong Kong and is the front line regulator of listed companies in Hong Kong.
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

2.2 Purposes of this MOU

2.2.1 Pursuant to section 13 of the Merger Ordinance, HKEx may become a listed company provided that the requirements of the section are complied with. In particular, listing may not take place until the SFC is satisfied that:

(a) rules made under section 34 of the Stock Exchanges Unification Ordinance (Cap. 361) adequately deal with possible conflicts of interest that might arise if HKEx were to be a listed company; and

(b) HKEx has entered into arrangements with the SFC that adequately ensure, inter alia, the integrity of the securities and futures market on the relevant Exchange Company and the compliance with obligations as a listed company which would fall on HKEx if it were to become a listed company.

Section 13(4) of the Merger Ordinance provides that the SFC shall have such powers and functions as are provided for it under rules and arrangements referred to in paragraphs (a) and (b) above respectively. The provisions of section 13 are set out in Appendix A.

2.2.2 HKEx proposes to become a listed company. This MOU sets out arrangements agreed between the parties, as contemplated by section 13 of the Merger Ordinance. SEHK has agreed to become a party to this MOU to facilitate the implementation of those arrangements. The SFC has the powers and functions provided in this MOU.

2.2.3 The parties recognize that it is important that there be consistency of outcome and timing as far as possible between:

(a) SEHK in its administration and enforcement of the Rules of the Exchange in relation to HKEx’s securities and other securities;

(b) SEHK in its administration and enforcement of the listing rules in relation to all applicants for listing and listed issuers other than HKEx (other applicants and issuers); and
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

(c) the SFC in its administration and enforcement of the listing rules in relation to HKEx.

2.2.4 Provisions of this MOU set out the way the parties will relate to each other in relation to:

(a) HKEx’s and other applicants and issuers’ compliance with the listing rules;

(b) SEHK’s enforcement of the Rules of the Exchange in relation to HKEx’s securities and those of other applicants and issuers;

(c) the SFC’s supervision and regulation of HKEx as a listed issuer and, where a conflict of interest arises, other applicants and issuers;

(d) conflicts of interest which may arise between the interests of HKEx as a listed company and companies of which it is the controller, and the interests of such companies in the proper performance of regulatory functions; and

(e) market integrity.

3. LISTING ARRANGEMENTS

3.1 General Powers and Rights

3.1.1 The SFC shall, instead of SEHK, take all actions and make all decisions in relation to HKEx that would be taken by SEHK in the case of other applicants and issuers except in the case of any action or decision in respect of which the SFC states in writing that it is satisfied that a conflict of interest will not arise if that action or decision were to be taken or made, as the case may be, by SEHK.

3.1.2 Without prejudice to the terms of this MOU, the parties shall have the powers and functions, rights and obligations (as the case may be) provided for them respectively in Chapter 38 of the listing rules. The powers and functions of the SFC referred
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

to in this MOU (including those in Chapter 38 of the listing rules) are hereinafter referred to as “SFC (HKEx Listing) Powers”.

3.2 Listing of HKEx

3.2.1 The SFC will receive and consider HKEx’s application for listing on the Stock Exchange of Hong Kong and any pre-application documents. The SFC may, subject to HKEx’s rights of appeal, reject HKEx’s application or approve (with or without conditions) the application. If the application is approved, the SFC will be responsible for the supervision of HKEx’s compliance with the listing rules as a listed issuer.

3.2.2 In relation to HKEx’s application for listing, the SFC will advise SEHK of any administrative steps it reasonably requires SEHK to take on its behalf. The SFC shall not require SEHK to take steps which SEHK would not take with respect to other applicants for listing. SEHK will carry out the administrative steps within the time period and in a like way to that which it would do with respect to other applicants for listing.

3.3 Ongoing Listing Procedures

3.3.1 If HKEx’s application for listing is approved the SFC shall, in relation to HKEx, have all the powers and functions that SEHK has in relation to a listed issuer, except SEHK’s power to make listing rules pursuant to section 34 (1) of the Stock Exchanges Unification Ordinance (Cap. 361). SEHK shall have, and be entitled to exercise, its normal powers and functions in the case of any action or decision in respect of which the SFC has stated in writing that a conflict of interest will not arise if that action or decision were to be taken or made, as the case may be, by SEHK.

3.3.2 The SFC has established a framework for exercising those SFC (HKEx Listing) Powers which are concerned with listing matters. Such framework has been set out in Chapter 38 of
Appendix 2: Memorandum of Understanding for the Listing of HKEX on SEHK

the listing rules. The provisions of Chapter 38 are set out in Appendix 2. The parties acknowledge that as Chapter 38 constitutes listing rules it may be changed pursuant to section 34 of the Stock Exchanges Unification Ordinance (Cap. 361). The version of Chapter 38 appended hereto is attached for ease of reference only and any change to Chapter 38 after the entry into force of this MOU will not constitute an amendment of this MOU requiring an Addendum.

3.3.3 SEHK will not, unless requested by the SFC and agreed by SEHK:

(a) be bound to monitor the listing rules in relation to HKEx;
(b) enforce the listing rules in relation to HKEx; or
(c) except as provided in clause 5, make any referral under its statutory obligations to the SFC in relation to HKEx.

3.3.4 SEHK will nominate the person or persons in the Listing Division who:

(a) from time to time, may be contacted by the SFC to discuss Listing Rule policy or administration or any other matters in relation to HKEx as a listed issuer (e.g., enforcement issues or general waiver policy); and
(b) will give the SFC the information referred to in clause 3.5.1.

3.3.5 All communications and contacts between the Listing Division and the SFC in relation to any matters referred to in clause 3.3.4 are deemed confidential and shall not be disclosed to any third party by SEHK (other than its internal and external legal or other professional advisers for the purposes of obtaining advice, or under compulsion of law) without the SFC’s prior written consent. The SFC acknowledges that the relevant persons in the Listing Division may also perform functions for HKEx as the parent company of SEHK. However, the Listing Division shall not disclose the
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

communications and contacts with the SFC in relation to HKEx to other personnel of HKEx other than the Chief Executive of HKEx who shall thereupon be subject to the same confidentiality obligation.

3.3.6 SEHK will take action as required by the SFC in relation to:

(a) the admission to, suspension or removal from, listing on the Stock Exchange of Hong Kong of HKEx's securities; and

(b) the suspension or resumption on SEHK's trading system of trading in HKEx's securities.

SEHK will do so within the respective time limits as reasonably prescribed by the SFC or in lieu thereof in a timely manner, and in the way as reasonably prescribed by the SFC or in lieu thereof and to the extent practicable, in a like way to that which it would do with respect to other listed issuers.

3.3.7 In relation to HKEx as a listed issuer, the SFC will advise SEHK of any administrative steps it reasonably requires SEHK to take on its behalf. The SFC shall not require SEHK to take steps which SEHK would not take with respect to other listed issuers. SEHK will carry out the administrative steps within the time period and in a like way to that which it would do in respect of other listed issuers.

3.4 Company Announcement Procedures

3.4.1 The SFC will advise SEHK of any administrative steps it reasonably requires SEHK to take on its behalf in relation to any division of the decision-making and administrative steps involved in HKEx issuing company announcements. The SFC shall not require SEHK to take steps which SEHK would not take with respect to other listed issuers. SEHK will carry out the administrative steps within the time period and in a like way to that which it would do with respect to other listed issuers.
Appendix 2: Memorandum of Understanding for the Listing of HKEX on SEHK

3.4.2 If a document for release to the market is served on SEHK that should have been served on the SFC acting in the place of SEHK as the regulator of HKEx in respect of listing matters, SEHK will:

(a) as soon as reasonably practicable, give the document to the SFC; and
(b) not release or otherwise deal with the document or copy thereof except in accordance with administrative steps specified by the SFC pursuant to this clause 3.4.

However, unless otherwise agreed between SEHK and the SFC, third party disclosures that are made under the listing rules and any of the relevant ordinances (e.g., a notice by any person pursuant to the Securities (Disclosure of Interests) Ordinance (Cap. 396)) are not affected by this clause, and SEHK will deal with any such release in accordance with its normal procedures with respect to listed issuers.

3.4.3 The SFC may specify documents, or classes of documents, required by the relevant ordinances to be served on a securities exchange that will not be subject to this clause 3.4.

3.5 Listing Rule Waiver Procedures

3.5.1 When the SFC receives a Listing Rule waiver application from HKEx, the Listing Division shall at the request of the SFC as soon as reasonably practicable provide the SFC with the following:

(a) access to SEHK’s internal waivers database;
(b) if asked, background papers retained by SEHK in relation to the waiver decisions in (a); and
(c) if asked, advice on SEHK’s policy, or administration, in relation to the relevant Listing Rule.

The above information may be provided wholly or in part by way of a direct data link.
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

3.5.2 Regulatory information given to the SFC in connection with an application for a waiver will be treated confidentially by the SFC.

3.5.3 Waivers granted and not granted to HKEx will be recorded by SEHK in its internal database. The SFC will give SEHK a copy of the entry to be recorded.

3.6 Fees and Expenses

3.6.1 HKEx will pay the SFC the following fees:

(a) in relation to HKEx’s listing application, and ongoing listing, any fees required by the listing rules; and

(b) in comparable circumstances applying to HKEx, any fee that would have been payable to SEHK by other applicants and issuers in connection with their listing on the Stock Exchange of Hong Kong.

3.6.2 The SFC will invoice HKEx and otherwise use the same timing and procedures that SEHK uses in relation to the payment of fees by other listed issuers.

3.6.3 The SFC will pay to SEHK, on written request from SEHK accompanied by adequate supporting information, its reasonable costs and out-of-pocket expenses incurred in performing administrative steps for the SFC hereunder. The aggregate amounts payable by the SFC shall not exceed the amount of the fees it receives from HKEx under clause 3.6.1.
4. CONFLICTS OF INTEREST AND MARKET INTEGRITY

4.1 Conflicts of Interest

4.1.1 Section 13(2)(a) of the Merger Ordinance requires the SFC to be satisfied that HKEx has put in place procedures (detailing among other things the powers and functions, rights and obligations of the SFC and HKEx respectively) to deal with conflicts of interest that may arise between, on the one hand, the interests of HKEx as a listed company and/or the companies of which it is the controller, and on the other hand, the interests of the proper performance of regulatory functions by such companies. The parties have agreed those procedures as are set out in Appendix C.

4.2 Market Integrity

4.2.1 HKEx and the SFC acknowledge that, with the coming into effect of the Merger Ordinance, there is a need to formalize new arrangements as soon as reasonably practicable for the effective discharge of their respective responsibilities in relation to SFC oversight of HKEx and its subsidiaries, supervision of Exchange Participants and market surveillance to reduce any areas of duplication of function, to facilitate a smooth and cooperative working relationship and to enable the SFC more effectively to discharge its statutory obligation of supervision and that the SFC has supplied HKEx with a draft of a proposed Memorandum of Understanding (MOU) covering these matters as a basis of further discussions. The parties agree to work together in good faith and in a spirit of mutual cooperation to consider that draft and to finalize as quickly as reasonably practicable an appropriate Memorandum of Understanding.

4.2.2 In the interim, the parties agree that each of them will continue to observe existing Memoranda of Understanding, arrangements and practices delineating their respective areas
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

of operation and the information-sharing arrangements between them, including those arrived at in an exchange of correspondence in relation to disciplinary arrangements and information-sharing immediately prior to the coming into force of the Merger Ordinance.

5. MARKET SURVEILLANCE

5.1 Where SEHK, in the course of its surveillance of Exchange Participants and listed issuers or as a result of complaints or market intelligence, detects unusual market activity (whether of an Exchange Participant, their representative or clients) involving HKEx's securities which reveals a possible breach of any of the relevant ordinances, business rules or conditions of a license, SEHK will immediately inform the SFC. This clause 5.1 does not require SEHK to undertake surveillance functions or actions which it does not already undertake at the date hereof.

5.2 If SEHK informs the SFC under clause 5.1, it will then inform the SFC of SEHK’s findings.

6. MISCELLANEOUS

6.1 Confidentiality

6.1.1 None of the parties will disclose any confidential information obtained under this MOU to a third party unless:

(a) prior written consent of the other parties is obtained; or

(b) it is required or authorised by law to disclose the information; or

(c) the information has come into the public domain otherwise than as a result of its breach of this clause.
6.2 Strategic Review

6.2.1 A strategic review of this MOU will take place once each year at a place, date and time to be agreed. It will be conducted by senior executive officers of the parties. It will address any matters that any party regards as necessary or desirable to review.

6.3 Operational Meeting

6.3.1 The parties will meet at the request of any party to discuss the operation of this MOU, any systems access, information access, and any other operational matters that any party regards as important to discuss.

6.3.2 Nothing in this MOU should be construed as restricting the ability of the SFC to raise with HKEx, or HKEx to raise with the SFC, any measures that seem necessary or desirable to enhance the operation of this MOU.

6.4 Amendment

6.4.1 If it becomes apparent that it is necessary or desirable to amend this MOU or any Addendum each of the parties will use its reasonable endeavours to agree on appropriate amendments as soon as practicable thereafter.

6.5 General Co-operation and Assistance

6.5.1 HKEx, SEHK and the SFC will provide each other with such co-operation and assistance in good faith as is necessary or desirable to achieve the objectives of section 13 of the Merger Ordinance, this MOU and Chapter 38 of the listing rules.

6.5.2 The parties acknowledge that:

(a) the SFC may determine at any time that it is necessary or desirable to change or supplement the rules in Chapter 38 of the listing rules; or
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

(b) either the SFC or HKEx may determine at any time that it is necessary or desirable to change or supplement the arrangements in this MOU, in order to continue to satisfy the requirements of section 13 of the Merger Ordinance. In such event, the parties will co-operate to ensure that the new or revised rules are made and the new or revised arrangements are entered into. Nothing in this sub-clause shall derogate from SEHK’s general rule making powers under section 34 of the Stock Exchanges Unification Ordinance (Cap. 361).

6.5.3 In the course of exercising its powers and functions under section 13 of the Merger Ordinance, the SFC may request that SEHK (or another company of which HKEx is the controller) perform such administrative tasks on its behalf as the SFC reasonably considers appropriate for the purposes of that section, Chapter 38 of the listing rules, this MOU or any addendum. HKEx shall procure that the relevant company will properly perform such tasks within the respective time limits as reasonably prescribed by the SFC or in lieu thereof in a timely manner, and in the way as reasonably prescribed by the SFC or in lieu thereof and to the extent practicable in a like way to that which it would do with respect to other listed issuers.

6.5.4 In relation to any request of the SFC under paragraph 6.5.3:

(a) the SFC will state in writing that it is satisfied that a conflict of interest will not arise if that task is performed by the relevant company; and

(b) HKEx will inform the SFC if the relevant task is not one which the relevant company would perform with respect to other persons it regulates and the SFC and HKEx will thereupon discuss whether and how the task should be performed.

6.5.5 HKEx shall procure that SEHK shall comply with the provisions of and promptly perform its obligations under this MOU.
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

6.5.6 As soon as reasonably practicable following a request of the SFC:

(a) SEHK will provide to the SFC information relating to HKEx and its securities (and/or where a conflict of interest may exist, those of any company regulated by SEHK) which is in the possession or control of SEHK; and

(b) HKEx will provide to the SFC information relating to holders of voting rights in HKEx which is in its possession or control.

6.6 Effect on Other Arrangements

6.6.1 The Amended and Restated Memorandum of Understanding Governing Listing Matters dated 6 March 2000 between the SFC and SEHK shall have effect subject to any conflicting provisions of this MOU or of Chapter 38 of the listing rules.

6.6.2 In the event of there being any conflict between the provisions of this MOU and/or Chapter 38 of the listing rules and any other arrangements entered into between the SFC and HKEx and/or SEHK with respect to listing matters, the provisions of this MOU and/or Chapter 38 of the listing rules shall prevail.

6.7 SFC May Delegate Powers and Functions

6.7.1 The SFC may delegate its powers and functions under this MOU and Chapter 38 of the listing rules pursuant to section 9 of the Securities and Futures Commission Ordinance (Cap. 24).

7. EFFECTIVE DATE AND TERMINATION OF MOU

7.1 This MOU shall come into force on the date hereof or such other date as may be agreed in writing between the SFC and HKEx.

7.2 This MOU will continue in force until:
Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

(a) HKEx ceases to be a listed issuer for the purposes of the listing rules; or
(b) subject to the Merger Ordinance, all parties agree in writing to terminate this MOU; or
(c) terminated by the SFC pursuant to clause 7.3.

Provided that the termination shall be without prejudice to any rights which any party may have against any other party arising prior to such termination.

7.3 In case of a failure or refusal on the part of HKEx or SEHK to comply fully with the provisions of, or to perform its respective obligations under this MOU, then the SFC may, in its absolute discretion, take any action it considers necessary or desirable, and in particular the SFC may (in addition and without prejudice to its statutory powers) unilaterally terminate this MOU by giving not less than 14 days written notice (which shall include the reason or reasons for such termination) to HKEx and SEHK respectively.

DATED this 19th day of June

SIGNED FOR AND ON BEHALF OF THE )
SECURITIES AND FUTURES COMMISSION )

BY Andrew L.T. SHENG ) Sgd. A. Sheng

authorized so to do by resolution of the )
Securities and Futures Commission )
on 19th June 2000 )
Appendix 2: Memorandum of Understanding for the Listing of HKEX on SEHK

SIGNED FOR AND ON BEHALF OF
HONG KONG EXCHANGES AND
CLEARING LIMITED

BY LEE Yeh Kwong, Charles
authorized so to do by resolution of its
Board of Directors on 14th June 2000

SIGNED FOR AND ON BEHALF OF
THE STOCK EXCHANGE OF
HONG KONG LIMITED

BY KWONG Ki Chi
authorized so to do by resolution of its
Board of Directors on 14th June 2000
APPENDIX 3:
Section 13 of the Exchanges and Clearing Houses (Merger) Ordinance

13. Provisions applicable where recognized exchange controller, etc, seeks to be listed company

(1) In this section—

- “listed company” means a listed company within the meaning of section 2(1) of the Securities and Futures Commission Ordinance (Cap. 24);
- “relevant company” means a company of which the relevant recognized exchange controller is the controller;
- “relevant recognized exchange controller” means a recognized exchange controller which is the controller of the Stock Exchange Company;
- “Stock Exchange Company” means the Stock Exchange Company within the meaning of section 2(1) of the Securities and Futures Commission Ordinance (Cap. 24).

(2) The relevant recognized exchange controller, or a relevant company, shall not become a listed company unless and until the Commission states in writing that it is satisfied that—

a) subject to subsection (3), rules made under section 34 of the Stock Exchanges Unification Ordinance (Cap. 361) adequately deal with possible conflicts of interest that might arise if the relevant recognized exchange controller or relevant company, as the case may be, were to be a listed company; and

b) the relevant recognized exchange controller or relevant company, as the case may be, has entered into arrangements with the Commission that adequately ensure—
Appendix 3: Section 13 of the Exchanges and Clearing Houses (Merger) Ordinance

(i) the integrity of the market in securities or futures contracts traded on or through the Exchange Company concerned; and

(ii) the compliance with obligations as a listed company which would fall on the relevant recognized exchange controller or relevant company, as the case may be, if it were to become a listed company.

(3) Rules referred to in subsection (2)(a) shall make provision to the effect that the Commission shall, instead of the Stock Exchange Company, take all actions and make all decisions in relation to the relevant recognized exchange controller or relevant company that would be taken by the Stock Exchange Company in the case of a company that was neither a recognized exchange controller nor a relevant company except in the case of any action or decision in respect of which the Commission states in writing that it is satisfied that a conflict of interest will not arise if that action or decision were to be taken or made, as the case may be, by the Stock Exchange Company.

(4) By virtue of this section, the Commission shall have such powers and functions as are provided for it under—

a) rules made for the purposes of subsections (2)(a) and (3);

b) arrangements referred to in subsection (2)(b).

(5) Where a fee is payable to the Stock Exchange Company by a person for the taking of an action or the making of a decision which may be taken or made, as the case may be, by the Commission by virtue of subsections (2)(a) and (3), then, notwithstanding any other enactment or rule of law, that person shall pay that fee to the Commission in any case where the Commission takes that action or makes that decision, as the case may be, by virtue of those subsections.
Listing of HKEC

38.01 This Chapter sets out requirements that must be satisfied for the securities of HKEC to be listed on the Exchange. HKEC is the holding company of the Exchange and a recognized exchange controller within the meaning of the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (Merger Ordinance). The exchange is a company of which HKEC is the controller within the meaning of the Merger Ordinance.

38.02 In the context of the listing of HKEC, and as contemplated by section 13 of the Merger Ordinance:

(1) the exchange has included this chapter in the Exchange; and

(2) HKEC and the exchange have entered into a Memorandum of Understanding (MOU) with the commission.

Powers and Functions of the Commission and the Exchange

38.03 Without limitation of the Commission’s general powers and functions in relation to listing matters, the Commission has the following powers and functions in relation to HKEC’s application for listing and status as a listed issuer:

(1) the powers and functions that the Exchange has in relation to an applicant for listing. The Exchange must not exercise powers or perform functions in relation to HKEC’s own application, except in the case of any action or decision in respect of which the Commission states in writing that it is satisfied that a conflict of interest will not arise if that action were taken or decision made by the Exchange;

(2) if HKEC’s application for listing is approved, the powers and functions
that the Exchange has in relation to a listed issuer, except the power to make listing rules. The Exchange must not exercise powers or perform functions that this rule gives to the Commission, except in the case of any action or decision in respect of which the Commission states in writing that it is satisfied that a conflict of interest will not arise if that action were taken or decision made by the Exchange.

38.04 In circumstances where the Commission has stated in writing that a conflict of interest will not arise if an action or decision were to be taken or made by the Exchange, the Exchange shall have, and be entitled to exercise, its normal powers and functions in taking the relevant action or making the relevant decision.

The SFC (HKEC Listing) Committee, SFC (HKEC Listing) Appeals Committee and SFC (HKEC Listing) Executive

38.05 The Commission has established a framework for exercising its listing related powers and functions with respect to HKEC. The framework comprises committees established by the Commission pursuant to section 6 of the Securities and Futures Commission Ordinance (Cap. 24) and persons who will exercise with respect to HKEC applicable powers and functions, in so far as is practicable and applicable, in a like manner to the Listing Committee, Listing Appeals Committee, Listing Division and the Chief Executive of the Exchange, respectively. The relevant committees and persons are:

(1) the SFC (HKEC Listing) Committee, which shall exercise applicable powers and functions equivalent to those of the Listing Committee including applicable powers and functions equivalent to those of the Listing (Review) Committee;

(2) the SFC (HKEC Listing) Appeals Committee, which shall exercise applicable powers and functions equivalent to those of the Listing Appeals Committee;

(3) the SFC (HKEC Listing) Executive, comprising the Executive Director in charge of the Corporate Finance Division of the Commission and members of staff of the Corporate Finance Division of the
Appendix 4: Chapter 38 of the Rules Governing the Listing of Securities on the Stock Exchanges of Hong Kong Limited

Commission, which shall exercise applicable powers and functions equivalent to those of the Listing Division;

(4) the Executive Director in charge of the Corporate Finance Division of the Commission, who shall exercise applicable powers and functions equivalent to those of the Executive Director – Listing and the Chief Executive of the Exchange; and

(5) the Secretary to the SFC (HKEC Listing) Committee and/or to the SFC (HKEC Listing) Appeals Committee, who shall exercise applicable powers and functions equivalent to those of the Secretary to the Listing Committee and/or Listing Appeals Committee.

38.06 The SFC (HKEC Listing) Committee shall consist of all Executive Directors of the Commission (except the Chairman of the Commission and the Executive Director in charge of the Corporate Finance Division) and an equal number of individuals (not being directors or employees of the Commission) with experience of the securities market in Hong Kong appointed by the Commission (each of the latter individuals being a “market representative”). The quorum necessary for the transaction of any business of the SFC (HKEC Listing) Committee shall be three individuals including at least one Executive Director of the Commission and one market representative. Any meeting of the SFC (HKEC Listing) Committee convened to review an earlier decision or ruling of the SFC (HKEC Listing) Committee (i.e., where the SFC (HKEC Listing) Committee is performing a role equivalent to that of the Listing (Review) Committee) shall consist of members who were not present at the meeting which made the earlier decision or ruling.

38.07 The SFC (HKEC Listing) Appeals Committee shall consist of the Chairman of the Commission and the nonexecutive Directors of the Commission. The quorum necessary for the transaction of any business of the SFC (HKEC Listing) Appeals Committee shall be the Chairman of the Commission and two nonexecutive Directors of the Commission or, in the absence of the Chairman of the Commission from Hong Kong, three nonexecutive Directors of the Commission.
Appendix 4: Chapter 38 of the Rules Governing the Listing of Securities on the Stock Exchanges of Hong Kong Limited

38.08 Each of the SFC (HKEC Listing) Committee and the SFC (HKEC Listing) Appeals Committee may elect any of its members to be chairman and may regulate its own procedures and business subject to any directions given to it by the Commission for this purpose. In so doing, each such committee may have regard to (but shall not be bound by) the practices and procedures of the Listing Committee or Listing Appeals Committee as set out in Chapters 2A and 2B, as the case may be. The Chairman of the Commission shall from time to time appoint a person or persons, who may be an employee or employees of the Commission, to act as Secretary of the SFC (HKEC Listing) Committee and/or SFC (HKEC Listing) Appeals Committee.

Rights and Obligations of HKEC as an Applicant for Listing and Listed Issuer

38.09 HKEC as an applicant for listing has all the rights and obligations that any other applicant for listing has, except that the Commission acts in the place of the Exchange.

38.10 HKEC as a listed issuer has all the rights and obligations that any other listed issuer has, except that the Commission acts in the place of the Exchange.

Rights and Obligations of the Commission

38.11 The Commission acting in the place of the Exchange has all the rights and obligations in relation to HKEC that the Exchange has in relation to any other applicant for listing or listed issuer.

Procedures Regarding Forms, Information and Documents

38.12 HKEC must complete any form, application or other document under the exchange listing rules that it gives to the Commission with any necessary adaptation including to reflect that the Commission is acting in the place of the Exchange.

38.13 Where the exchange listing rules require documents or information to be filed with or delivered to the Exchange, such documents
or information shall be filed with or delivered to both the Commission and the Exchange in accordance with any procedures issued by them respectively from time to time.

The Commission's Role in Relation to Other Applicants for Listing and Listed Issuers

38.14 Conflicts of interest may arise between the Exchange and persons whom the Exchange regulates, including applicants for listing and listed issuers. Any person that considers a conflict of interest may exist or may come into existence, or may have existed and may continue or be repeated, between the interests of HKEC, the Exchange or any other company of which HKEC is the controller and the interests of the proper performance of any regulatory function performed by the Exchange should bring the facts of the matter to the attention of the Executive Director in-charge of the Corporate Finance Division of the Commission.

The Commission's Powers and Functions in the Event of a Conflict of Interest

38.15 Pursuant to section 13 of the Merger Ordinance the Commission shall have those powers and functions in relation to conflicts of interests or potential conflicts of interest as are set out in this chapter and in the Memorandum of Understanding referred to in rule 38.02(2).

38.16 Where, pursuant to section 13 of the Merger Ordinance and this Chapter, the Commission exercises powers and functions with respect to other applicants for listing or listed issuers in place of the Exchange:

(1) the provisions of rules 38.03, 38.04 and 38.09 to 38.13 shall apply as between the Commission and the Exchange and such applicant or issuer as if references to HKEC were replaced with references to the relevant applicant or issuer;

(2) the Commission shall exercise such powers and functions through and within the framework described in rules 38.05 to 38.08.
APPENDIX 5:  
Procedures to Deal with Conflicts of Interest

INTRODUCTION

1. Set out below are the procedures, powers and functions that will be adopted and/or exercised by the Securities and Futures Commission (SFC), Hong Kong Exchanges and Clearing Limited (HKEx) and/or The Stock Exchange of Hong Kong Limited (SEHK) with respect to conflicts of interest or potential conflicts of interest following HKEx’s listing.

Definitions

2. For the purposes of these Procedures the following expressions shall have the following meanings:

- Commission means the executive and nonexecutive directors, including the chairman, of the SFC appointed pursuant to section 5 of the Securities and Futures Commission Ordinance (Cap. 24) acting as a quorate body.

- Conflict Committee Secretary means the Head, Listing Regulation and Risk Management from time to time of HKEx, or his or her equivalent. The Conflict Committee Secretary may not be a Committee Member.

- Conflict Committee means a committee nominated by the Board of HKEx to consider conflicts of interest or potential conflicts of interest and comprising not less than 3 employees of HKEx (each a “Committee Member”) provided that at least two Committee Members shall be Senior Executives. A meeting of the Conflict Committee may be effected by telephone or such other form of communication as the Committee Members may from time to time decide provided that all Committee Members participating in the meeting are able effectively to communicate with each other.
Appendix 5: Procedures to Deal with Conflicts of Interest

- Minimal Value means a sum equal to 3% of the most recently reported book value of net tangible assets of HKEx.
- Senior Executive means any of: (a) the Chief Executive of HKEx; (b) the Chief Operating Officer of HKEx; (c) the Chief Executive of SEHK; and (d) the Chief Executive of the Hong Kong Futures Exchange Limited.
- SFC Representatives means any one or more director, manager or other executive of the SFC from time to time nominated by the SFC for the purposes of these Procedures.
- In these Procedures, unless provided for above, where the context admits words and expressions the definitions of which are contained or referred to in the Exchanges and Clearing Houses (Merger) Ordinance shall be construed as having the meanings so attributed to them.

The Conflict Committee

3. HKEx shall use its best endeavours to ensure that staff within HKEx and companies of which it is the controller are alert to, and identify, conflicts of interest or potential conflicts of interest which may arise in the course of the performance of regulatory functions. All relevant facts giving rise to any significant conflict of interest or significant potential conflict of interest shall be brought to the attention of the Conflict Committee Secretary at the earliest possible opportunity. For these purposes, “significant” shall mean facts which a reasonable person would regard as giving rise to a conflict of interest or potential conflict of interest. A conflict of interest or potential conflict of interest involving any relevant contract, arrangement or other proposal which involves sums exceeding the Minimal Value shall always be referred to the Conflict Committee Secretary. The Conflict Committee Secretary shall convene a meeting of the Conflict Committee as soon as practicable after a conflict of interest or potential conflict of interest has been brought to his or her attention.

4. The Conflict Committee shall on such a referral consider the facts and determine whether a conflict of interest or potential conflict of
Appendix 5: Procedures to Deal with Conflicts of Interest

interest does or may arise. It will then proceed as follows depending on the circumstances:

4.1 If the Conflict Committee determines that a conflict of interest or potential conflict of interest does not and will not arise in the circumstances, a brief written record of that determination will be made and placed on file.

4.2 If the Conflict Committee determines that a conflict of interest or potential conflict of interest does or may arise but considers that the matter can be resolved in a manner which assures the proper performance of any regulatory functions, it shall make written proposals to that effect to be considered in turn by the SFC.

4.3 If the Conflict Committee determines that a conflict of interest or potential conflict of interest does or may arise and considers that the matter cannot be resolved in a manner which assures the proper performance of any regulatory function, it shall notify the SFC accordingly which may then exercise the powers and functions set out at paragraph 11.

Resolution of Conflicts of Interest

5. Where the Conflict Committee has determined that a conflict of interest or potential conflict of interest does or may arise it shall notify the SFC Representatives of all relevant facts including any proposals for resolving the matter in a manner which assures the proper performance of any relevant regulatory function. The SFC Representatives shall then consider the circumstances of the case and determine whether in their opinion the regulatory function can be discharged without the intervention of the SFC. HKEx shall provide any further particulars that the SFC Representatives reasonably require.

6. If the SFC Representatives are satisfied that any proposal made by the Conflict Committee (incorporating, as applicable, any recom-
Appendix 5: Procedures to Deal with Conflicts of Interest

Recommendation of the SFC Representatives) will assure the proper performance of any relevant regulatory functions, then HKEx shall implement such proposal, incorporating, as applicable, any such recommendation of the SFC Representatives.

7. If the SFC Representatives are not satisfied that action taken by HKEx (or a company of which it is the controller) will assure the proper performance of any relevant regulatory function then the SFC shall have the powers and functions provided pursuant to paragraph 11.

Appeal to the Commission

8. If the Conflict Committee disagrees in any respect with the approach taken by the SFC Representatives, the two parties will discuss the differences between them for a period of not more than 5 business days with a view to resolving their differences and reaching an agreed position as regards the conflict of interest or potential conflict of interest. On the expiry of such period if the differences have not been resolved the matter will be referred to the Commission and each of the Conflict Committee and the SFC Representatives shall prepare brief written statements of their respective views and the reasons for adopting those views for submission to the Commission.

9. The Commission shall within 5 business days of receiving such statements provide a written determination setting out (with reasons where applicable): (i) whether in its opinion the relevant facts do give rise to a conflict of interest or potential conflict of interest and, (ii) if so, the proposals, if any, it considers should be made for resolving the matter in a way which assures the proper performance of any relevant regulatory function in order to obviate the need for the SFC to intervene, or (iii) its conclusion that such intervention is unavoidable pursuant to paragraph 11 below.

10. The determination of the Commission shall be final and binding on all relevant parties. The Commission shall act as experts and not as arbitrators.
The Role of the SFC

11. Where it has been determined or agreed in accordance with these Procedures that a conflict of interest or potential conflict of interest does or may exist, the SFC shall have the following powers and functions with respect to the performance of regulatory powers and functions by HKEx or any company of which it is the controller:

11.1 the power to require HKEx to provide information with respect to its present and proposed interest and all those of any company of which HKEx is the controller;

11.2 the power to give a direction to HKEx and/or any company of which it is the controller (and HKEx shall forthwith comply with such direction and procure compliance with such direction by any such company);

11.3 the power to exercise all or any of the powers and functions of any company of which HKEx is the controller, and in such event the SFC shall have and be entitled to exercise such powers and functions to the exclusion of any such company.

12. Save in circumstances of mutual agreement prior to a determination by the Commission pursuant to paragraph 9, the SFC shall not exercise its powers and functions pursuant to paragraph 11 unless and until:

12.1 the SFC Representatives notify HKEx in writing of: (i) the powers and functions the SFC intends to exercise and, (ii) the date on which such notice is to take effect; and

12.2 HKEx has been given the opportunity to exercise its rights under paragraph 8.
No Preferential Treatment

13. With effect from its listing and for so long as it is a listed issuer on the Stock Exchange of Hong Kong, HKEx shall not ask or require (or purport to ask or require) any company of which it is the controller to exercise regulatory powers or functions, take regulatory actions or make regulatory decisions which a reasonable person would regard as being intended either:

13.1 to place HKEx (or any company of which it is the controller) in an advantageous position as compared with any person regulated by any such company; or

13.2 to place any person regulated by any such company in a disadvantageous position as compared with HKEx (or any company of which it is the controller).

14. The prohibited behaviour in paragraph 13 shall be regarded as extending to persons with which HKEx (or any company of which it is the controller) has or proposes to have a business relationship or a person with which HKEx (or a company of which it is the controller) has entered into or proposes to enter into a business arrangement.

15. For the purposes of ensuring compliance with paragraphs 13 or 14, if the SFC has concerns at any time as to the proper performance of regulatory functions with respect to any particular person regulated by HKEx or companies of which it is the controller, the SFC shall be entitled to ask HKEx to provide reasonable particulars of any current and proposed business relationships and business arrangements between HKEx and companies of which it is the controller and that person and HKEx shall comply with such request as soon as reasonably practicable following receipt of such request.

16. HKEx shall procure that any company of which it is the controller shall take such actions, make such decisions and exercise such powers and functions in such a way as to avoid any occurrence as is contemplated in paragraphs 13 or 14.
Appendix 5: Procedures to Deal with Conflicts of Interest

Cooperation Regarding Conflicts of Interest

17. HKEx shall procure that any company of which it is the controller shall comply with the provisions of these Procedures.

18. HKEx shall work with the SFC when the SFC has concerns regarding conflicts of interest, and shall implement any procedures which the SFC reasonably believes will enhance the operation of matters referred to in these Procedures.
6.1 Introduction

Demutualization and listing of an exchange places a spotlight on management of potential conflicts of interest. This chapter briefly outlines the nature of these conflicts, and the means of addressing them, under the following headings:

- Background to Conflicts
- An Exchange's Listing
- Regulation of Other Listings
- Supervision of Intermediaries
- Profit Motive versus Supervisory Function
- Public Interest versus the Exchange's Commercial Interest
- New Business Lines

Where appropriate reference is made to the Australian Stock Exchange's (ASX) experience.

---

1 National Manager, International Affairs, Australian Stock Exchange.
6.2 Background to Conflicts

The incidence of conflict or potential for conflict is not unique to a demutualized exchange. However, a key consideration in preparing for a demutualized environment is the need to demonstrate that effective mechanisms exist to address potential conflicts of interest arising from an exchange’s profit motive and the supervisory function that it performs.

Four main types of conflict present themselves:

- **The resources conflict.** Will a for profit organization devote sufficient resources to regulatory activities?

- **Executive time conflict.** Will senior executives of an exchange devote sufficient of their “high-powered” time to regulation compared with profit making?

- **Listings supervisory conflict.** Will the Listings Division ease up on scrutiny of new listings, grant listing rule waivers more readily and subject existing listed companies to less intense scrutiny? In addition, will the Listings Division be too tough in applying listing rules to listed competitors, or conversely, give favoured treatment to any listed companies with which the exchange conducts business?

- **Broker supervisory conflict.** Will the Compliance Division ease up on its scrutiny of brokers because they are now viewed as paying customers?

There are a number of ways of dealing with these conflicts:

- **Removal of activity option.** Remove the activity from the relevant division of the exchange.

- **Separation option.** Separate the business activities of the exchange from the regulatory activities of the exchange.

- **External oversight option.** Subject the regulatory activities of the exchange to external oversight.

- **Disclosure option.** Disclose how an exchange has dealt with regulatory issues, for example in an annual report.

- **Restricting ownership or involvement option.** Limit those who can control or influence exchange activities.
These options are not always mutually exclusive for a given activity. Moreover, it is possible to adopt different options for different types of activities; indeed ASX has adopted elements of each option across its business. Examples include:

- The removal of activity option has been adopted in relation to the oversight of ASX’s own listing, see below.

- ASX has created a separate Investigations and Enforcement Unit. Prior to demutualization that role was blended with “membership” administration.

- The law was amended to clarify the continuing obligations of ASX and to ensure accountability to the government regulator and the government in carrying out these responsibilities. Reporting requirements and audit and direction powers concerning compliance with these ongoing requirements were introduced.²

- ASX has taken initiatives to enhance transparency of its supervisory policies and procedures. This has included public consultation for rule development proposals, publication of waiver and disciplinary determinations, issue of Guidance Notes about our procedures and compliance expectations and improved mechanisms for public access to supervisory outcomes. More recently ASX announced the formation of ASX Supervisory Review Pty Limited (discussed below) which, among other things, reviews and separately reports on ASX’s supervisory activities.

- An ownership limitation was imposed on ASX. This limited persons and their associates to having voting power in ASX not exceeding 5%.³

Whichever model is chosen, it is important regularly to review existing arrangements to help ensure that an exchange builds for itself a reputation for integrity, efficiency and transparency. In view of the increasing globalization of markets, there is also a need to monitor

---

² The external oversight mechanisms in the law will be further enhanced under the Financial Services Reform legislation by conferral upon Australian Securities and Investment Commission (ASIC) of direct audit powers.

³ The Financial Services Reform Bill proposes to increase the limit to 15% with the capacity to acquire more than 15% provided the Government considers the proposed acquisition is in the national interest and agrees to vary the limit. This amendment will be accompanied by the introduction of a fit and proper person requirement in relation to those involved in ASX.
international developments in governance of supervisory activities and to assess whether the model chosen will best equip an exchange to embrace international alliances.

### 6.3 An Exchange’s Listing

If an exchange is to remain credible in its oversight of public companies, it must ensure that, in relation to its own listing, it adheres strictly to the highest standards set for other companies.

In Australia the *Corporations Law* has been amended to provide that a securities exchange such as ASX may be included in its own official list and its securities granted quotation, if the securities exchange has entered into such arrangements as the Australian securities regulator, the Australian Securities and Investments Commission (ASIC), requires for:

1. dealing with possible conflicts of interest that might arise from the securities exchange quoting its own securities on itself; and
2. the purpose of ensuring the integrity of trading in securities of the securities exchange.

To complement this change in the law, ASX and ASIC entered into a Memorandum of Understanding (MOU) setting out the way that ASX and ASIC would relate to each other in the monitoring of ASX’s compliance as a listed entity with the listing rules, the settlement rules and the *Corporations Law*, and of ASIC’s supervision of ASX as a listed entity. A key objective of ASX and ASIC in negotiating the MOU was to ensure consistency of outcomes and timing between ASX in the administration of the listing rules for other entities, and ASIC in its administration of the listing rules for ASX.4

---

4 Under the MOU, ASIC is responsible for supervising ASX’s compliance with the listing rules. It received ASX’s application for admission to the official list. In relation to the continuing regulation of ASX as a listed entity, ASIC is responsible for exercising the powers and functions that ASX has as a securities exchange in relation to other listed entities. ASX is not bound to monitor or enforce the listing rules in relation to itself. If ASX wishes to apply for an exemption or declaration in relation to a modifiable provision of the *Corporations Law*, or a waiver of the Listing Rules it may apply to ASIC. ASX pays fees required by the listing rules to ASIC. Under the MOU, ASX is responsible for supervision of ASX’s compliance with the *SCH Business Rules* and its application for admission to CHESS, as it is for other listed entities. However, ASIC may direct ASTC to exercise certain powers and functions.
Under the terms of the MOU, ASX makes its own announcements to ASIC in the same way that other entities make their announcements to ASX. Once cleared by ASIC, ASX’s announcements are released to the market through ASX’s own company announcements platform. Furthermore, ASX sets appropriate parameters for generating surveillance alerts relating to dealings in its own securities. If required by ASIC, ASX must provide assistance and allow ASIC access to ASX’s surveillance department in order to analyze trading in ASX’s securities.

This structure is designed to allow independent supervision of ASX’s compliance with its listing rules, while at the same time utilizing the same platforms and mechanisms that ASX has established practically to accommodate supervisory activities. ASX is confident that this structure operates effectively and efficiently.

### 6.4 Regulation of Other Listings

As noted above, an issue arises as to whether a for profit exchange will ease up on its supervision of listed companies. It is argued here that there are strong commercial reasons for exchanges to maintain a high level of supervision: if they do not, a fall in investor confidence is likely. Where there is a loss of confidence, investors will almost certainly withdraw from the exchange’s market and go elsewhere to make their investments. The consequentially reduced market activity will have a direct negative impact on an exchange's profits.

In addition to this commercial discipline, there are usually significant regulatory controls on exchanges that collectively serve as a strong deterrent to inappropriate supervisory decisions. These are outlined below in part 6.6.

### 6.5 Supervision of Intermediaries

Similar issues to those outlined in the preceding section arise in relation to the supervision of intermediaries.

When it was a mutual, ASX had a membership department that was responsible for monitoring and enforcing compliance with ASX’s business rules, as well as acting as the central point of contact for members regarding exchange enquiries. When it demutualized, ASX separated its supervisory functions associated with brokers from its customer relations
functions. The situation now is that, within its Market Services Division (replacing the old Membership Division), ASX has separated the client relations and compliance units, and investigations and enforcement matters are handled by a department, which has a separate reporting line through to the Office of General Counsel of ASX.

6.6 Profit Motive versus Supervisory Function

6.6.1 Market and Regulatory Controls

In Australia, the regulatory framework governing supervision of exchanges and prohibiting anti-competitive behaviour provide powerful incentives to an exchange and its board of directors and senior management to behave ethically and responsibly. So do the commercial interests of an exchange in promoting public confidence in, and therefore custom to, its markets.

There are numerous checks and balances to ensure an appropriate level of accountability by ASX in respect of its market supervision obligations. These include:

(i) clear and continuing obligations imposed on ASX as a market operator under the Corporations Law;
(ii) transparency of processes, by their embodiment in rules which are available for public scrutiny and comment; these rules are subject to informal ASIC approval processes and ministerial disallowance procedures;
(iii) structural arrangements which enable the quarantining of supervisory decision-making;
(iv) hearing and appeal rights afforded to customers;
(v) public registers of listing rule waiver decisions and of business rule disciplinary determinations;
(vi) the publication of the bases upon which the exchange exercises discretion under, or grants relief from, business rules;
(vii) a requirement to lodge a compliance report annually with ASIC and the relevant Australian Government Minister; and the Minister’s power to direct that this report be audited;
(viii) a ministerial power to direct ASX to do specified things in order to promote compliance with its ongoing obligations under the *Corporations Law*;\(^5\)

(ix) the Minister's ability to request a special report from ASX on the extent to which ASX is complying with its ongoing obligations under the *Corporations Law*, and the minister's power to direct that this report be audited;

(x) ASIC's power to prohibit trading in the securities of any listed company;

(xi) the power of ASIC or of an aggrieved person to apply for a court order for ASX to enforce its rules;

(xii) the requirement to lodge particulars of disciplinary action and serious contraventions of the law/rules with ASIC;

(xiii) the obligations imposed by ASX's MOUs with ASIC;\(^6\)

(xiv) the committees and tribunals which assist ASX in the performance of its supervisory responsibilities; these committees and tribunals include people external to ASX; and

(xv) prohibitions on anti-competitive behavior or misuse of market position contained in trade practices law.

### 6.6.2 Supervisory Activities

Where there is discontent with a supervisory outcome, commentators may try to attribute this to an exchange's for-profit status. ASX has accordingly been very careful to ensure that its internal structure best complements the legislative framework designed to ensure the fair and efficient conduct of the market. ASX commits significant financial, human and technological resources to ensure the highest standards of integrity. ASX also works closely with the market regulator, ASIC, in the implementation of its supervisory responsibilities. Table 6.1 summarises below some of the key market integrity activities undertaken by ASX.

\(^5\) Refer to *Corporations Law*, section 769A for these on-going requirements.

\(^6\) ASX has entered into a number of MOUs with ASIC to further refine, and ensure that, ASX properly implements and carries out its supervisory responsibilities. These MOUs, dealing with markets, membership matters, companies matters and transfer of information, place responsibilities on ASX which expand on and complement its supervisory responsibilities under the *Corporations Law*. A description of these MOUs is contained in *Part II: Demutualization Cases Studies*, Chapter 12, section 12.7.
Table 6.1. Supervision

<table>
<thead>
<tr>
<th>AREA OF SUPERVISION</th>
<th>MARKET INTEGRITY ACTIVITIES</th>
</tr>
</thead>
</table>
| Systems             | • Establishing standards for the testing and authorization of designated trading representatives.  
                      | • Maintaining trading parameter settings and access passwords.  
                      | • Gauging compliance with trading rules and procedures.  
                      | • Reporting incidents to relevant ASX departments.  
                      | • Provision of fair, orderly and transparent systems for trading, settlement, clearing and dissemination of company information.  
                      | • Guarantees of trade completion.  
                      | • Risk management. |
| Markets             | • Surveillance of market activity.  
                      | • Identifying unusual trading.  
                      | • Preliminary investigation of unusual trading and where necessary, referral to ASIC or relevant ASX departments |
| Listed Entities     | • Setting standards for listed entities through the ASX listing rules.  
                      | • Supervising and encouraging compliance with the listing rules.  
                      | • Implementation of trading halts, suspensions and removals.  
                      | • Where necessary referral to ASIC. |
| Market Participants | • Setting standards for participants, including prudential and systemic risk management through business rules.  
                      | • Supervising and encouraging compliance with business rules and relevant provisions of the Corporations Law, including education, administration of self assessment procedures, inspections, as well as formal investigations.  
                      | • Investigating breaches and presenting appropriate cases for disciplinary action.  
                      | • Adjudication and appeal of disciplinary matters.  
                      | • Powers to restrict or suspend access.  
                      | • Referral or notification to ASIC, as required. |

6.7 Public Interest versus the Exchange’s Commercial Interest

There is a high level of public interest surrounding the affairs of an exchange. Given that exchanges have commercial objectives, the issue arises whether an exchange might put its commercial interests ahead of public interests. The potential conflicts are generally regarded as greater where exchanges are structured as for-profit bodies.
There is a very high correlation between what is in the public interest and what is in an exchange's interests. For example, it is a commercial imperative for any stock exchange to engender confidence among investors in the operation of the exchange's market(s). This is achieved by providing a fair and efficient marketplace in which investors may buy or sell their securities.

Another commercial imperative for exchanges is to operate a listings business and to encourage listings by providing an environment where companies are able to lower their costs of raising capital.

In addition to the alignment of such interests as noted above, there are also a variety of controls on exchanges that help to reduce the possibility that they will act in a manner contrary to the public interest. First and foremost, exchanges are typically subject to some form of regulatory approval process that includes an assessment of whether an exchange has paid due regard in its rules to the interests of the public. Other controls include:

(i) anti-trust legislation which prohibits anti-competitive behaviour or misuse of market position; and

(ii) a requirement that there be transparency in processes. This may encompass, for example, the embodiment of processes in rules, rule changes being made available for public scrutiny and comment, and government oversight of rule changes.7

6.8 New Business Lines

If an exchange expands its business lines, it may find itself in collaboration or competition with entities that it supervises. Such a relationship might develop, for example, because an exchange decides that there are strong commercial imperatives for it to enter into a joint venture with another listed company. In the absence of special arrangements, this may place the exchange in a position where it could, potentially, favor that company.

Conflict may also arise when the exchange is in competition with another listed company. The exchange could, conceivably, in the

---

7 In Australia, rule changes are subject to informal ASIC approval processes and ministerial disallowance procedures.
performance of its supervisory functions, discriminate against the other listed company.

One way of addressing this potential for conflict is by ensuring the transparency and accountability of the supervisory decision-making process. A mechanism for this is the introduction of an oversight role in relation to supervisory decision making concerning entities with whom there is potential for conflict of interest. This is the model adopted by ASX. Under the ASX model, there is both:

(i) general oversight of the supervisory activities of ASX; and
(ii) specific oversight of ASX’s supervision of those of its listed entities who have special identified conflicts. The latter oversight function encompasses consultation on each supervisory decision involving the exercise of a discretion.

ASX considers this model to be preferable to the removal of supervision responsibility for such parties to another entity. In considering what are appropriate arrangements to handle conflicts, it is important to remember why markets around the world have tended to favour a co-regulatory model in the first place. Co-regulation is designed to achieve a productive collaboration between the government regulator and the self-regulatory organization with its special expertise and close proximity to the market. The proximity of the market operator to the market and its participants allows it to respond quickly and effectively to supervisory issues. If the market operator outsources part of that function for particular entities with whom there may be potential for conflict, there is a risk that the distance and isolation of the alternate supervisor will produce less effective supervisory responses or result in a disparity of outcomes and timing of supervisory responses.

6.9 Conclusion

This chapter has sought to comment briefly on the main types of conflict that can arise for demutualized exchanges. Many of these conflicts also arise in the case of mutual exchanges, but they are brought into sharper focus when an exchange demutualizes. There are a variety of ways of addressing these areas of potential conflict and the chapter identifies some of them.
The fundamental truth is that it is in the commercial interests of each exchange to ensure that there are appropriate controls in place for comprehensively addressing these areas of potential conflict in order to retain public confidence in the integrity and efficiency of the markets operated by the exchange.
7

Demutualization of Exchanges—The Conflicts of Interest
(The Australian Regulator’s Experience)

Claire Grose

7.1 Introduction

Today Australia has three regulated securities exchanges and two futures exchanges. They are all demutualized, for profit companies but only the Australian Stock Exchange Limited (ASX) is listed on its own exchange. Shares in SFE Corporation Limited (SFE), formally known as Sydney Futures Exchange Limited, can be traded on an exempt issues market established for this purpose. SFE has announced that it is proposing to list on ASX in the first quarter of 2002.

This chapter concentrates on ASX because so much of Australian Securities and Investment Commission’s (ASIC) learning about conflict of interest issues derives from its regulation of ASX since trading in ASX shares began on its market on 14 October 1998. This was the first time, as far as ASIC is aware, that shares in an exchange anywhere in the world traded on a market operated by the exchange.

7.2 Self-Listing

The Corporations Act 2001 confers power on ASIC to administer ASX’s listing rules in relation to ASX as a self-listed exchange. The provisions were first enacted at the time ASX demutualized to overcome conflicts of interest, which might arise because ASX is both the securities exchange and a listed entity. They enable ASIC to require an exchange to

1 Special Counsel, Regulatory Policy Branch, Australian Securities and Investments Commission.
enter into arrangements designed to address the potential for conflicts of interest that might arise from the quotation of its securities on its own market. The arrangements are to be entered into at the time that securities are granted quotation on the exchange.

The provisions are restricted to possible conflicts arising only from the quotation and trading of an exchange's securities on its own market. Potential conflicts of interest which may arise in an exchange's administration of the listing and business rules are not dealt with since they relate to the exchange's corporate objectives and business interests and not directly to the trading of the exchange's securities.

The limitations in the provisions have been revealed in several recent situations involving ASX as it has pursued business opportunities in many directions and concerns of possible conflicts of interest have been addressed on an interim basis.

The arrangements ASIC entered into with ASX are reflected in a Memorandum of Understanding (MOU) between ASIC, ASX and ASX Settlement and Transfer Corporation Pty Limited (ASTC), dated 23 September 1998. ASTC is a party to the memorandum because it is responsible for certain clearing and settlement functions and ASIC may have to take discretionary action in relation to ASX which it may direct ASTC to take on its behalf.

The MOU sets out the procedures that operate between ASIC, ASX and ASTC in monitoring of:

(i) ASX's compliance with the ASX listing rules, *the SCH Business Rules* and the *Corporations Act* as a listed entity;

(ii) ASX's enforcement of the ASX Business Rules in relation to ASX's securities; and

(iii) ASIC's supervision of ASX as a listed entity.

ASIC makes the decisions on all listing matters affecting ASX and ASX securities and relevant staff in ASX who undertake procedural functions such as the processing of ASX company announcements act on the direction of ASIC.

As far as possible, ASIC administers the rules in relation to ASX as a listed entity in a manner consistent with the way in which ASX or ASTC applies the rules to other entities listed on ASX. ASIC charges fees for supervision of ASX as a self-listed entity calculated on the same basis that ASX charges fees to other listed entities for the same service.
To provide administrative flexibility the MOU permits administrative letters to be exchanged between the parties. These letters detail the procedures and relevant personnel within ASIC, ASX and ASTC who will be responsible for performing a relevant function or procedure which is envisaged to be performed under the MOU.

ASX has “Chinese Wall” arrangements in place whereby discussions between ASIC officers and the nominated ASX surveillance and listings staff cannot be revealed to ASX staff responsible for ensuring ASX complies with the listing rules. The ASIC officer’s contact is with the ASX staff nominated in the administrative letters. Within ASIC there is a hierarchy of responsible officers for administering the self-listing arrangements which mirrors the ASX structure of responsibilities for monitoring and enforcing compliance of the listing rules by all other listed entities.

The types of matters dealt with at the operational level include monitoring compliance by ASX with continuous disclosure and other obligations in the listing rules, referring any share trading anomalies, approving for release market announcements, assessing waiver applications and reviewing notices of meetings. Matters such as significant waivers from the listing rules are elevated to more senior staff within ASIC based on their regulatory significance. The arrangements are working well under the MOU.

ASX introduced a specific chapter (Chapter 20) in its listing rules that apply solely to it as a listed entity. The effect of the rules is to provide a substitute for the ordinary listing arrangements reflected in the listing rules for all other listed companies. In short, ASX makes all the undertakings that any listed entity makes normally to ASX, but these undertakings are made to ASIC and not ASX.

ASIC is empowered by the Corporations Act to exempt ASX and ASTC from compliance with the Act where it considers it is necessary to provide for appropriate operation of the statutory provision. This power was included to remove the need for extensive law reform to accommodate the “one-off” circumstance of ASX as a self-listed entity and co-regulatory organization and to provide some flexibility in case a section of the Act was subsequently identified which needed modification or for which an exemption was required. Declarations making technical modifications and exemptions of the legislation as it applies to ASX and ASTC were made by ASIC pursuant to this power immediately before ASX listed on its exchange.
7.3 Other Conflicts

ASX’s retention of the listings function on demutualization and self-listing gave rise to the potential for a conflict of interest that was not covered by these comprehensive arrangements within months of their being entered into. As outlined earlier in this chapter the only conflict the law dealt with was about ASX itself as a listed entity, not as a commercial rival of another listed entity. This regulatory gap is to be filled under the Financial Services Reform Act 2001.

7.3.1 Bid for the Sydney Futures Exchange (SFE)

ASX had announced a bid for the SFE in December 1998. In May 1999, Computershare Limited, a public company listed on ASX, announced a rival bid for SFE. Computershare has a major business in supplying market technologies and a substantial part of the share registry services business in Australia and elsewhere. The question confronting ASIC was what arrangements should be put in place to ensure that the supervision of Computershare as a listed company was not seen as tainted by the obvious conflict between ASX’s role as a market supervisor and its interests as a competing bidder for SFE.

What ASIC did was to enter into an agreement with ASX and Computershare, which provided that until the issue of the rival bids was resolved, ASX as market operator would not make any substantive decision about Computershare without first consulting with ASIC and acting in accordance with advice provided by ASIC. The agreement was made public and details released to the market. As it turned out neither bid succeeded and SFE proceeded with its demutualization independently.

This experience taught ASIC that conflicts can arise very quickly without any prior warning, that they need to be dealt with immediately when they arise and must be dealt with as close to instantly as ASIC as a regulator can manage. In this case the very announcement of the bid was a first test, as it had to be released to the market over the companies announcement platform managed by ASX.

7.3.2 Other Commercial Conflicts

ASX has pursued a number of other business opportunities in the three years since demutualization. They illustrate the broad scope for possible conflicts between an exchange’s role as a market regulator and
its role as a commercialized entity able to undertake a variety of business initiatives. ASX competes with financial service providers generally, and potentially with the intermediaries who trade on its markets. It has commercial interests which may result in conflicts with entities listed on its exchange and it no longer has the close ties of ownership and membership with those who trade directly on its markets.

ASX has responded to concerns about the conflicts issues by forming a special purpose subsidiary, ASX Supervisory Review Pty Limited. The entity’s purpose is to provide assurance that the ASX group adequately complies with its obligations as market operator and clearing house operator. It is not intended to be a direct supervisor so much as to develop best practice policies and practices for ASX’s supervisory functions, and to monitor and report to ASIC and the government on compliance by the ASX group with its supervisory obligations. It will also play a role where actual or perceived conflicts might require an extra layer of scrutiny of ASX’s supervisory activity.

7.3.3 Financial Services Reform Act 2001

The Financial Services Reform Act 2001 directly addresses the wider conflicts issue. It permits regulations identifying conflicts and potential conflicts between the commercial interests of a licensed market operator and its statutory obligations to run an orderly, fair and transparent market and empowers ASIC to act in place of the licensee or to require the licensee to take action under its rules in relation to a conflict or potential conflict. The Act also places an obligation on ASIC to audit annually the adequacy of supervision arrangements of all licensed market operators, including arrangements for dealing with conflicts of interest. The Act is to commence on 11 March 2002.

Under these new arrangements, ASIC will be working to ensure that the conflict situations, which are likely to arise, are appropriately dealt with, that the costs of market supervision continue to be borne by those who use the market rather than the public purse, and that market integrity and consumer protection standards are maintained and enhanced.
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

---

1 Partner, Blake, Cassels & Graydon LLP, Toronto, Canada. The author thanks Daniel Bernstein, associate, and Tariq Taherbhai, student-at-law, Blake, Cassels & Graydon LLP for their assistance in the preparation of this chapter.
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

---

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.

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.
\(^11\) 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.\(^\text{14}\)

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

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.
Regulation of a Demutualized Exchange (Canada)

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.  

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 takeovers 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.\(^3\) 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. IOSCO\(^3\) 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:

\(^3\) Supra note 2, at 11.
\(^3\) 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.
34 Id. at 60.
9.1 Background

In 1997, the Singapore Government formed a Financial Sector Review Group, initiating a comprehensive study of the strategies and approaches towards regulating and developing the financial sector in Singapore. One major focus of the review was to develop strategies to broaden and deepen Singapore's capital markets. Two private sector committees were set up—a Corporate Finance Committee and a Stock Exchange of Singapore (SES) Review Committee, both chaired by private sector professionals. The government subsequently accepted the recommendations of the SES Review Committee to liberalize stockbroking commissions, and progressively open access to the exchanges.

The SES Review Committee also highlighted the need to fundamentally review the governance structure of the Stock Exchange of Singapore before opening up access. A third committee was therefore set up, the Committee on the Governance of the Exchanges (CGE), to follow up on this basic issue for both exchanges in Singapore, the SES and Singapore International Monetary Exchange (SIMEX). The CGE included Monetary Authority of Singapore (MAS) officers, SES and SIMEX members, the Presidents of the two exchanges, capital market participants and corporate lawyers. Among other things, the CGE recommended that SES and SIMEX be demutualized and merged into a single integrated privately-held stock company. The demutualization and merger was effected pursuant to a statute passed for that purpose, *The Exchanges*
Part I: Issues Involved in Stock Exchange Demutualization

(Demutualization and Merger) Act. The process was completed in 1999 with the launch of the Singapore Exchange (SGX), and was followed by SGX’s listing on its own mainboard in 2000.

9.2 Regulatory Issues Arising from Demutualization

9.2.1 Changes due to Ownership

The key regulatory issue arising from the demutualization of SGX is whether the changes to its ownership and operating structure will undermine its ability to discharge its role as a frontline regulator competently and effectively. It should be noted, however, that conflicts of interests issues are not new to demutualized exchanges. Prior to their demutualization and merger, SES and SIMEX already assumed regulatory and business development functions concurrently with potential conflicts on two levels:

(i) members of the exchanges had to set and enforce rules in the public interest that could negatively affect their commercial interests.

(ii) the exchanges were also expected to conduct effective and impartial supervision of their own members.

The potential conflicts of interests in these respects were mitigated by the fact that in a mutually-owned exchange, members share the financial and reputation risks from a failure to properly regulate.

9.2.2 Potential Conflicts

With the demutualization and listing of SGX, a new set of potential conflicts arises. While profits were never irrelevant to the mutual exchanges, it has become the primary motive for shareholders of the listed SGX. Share values and dividends reflect more transparently earnings and prospects, providing the management with greater incentive to raise operational efficiency, and seek competitive advantage. This is as it should be, and is indeed a principle benefit of demutualizing and listing SGX. There will however be concern from time to time as to whether the greater drive for commercial success will reduce the commitment and resources
deployed by the exchange to effectively fulfill its regulatory and public interest responsibilities at an appropriate standard.

**9.2.3 The “Public Interest”**

On the other hand, the interest of SGX shareholders and the “public interest” as represented by the users of the exchange can be presented as for the most part aligned rather than divergent. Common interest in a well-run liquid and large market place is not altered by the demutualization of SGX. A fair, transparent and efficiently-regulated market is indispensable to the vibrancy and sustained business success of SGX. Serious investors will not trade on an exchange that does not have internationally acceptable rules of listing, trading and settlement, or does not enforce the rules fairly and effectively. Without the interest and liquidity provided by investors, no exchange will find it easy to attract issuers and to build its business.

**9.2.4 Credibility**

Credibility in regulation is therefore a vital commercial asset for SGX. Strong, effective and fair supervision is key to SGX’s brand name. Corporate governance of SGX is not designed to favour short-term revenue objectives at the expense of long-term gains. Shareholders would also have it in their interests to hold the exchange to high standards of market regulation, so as to achieve sustained returns on their investments.

**9.3 The Regulatory Relationship between the Monetary Authority of Singapore and Stock Exchange of Singapore**

**9.3.1 The Monetary Authority of Singapore's Role**

A demutualized, listed exchange however requires an enhanced role for the MAS in some respects, even as the functions of SGX and MAS are more clearly delineated than in the past. *The Exchanges (Demutualization and Merger) Act* passed in 1999 was drafted to give MAS the power to issue directives to SGX in the interest of ensuring fair and orderly securities and futures markets, and the proper management of systemic risks. MAS has the authority to put things right, where any potential conflicts of interest become real.
9.3.2 The Stock Exchange of Singapore’s Responsibilities

The SGX retains direct and frontline regulatory responsibilities of the securities and futures markets, and over the broker-dealers who trade on the exchange. MAS, as the statutory regulator, administers the corpus of statutory law regulating the capital markets, as well as maintains oversight of SGX’s exercise of its regulatory responsibilities, and seeks to ensure that there are no gaps in the overall regulatory framework.

9.3.3 Areas of Regulation

Details of MAS’ regulatory relationship with SGX in the major areas of regulation are as follows:

- **Appointment of Senior Management.** Under a notification issued pursuant to the Exchanges (Demutualization and Merger) Act, SGX was required to establish a nominating committee comprising not less than four members of SGX’s board of directors. All appointments to the nominating committee are subject to MAS’ approval. The nominating committee is responsible for reviewing all nominations for appointment or re-appointment of members of SGX’s board of directors and the chief executive officer of SGX. The nominating committee shall take into consideration, *inter alia*, that nominated candidates are fit and proper persons to hold such office, taking into account the candidates’ track record, age, experience, capabilities and other relevant factors. MAS’ prior approval is required for the appointment of the Chairman of SGX’s board of directors and the chief executive officer.

- **Supervision of Listings.** SGX defines and enforces the rules that apply to companies seeking to raise capital on the exchange through primary or secondary issues. MAS’ approval must be sought for any changes to SGX’s listing rules. SGX enforces the continuous listing requirements on companies, to see to it that listed companies maintain timely and adequate disclosure of material information. SGX has the power to suspend and de-list an issuer if a company fails to meet the standards set out in the listing rules. Continuous disclosure by listed companies will also become a statutory obligation.
under the proposed Securities and Futures Act (SFA).² This means that non-disclosure or late disclosure of material information by listed companies will be a breach of the law, not just a breach of SGX’s listing requirements, and carry either civil or criminal penalty.

- **Market Surveillance.** SGX carries out market surveillance to detect unusual trading activities that could reflect attempts to manipulate the market. Such surveillance efforts could also lead to discovery of parties trading on privileged insider information. SGX has the power to suspend or de-list an issuer if conditions for orderly trading are found to be absent. MAS will carry out independent surveillance on a selective basis, to ensure that SGX is performing its responsibilities effectively. MAS will have the power under the proposed SFA to pursue civil prosecution of listed companies which fail to make timely disclosure of material information, and of any participants suspected of market misconduct. The civil remedy regime for insider trading will be extended to cover other forms of market misconduct such as market manipulation, or the employment of fraud and deceit in dealing. Civil remedy, which lowers the burden of proof against offenders, will complement the present framework of criminal remedy for offences under securities law.

- **Supervision of Brokers.** SGX supervises and inspects brokers to ensure that they comply with SGX’s rules, are prudentially sound, and uphold high standards of market integrity. SGX has to act swiftly and firmly to deal with any unprofessional conduct by brokers and their representatives. MAS conducts continuous off-site review of brokers’ operations to check if they comply with statutory licensing requirements. Such off-site reviews are complemented by MAS’ selective, on-site inspection of brokers to assure itself of the competence and effectiveness of SGX’s supervision.

- **Regulation of SGX as a Self-Listed Entity.** When the SGX was listed on its own mainboard, MAS assumed the role of frontline regulator for the listing and trading of SGX’s shares. MAS was the approving authority for SGX’s listing, and was directly responsible for vetting SGX’s prospectus. MAS is the supervisory authority for SGX’s compliance with its own listing rules. MAS also conducts surveillance

---

² The Securities and Futures Bill is a omnibus legislation which will consolidate the provisions within the Securities Industry Act and the Futures Trading Act, as well as introduce some structural policy reforms in the regulation of the capital markets.
of trading in SGX’s shares, and monitors the continuous disclosure of material information by SGX. MAS has powers under *The Exchanges (Demutualization and Merger) Act* to issue directives to SGX to resolve any conflicts of interest arising from its self-listing. Such conflicts are also addressed in a Deed of Undertaking to the MAS. Pursuant to the Deed, SGX has appointed a Conflicts Committee to deal with such issues, and MAS is the approving authority for the composition of the Committee.

- **Approval of Substantial Shareholdings in the SGX.** Under the *Exchanges (Demutualization and Merger) Act*, anyone who wishes to acquire 5% or more of SGX is required to seek prior approval from MAS. This provision recognizes the unique and important role of SGX in providing the infrastructure and marketplace for the trading, clearing and settlement of securities and derivatives in Singapore.

In reviewing applications from investors to acquire more than a 5% stake in SGX, MAS has made the following announcement:

- MAS will allow suitable strategic investors who can promote SGX’s growth and development to acquire substantial stakes of 5% or more in SGX. The size of their permitted stakes will depend on what these strategic investors can contribute to the exchange in terms of business alliances, technology or other ways of supporting the business and infrastructure of the exchange.

- MAS will also generally allow fund managers who invest pools of customer funds to hold SGX’s shares beyond the 5% limit. The combined holdings of such a fund manager will be capped at 10%. This takes into account feedback from fund managers that they would like to hold larger absolute stakes in SGX than the 5% limit allows. As key institutional players on the buy-side of the capital markets, the presence of fund managers would ensure a broader shareholder base for the SGX add to the diverse range of groups with an interest in the exchange.
9.4 Conclusion

Internationally, the regulatory relationship between the statutory regulator and exchanges is continuously evolving. There is no single model that is appropriate for all countries. In Singapore, with the demutualization and listing of SGX, the division of regulatory responsibilities between MAS and SGX has been explicitly defined. MAS believes that the current arrangements for the regulation and supervision of the securities and futures markets between MAS and SGX, with an enhanced oversight responsibility for MAS and powers to pursue civil prosecution, will prove robust. However, given the rapid changes in the capital markets brought about by globalization and technological advances, the arrangement can be expected to evolve over time. MAS’ regulatory relationship with SGX will continually be reviewed, and recalibrated if necessary, in keeping with market developments, to ensure effective oversight of the capital markets in Singapore.
10

Regulation of a Demutualized Derivatives Exchange (United States)

Natalie A. Markman

10.1 Introduction

The Commodity Futures Trading Commission (CFTC) has regulated commodity futures and option markets in the United States for the past quarter century. Until recently, virtually all exchanges were structured as non-profit membership organizations. Competitive pressures now have convinced existing exchanges to reexamine traditional business models – and in some cases demutualize – and have encouraged new markets to launch as for-profit nonmutualized entities. At the same time, the US Congress has enacted a sweeping and deregulatory revision of the Commodity Exchange Act (Act), and the CFTC has revised its regulations accordingly.

The CFTC’s new regulatory framework was developed to foster diversity in derivatives markets through deregulation, but exchanges already were testing new business strategies within the existing regulatory structure. The CFTC has viewed exchange demutualization plans and new exchange applications through the same lens as mutualized exchange submissions. Although some unique issues do surface,

---

1 Legal Counsel to Commissioner Erickson, US Commodity Futures Trading Commission.
2 The Commodity Futures Trading Commission (CFTC) was formed in 1975, but futures have been subject to federal regulation since 1922.
3 To demutualize means to convert from a member-owned organization to a shareholder-owned organization, typically from a not-profit entity. Demutualization has been making headlines in the United States for the past few years and has been widely viewed as a means for exchanges to streamline governance and management, to improve and expedite decision making, and to raise capital. Appendix 1 provides an overview of regulated US derivatives exchanges and their business models.
demutualized and nonmutualized exchanges continue to be regulated much the same as mutualized exchanges.

This chapter is intended to provide an overview of CFTC’s regulation of derivatives exchanges. Part 10.2 of the chapter highlights changes created by the recent legislation with regard to new types of derivatives markets. Part 10.3 reviews CFTC’s oversight authority over regulated exchanges. Part 10.4 identifies some issues raised when an exchange chooses to demutualize and discusses these issues in light of the CFTC’s recently promulgated regulations.

10.2 A New Framework

The *Commodity Futures Modernization Act (CFMA)*, signed into law by the President on 21 December 2000, redefines the CFTC’s mission and transforms the way financial markets may trade derivatives in the United States. The *CFMA* changed both the role of the CFTC and the scope of its authority. CFTC is no longer a “front-line” regulator; instead, it must “oversee” markets and their participants. So-called prescriptive regulations are being replaced with regulations that establish general criteria and broad core principles. Moreover, the scope of the CFTC’s regulatory authority varies depending on the type of transaction and

---

5 This chapter reflects solely the author’s views and not the views of the Commodity Futures Trading Commission (CFTC) or any office or division of CFTC.


7 New Section 3 of the Act envisions a “system of effective self-regulation … under the oversight of CFTC” and lists four regulatory goals: (i) to deter and prevent price manipulation or any other disrurbations to market integrity; (ii) to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk; (iii) to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and (iv) to promote responsible innovation and fair competition among boards of trade, other markets and market participants.

8 In addition, the CFMA specifically excluded certain over-the-counter bilateral transactions from the CFTC’s jurisdiction, excluded electronic principal-to-principal trading of an excluded commodity between “eligible contract participants,” clarified the CFTC’s jurisdiction over certain aspects of the retail market in foreign exchange trading, gave the CFTC authority to regulate clearing organizations, and reauthorized the CFTC for five years. The CFMA also repealed the Shad-Johnson jurisdictional accord between the CFTC and the U.S. Securities and Exchange Commission (SEC), thereby lifting the ban on single-stock futures, and established a new regulatory regime for security futures products. The CFTC has exclusive jurisdiction over broad-based security indices and shares jurisdiction with the SEC over futures on individual securities and narrow-based security indices. The two agencies are drafting regulations to enable the trading of these products.

9 The term “core principle” is not defined in either the CFMA or CFTC’s regulations.
facility, the type of underlying commodity, and the type of participant. The *CFMA* constructs a complex matrix in which a wide range of financial commodities are deemed “excluded” commodities and all but agricultural commodities are “exempt” commodities. CFTC-regulated markets may choose to trade contracts on any commodity, whether included, exempted, or excluded.\(^\text{10}\)

The *Act* now provides for two tiers of markets, each of which contains two types of markets:

**Regulated Markets**
- designated contract markets (DCMs); and
- registered derivatives transaction execution facilities (DTFs).

**Exempt Markets**
- exempt commercial markets (ECMs); and
- exempt boards of trade (EBOTs).\(^\text{11}\)

Generally, the CFTC has less oversight responsibility where markets limit access to more sophisticated participants and trade commodities unlikely to be susceptible to manipulation. DCMs are regulated most like traditional derivatives exchanges, DTFs operate under an intermediate level of regulation, and the exempt markets enjoy minimal regulation.

---

\(^{10}\) Some have raised concerns about the CFTC’s jurisdiction under the CFMA when, for example, a market in excluded commodities gains the CFTC designation or registration. See, e.g., Dissent of Commissioner Thomas J. Erickson to Rules Implementing the Commodity Futures Modernization Act (CFMA) with Respect to Transaction Execution Facilities, 66 Fed. Reg. 42256, at 42288-89 (10 August 2001), available at <http://www.cftc.gov/files/foia/fedreg01/foi010810a.pdf>; Remarks of Commissioner Thomas J. Erickson, Commodity Futures Trading Commission, New York State Bar Association, Committee on Futures and Derivatives Law (22 February 2001), available at <http://www.cftc.gov/opa/speeches01/opaericks-9.htm>.

\(^{11}\) The CFTC has implemented the statutory provisions of the CFMA by promulgating regulations for DCMs in Part 38 of its regulations, for DTFs in Part 37, and for the two exempt markets in Part 36. CFTC also provided guidance through non-exclusive safe harbors for DCMs and DTFs in Appendices A and B to Parts 38 and 37, respectively. See <http://www.cftc.gov/opa/press01/opapa4547-01.htm>. The regulations will be compiled at 17 C.F.R. Ch. I (2002).
10.2.1 Designated Contract Markets

Boards of trade designated as contract markets may list for trading futures or option contracts on any underlying commodity, index, or instrument and may allow access to their facilities by all types of participants, including retail customers. Those boards of trade that existed at the time of the CFMA’s enactment are considered to be DCMs. Applicants for initial designation must satisfy certain criteria: adherence to designation criteria, prevention of market manipulation, fair and equitable trading, enforcement of rules on the trade execution facility, financial integrity of transactions, disciplinary procedures, public access to information on the contract market, and the ability to obtain information. They also must demonstrate the ability to comply with, and once designated must comply with, 18 core principles.

10.2.2 Registered Derivatives Transaction Execution Facilities

Boards of trade registered as DTFs may list for trading futures or option contracts on commodities that have a nearly inexhaustible deliverable supply, have a deliverable supply sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation, have no cash market, are security futures products, or have been determined (on a case-by-case basis) by CFTC to be highly unlikely to be susceptible to the threat of manipulation. DTFs may allow access to their facilities by “eligible contract participants” or by any other person trading through a registered futures commission merchant (FCM) with, among other things, at least US$20 million in net capital. Those DTFs that permit only “eligible commercial entities” to trade for their own accounts may offer contracts on a wider range of commodities (all but agricultural commodities specifically enumerated in Section 1a(4) of the

---

12 New Section 1a(2) of the Act defines “board of trade” as “any organized exchange or other trading facility.” This paper uses the term “exchange” in its generic sense to refer to regulated derivatives markets.

13 See generally new Section 5 of the Act. Appendix 1 of this chapter lists the designation criteria and core principles applicable to DCMs.

14 Pursuant to new Section 5a(g) of the Act and Regulation 37.4, if a DTF chooses to trade agreements, contracts, or transactions involving excluded or exempt commodities, the CFTC has exclusive jurisdiction over these agreements, contracts, and transactions to the extent that they are traded on a DTF.
Applicants must satisfy certain criteria: adherence to registration criteria, deterrence of abuses, enforcement of trading procedures, and financial integrity of transactions. They also must certify that they have the capacity to comply with, and upon commencing operations must comply with, nine core principles.

10.2.3 Exempt Commercial Markets

Electronic trading facilities operating as ECMs may provide for the execution or trading of agreements, contracts, or transactions in all commodities but agricultural commodities specifically enumerated in Section 1a(4) of the Act. They must limit access to their facilities to “eligible commercial entities” trading for their own accounts. ECMs must file a notice and certifications with CFTC and comply with informational, record keeping, and other requirements. They are subject to the Act’s antifraud and anti-manipulation provisions and, if CFTC finds that they perform a price discovery function, they must provide certain pricing information to the public. ECMs may not claim to be registered with or recognized, designated, licensed, or approved by the CFTC.

10.2.4 Exempt Boards of Trade

Boards of trade electing to operate as EBOTs may list for trading only futures or option contracts on commodities (not securities) that have a nearly inexhaustible deliverable supply, have a deliverable supply sufficiently large and a cash market sufficiently liquid that the contract is highly unlikely to be susceptible to the threat of manipulation, or have no

---

15 Enumerated commodities are wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Irish potatoes, wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. At some point in the future, the CFTC may consider approving contracts on such commodities.

16 Regulation 37.5(a) provides that existing DCMs may simply notify CFTC of their intent to operate as DTFs and file their DTF rules (or a list of such rules) and a certification with the CFTC that they meet the requirements for trading and criteria for designation. New Section 5a(b)(4) requires DCMs either to provide a separate physical location for their DTFs or, for electronic trading, to identify whether the trading is occurring on a DCM or on a DTF.

17 See generally new Section 5a of the Act. Appendix 2 of this chapter lists the registration criteria and core principles applicable to DTFs.

18 See generally new Section 2(h)(3)-(5) of the Act.
Part I: Issues Involved in Stock Exchange Demutualization

They are not limited to principal-to-principal trading, but must limit access to their facilities to "eligible contract participants." EBOTs need only to file a notice with CFTC and are subject only to the Act's antifraud and anti-manipulation provisions. If CFTC finds that they perform a price discovery function, however, they must provide certain pricing information to the public. EBOTs may not claim to be registered with or recognized, designated, licensed, or approved by CFTC.

10.3 Exchange Oversight

The CFMA creates a new array of possibilities—and greater responsibilities—for derivatives markets. They not only will face challenging business decisions that will demand resolution with greater expediency, but also will bear increased self-regulatory responsibility. No longer constrained by what some termed restrictive regulations, markets will be challenged to develop more creative solutions and will be required to answer to a broader constituency than the traditional collective of exchange members.

At the same time, CFTC will be mapping the contours of regulatory oversight under the CFMA. The scope of a market’s self-regulatory responsibility varies depending upon whether it is a DCM, a DTF, an ECM, or an EBOT – not upon whether it is demutualized or mutualized. Over the next several years, the CFTC, the self-regulatory organizations (SROs), and maybe even the courts will have a voice in how this responsibility will be allocated.

Pursuant to new Section 5d(e) of the Act, the CFTC has exclusive jurisdiction over any account, agreement, contract, or transaction involving a contract of sale of a commodity for future delivery, or option on such a contract or on a commodity, to the extent that the account, agreement, contract, or transaction is traded on an EBOT.

New Section 5d(f) of the Act provides that DCMs and DTFs may operate EBOTs by establishing separate subsidiaries or other legal entities.

See generally new Section 5d of the Act.

Today's markets have a wide range of choices: trade cash, futures, options, over-the-counter derivatives, and/or debt and equity securities; link or form alliances; acquire or be acquired by other entities; form new subsidiaries or holding companies; branch out or establish other businesses. As regulatory restrictions loosen and technological capability expands, however, markets also face an ever-widening range of competitors.

Self-regulatory organizations (SROs), i.e., DCMs, DTFs, derivatives clearing organizations, and the National Futures Association (NFA), must enforce minimum financial and reporting requirements for their members, among other responsibilities. To date, the NFA is the sole futures association registered under the Act. NFA is responsible, with CFTC oversight, for certain aspects of regulating CFTC's registrants and focuses primarily on the qualifications and proficiency, financial condition, retail sales practices, and business conduct of these futures professionals.
CFTC oversight of regulated exchanges will focus on reviewing their adherence to the core principles24 governing their compliance with the Act and CFTC regulations.25 Rule enforcement reviews conducted by the CFTC’s Division of Trading and Markets (Division) will continue to ascertain exchanges’ ongoing fulfillment of self-regulatory obligations.26 Upon request, DCMs must provide the CFTC with information related to their business as a contract market and with a written demonstration that they are in compliance with one or more core principles. DCMs remain subject to the reporting provisions in Parts 15 and 16 of the CFTC’s existing regulations, as well as to CFTC’s special call provisions in Part 21. The new regulations require DTFs to provide the CFTC, upon request, with information to enable CFTC “to satisfy its statutory obligations” and with a written demonstration that they are in compliance with one or more core principles. DTFs face reduced reporting requirements but are subject to special call requirements under the new regulations.27

The Act vests the CFTC with a range of potential responses to exchange noncompliance. If CFTC determines, based on substantial evidence, that a DCM or DTF is violating a core principle, the CFTC may provide notice to the exchange, give it 30 days to comply, and take further action if the exchange fails to take curative action. The commission may alter or supplement, after notice and opportunity for hearing, an exchange’s rule(s) if changes have not been made and are necessary or appropriate to protect producers or traders or to ensure fair dealing. In addition, CFTC has the authority to take action against an exchange making a false statement and to suspend or revoke an exchange’s designation or registration for violating the Act, any regulation, or order, or for an exchange’s failure to enforce its own rules.

---

24 Exchanges generally no longer are required to seek CFTC’s approval of their rules and rule amendments. Although this change was implemented prior to the CFMA’s enactment, new Section 5c(c) of the Act and new Regulations 38.4(a) and 37.7(c) make clear that CFTC’s approval is voluntary for DCMs and DTFs, respectively.

25 The CFTC also will use surveillance to spot unusual market events that can reveal systemic problems and risks. Appendix 3 provides background on the CFTC’s market surveillance program.

26 The Division oversees SRO compliance activities. Its rule enforcement reviews examine the adequacy of each exchange’s program for enforcing its market surveillance, trade practice surveillance, audit trail, disciplinary, and financial and sales practice rules, as well as rules governing conflicts of interest.

27 For DCMs, see new Regulations 38.2 and 38.5 and, for DTFs, see Regulations 37.6(c) and 37.8. In addition, ECMs are subject to special calls pursuant to new Section 2(h)(5)(B)(iii) of the Act and Regulation 36.3(b)(2).
10.4 Regulatory Issues Raised by Demutualization

10.4.1 Conflicts of Interest

Do demutualized exchanges raise greater concerns about conflicts of interest than mutualized exchanges?

Mutualized exchanges answer to their members. Once demutualized, exchanges must protect their owners’ interests. Although an exchange’s members initially may be the exchange’s owners, they eventually may choose to sell their ownership interests in the exchange. The new owners may have no interest in trading and may be disinterested in the exchange beyond reaping a return on their investment.\(^{28}\) The exchange, however, must continue to maintain an effective program of self-regulation. A conflict of interest may arise if an attempt to fulfill self-regulatory obligations negatively affects the profitability of a demutualized exchange. A conflict also may arise in disciplinary proceedings involving an exchange participant who is the owner, or a significant shareholder, of a competing exchange.\(^{29}\)

Conflicts of interest inherent in self-regulation manifest equally, albeit differently, in demutualized and mutualized entities. After all, traditional exchanges are run by members interested in making money and enhancing value through trading and maximizing seat value. Furthermore, exchange disciplinary programs where members sanction fellow members arguably can affect the rigor of an exchange’s self-regulatory program. Even if conflicts are heightened in a demutualized environment, exchanges would continue to have a vested interest in preserving their reputations for providing fair and efficient markets. These exchanges ultimately would bear a heavy price in sacrificing good will and their reputations in the interest of short-term profits.

The CFTC’s new regulatory framework explicitly addresses conflicts of interest for both types of regulated exchanges. For DCMs and DTFs, Core Principles 15 and 7, respectively, state that they “shall establish and enforce rules to minimize conflicts of interest in the decision making

\(^{28}\) While this divergence of interests may exist regardless of whether such an exchange is privately or publicly owned, the divergence would be greater in the case of a publicly traded exchange because its shareholders are less likely to be market participants. In addition, shareholder interests may be protected by shareholder derivative litigation or shareholder class actions, at the expense of market participants.

\(^{29}\) The securities industry is facing the additional complication of exchanges listing their own shares. However, until derivatives exchanges begin to offer contracts on single equities, the Commodity Futures Trading Commission does not yet share analogous concerns.
process … and establish a process for resolving such conflicts of interest.” CFTC’s guidance explains that exchanges should develop methods to ascertain the presence of conflicts of interest and to make decisions in the event of such conflicts. Moreover, exchanges should provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members, and employees or gained through an ownership interest in the facility.30

10.4.2 Exchange Governance

Does exchange governance warrant greater scrutiny at demutualized exchanges?

Mutualized exchanges are governed by boards of directors that must reflect the composition of their membership and must represent the interests of a variety of market participants. Upon demutualization, boards of directors must comply with state governance laws that may have different composition requirements. A demutualized exchange’s board of directors must heed owner interests, which may no longer align with the interests of market participants.

The CFMA imposes board composition requirements solely upon DCMs that are mutually owned. For such DCMs, Core Principle 16 states that they “shall ensure that the composition of the governing board reflects market participants.” Fitness requirements, however, apply to those who exercise governance responsibilities or control over regulated exchanges, whether demutualized or mutualized. For DCMs and DTFs, Core Principles 14 and 6, respectively, state that they “shall establish and enforce appropriate fitness standards” for directors, disciplinary committee members, exchange members,31 any other persons with direct access32 to the exchange, and any parties affiliated with any of these types of persons. The CFTC’s guidance provides that eligibility criteria should include standards for fitness and for collecting and verifying information that supports compliance with such standards. Information

30 Pursuant to new Regulations 38.2 and 37.2, DCMs and DTFs, respectively, remain subject to existing limitations in Regulation 1.59(d) with respect to material, non-public information.
31 An exchange’s owner(s) would have governance authority at a demutualized exchange. Regulations 38.3(b)(4) and 37.6(d)(5) provide that the core principle on fitness requires demutualized DCMs and DTFs, respectively, to establish fitness requirements for all natural persons that directly or indirectly have greater than a 10% ownership interest in the facility.
32 In the preamble to its final rules, the CFTC noted that fitness standards do not apply to customers who have direct trading access but exercise no governance authority.
substantiating a person’s fitness may include registration information, a certification of fitness, an affidavit by the exchange’s counsel, or other information.

### 10.4.3 Delegating or Outsourcing Self-Regulatory Obligations

Does self-regulation suffer if exchanges contract with third parties for the performance of their SRO responsibilities?

Mutualized exchanges traditionally maintain in-house SRO programs. Once demutualized, exchanges may respond to their owners’ desire to reduce expenses by shifting certain SRO functions to third parties.\(^{33}\) In today’s competitive environment, however, both demutualized and mutualized exchanges must strive to minimize costs while maintaining effective SRO programs.

Section 5c(b) of the CFMA provides that DCMs and DTFs may comply with any applicable core principle by delegating any relevant function to a registered futures association or another registered entity.\(^ {34}\) A few newly-approved DCMs already have contracted at least some self-regulatory functions to the NFA. The CFTC obtains detailed descriptions of how SRO obligations would be fulfilled and reviews the contractual agreements in assessing these arrangements. DCMs, as well as DTFs, remain responsible for carrying out each delegated function and must assure themselves that they remain in compliance with the Act’s requirements. The CFTC has the authority to intervene if an exchange

---

\(^{33}\) Adequate funding for self-regulatory programs is essential for any exchange. A demutualized exchange eager to reduce costs could decide to trim its budget by reducing self-regulatory programs. Perhaps an exchange would choose to base payments to third-party vendors on transaction volume (transaction fees) or a percentage of the dollar value of transactions rather than paying a set dollar amount. Such a payment structure potentially could dedicate insufficient resources to self-regulatory obligations. However, these risks exist for mutualized exchanges as well.

\(^{34}\) Designation Criterion 6 for DCMs explicitly states that DCMs may delegate their disciplinary programs to third parties. Although the CFTC’s new regulations do not address delegation or outsourcing, its guidance for DCMs contemplates delegation of several functions: market surveillance, trade practice surveillance, financial review and audits of intermediaries, and customer dispute resolution. Moreover, the preamble to the final regulations explains that DCMs and DTFs also may outsource specified activities, such as the operation of a trading platform, to third parties. Delegation confers the authority to act in the delegating entity’s name. For example, an exchange that delegates its member discipline and market surveillance empowers its delegatee to take appropriate remedial actions, including sanctioning members or market participants for rule violations. In contrast, if an exchange contracts with an entity to conduct trade surveillance and to investigate alleged rule infractions, the contractor would not have the authority to decide on behalf of the exchange whether an infraction had occurred or to impose remedial sanctions.
does not adequately perform its self-regulatory functions and may hold an exchange accountable for compliance failures and disciplinary violations.

10.5 Conclusion

The US Congress and the CFTC have developed a regulatory structure that is designed to encourage creativity. Exchanges undoubtedly will test the boundaries of the CFMA and the CFTC’s new regulatory framework as they explore new business possibilities. Corporate structure will be but one of many business decisions for an exchange and but one facet in the CFTC’s review of the exchange.

The CFMA creates a new regulatory template for CFTC to apply in a world of new markets, new products, and even new market participants. Exchange oversight must respect diversity but protect market integrity and transparency. The CFTC is entrusted with the public interest in liquid, fair, and financially secure markets.
### APPENDIX 1:

**DESIGNATED CONTRACT MARKETS FOR REGULATED US DERIVATIVES EXCHANGES**

<table>
<thead>
<tr>
<th>Exchange Name</th>
<th>Status and Information</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BrokerTec Futures Exchange</strong></td>
<td>Designated 6/18/01: <a href="http://www.cftc.gov/opa/press01/opa4526-01.htm">http://www.cftc.gov/opa/press01/opa4526-01.htm</a></td>
</tr>
<tr>
<td><strong>Chicago Board of Trade</strong></td>
<td>Established 1848 and designated 1923 Step one of reorganization plan approved 8/7/00: <a href="http://www.cftc.gov/opa/press00/opa4434-00.htm">http://www.cftc.gov/opa/press00/opa4434-00.htm</a></td>
</tr>
<tr>
<td><strong>Chicago Mercantile Exchange</strong></td>
<td>Established 1919 and designated 1936 Demutualization plan approved 6/15/00: <a href="http://www.cftc.gov/opa/press00/opa4407-00.htm">http://www.cftc.gov/opa/press00/opa4407-00.htm</a></td>
</tr>
<tr>
<td><strong>FutureCom</strong></td>
<td>Designated 3/13/00: <a href="http://www.cftc.gov/opa/press00/opa4378-00.htm">http://www.cftc.gov/opa/press00/opa4378-00.htm</a></td>
</tr>
<tr>
<td><strong>Kansas City Board of Trade</strong></td>
<td>Established 1856 and designated 1923 (incorporated 1973)</td>
</tr>
<tr>
<td><strong>Merchant's Exchange of St. Louis</strong></td>
<td>Established 1836 and designated 7/10/00: <a href="http://www.cftc.gov/opa/press00/opa4421-00.htm">http://www.cftc.gov/opa/press00/opa4421-00.htm</a></td>
</tr>
</tbody>
</table>


New York not-for-profit corporation (joint venture of the NYCE and a subsidiary of Cantor Fitzgerald)

Delaware for-profit non-stock corporation (step two of restructuring plan pending)

Delaware for-profit corporation

Texas for-profit limited partnership

Missouri for-profit limited liability company

*continued next page*
### Appendix I: Designated Contract Markets for Regulated US Derivatives Exchanges

**MidAmerica Exchange**  
Established 1848 and designated 1922  
Wholly-owned subsidiary of CBOT (acquired in 1986)

**Minneapolis Grain Exchange**  
Established 1881 (as Minneapolis Chamber of Commerce) and designated 1923  
Minnesota not-for-profit corporation

**NASDAQ/LIFFE Futures Exchange**  
Designated 8/21/01:  
http://www.cftc.gov/opa/press01/opa4559-01.htm  
Delaware for-profit limited liability company

**New York Mercantile Exchange**  
Established 1872 and designated 1936  
Demutualization plan approved 7/26/00:  
http://www.cftc.gov/opa/press00/opa4427-00.htm  
Delaware for-profit non-stock corporation  
(consisting of two divisions) that is a subsidiary of a for-profit stock holding company, NYMEX Holdings, Inc. (exchange was formed via a 1994 merger between two contract markets: NYMEX and the **Commodity Exchange**, established 1933 and designated 1975)

**OnExchange Board of Trade**  
Designated 12/22/00:  
http://www.cftc.gov/opa/press00/opa4483-00.htm  
Delaware for-profit corporation

### Applicants for CM Designation

<table>
<thead>
<tr>
<th><strong>Hedge Street</strong></th>
<th>Applied 3/13/01 (stayed)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Island Futures Exchange</strong></td>
<td>Applied 11/27/01 (pending)</td>
</tr>
<tr>
<td><strong>One Chicago</strong></td>
<td>Applied 1/14/02 (pending)</td>
</tr>
</tbody>
</table>

* Only operational or newly designated contract markets are included. To date, no entities are registered as derivatives transaction execution facilities and none have filed notices as exempt boards of trade. Three entities have filed notices as exempt commercial markets: Intercontinental Exchange, LLC; Optionable, Inc.; and the International Maritime Exchange. For a list of registered derivatives clearing organizations, please visit the Commodity Futures Trading Commission’s (CFTC) website at: <http://www.cftc.gov/dea/dearegistered_dco.htm>
DESIGNATION CRITERIA

1. **In general.** To be designated as a contract market, the board of trade shall demonstrate to the CFTC that the board of trade meets the criteria specified in this subsection [Section 5(b) of the Act].

2. **Prevention of market manipulation.** The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.

3. **Fair and equitable trading.** The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize: (a) transfer trades or office trades; (b) an exchange of—(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps;—or (c) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

4. **Trade execution facility.** The board of trade shall: (a) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (b) demonstrate that the trade execution facility operates in accordance with the rules or specifications.

5. **Financial integrity of transactions.** The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.
6. **Disciplinary procedures.** The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

7. **Public access.** The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.

8. **Ability to obtain information.** The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the CFTC may require.

**CORE PRINCIPLES**

1. **In general.** To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection [Section 5(d) of the Act]. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.

2. **Compliance with rules.** The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

3. **Contracts not readily subject to manipulation.** The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

4. **Monitoring of trading.** The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

5. **Position limitations or accountability.** To reduce the potential threat
of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

6. **Emergency authority.** The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the CFTC, where necessary and appropriate, including the authority to: (a) liquidate or transfer open positions in any contract; (b) suspend or curtail trading in any contract; and (c) require market participants in any contract to meet special margin requirements.

7. **Availability of general information.** The board of trade shall make available to market authorities, market participants, and the public information concerning: (a) the terms and conditions of the contracts of the contract market; and (b) the mechanisms for executing transactions on or through the facilities of the contract market.

8. **Daily publication of trading information.** The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

9. **Execution of transactions.** The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.

10. **Trade information.** The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

11. **Financial integrity of contracts.** The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures
commission merchants and introducing brokers and the protection of customer funds.

12. **Protection of market participants.** The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.

13. **Dispute resolution.** The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.

14. **Governance fitness standards.** The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).

15. **Conflicts of interest.** The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.

16. **Composition of boards of mutually owned contract markets.** In the case of a mutually-owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.

17. **Record keeping.** The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the CFTC for a period of five years.

18. **Antitrust considerations.** Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid: (a) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (b) imposing any material anticompetitive burden on trading on the contract market.
APPENDIX 2:
Registered Derivatives Transaction Execution Facilities

REGISTRATION CRITERIA

1. **In general.** To be registered as a registered derivatives transaction execution facility, the board of trade shall be required to demonstrate to the CFTC only that the board of trade meets the criteria specified in [Section 5a(b) of the Act] and this subsection [Section 5a(c) of the Act].

2. **Deterrence of abuses.** The board of trade shall establish and enforce trading and participation rules that will deter abuses and has the capacity to detect, investigate, and enforce those rules, including means to: (a) obtain information necessary to perform the functions required under this section; or (b) use technological means to—(i) provide market participants with impartial access to the market; and (ii) capture information that may be used in establishing whether rule violations have occurred.

3. **Trading procedures.** The board of trade shall establish and enforce rules or terms and conditions defining, or specifications detailing, trading procedures to be used in entering and executing orders traded on the facilities of the board of trade. The rules may authorize: (a) transfer trades or office trades; (b) an exchange of—(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps;—or (c) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the registered derivatives transaction execution facility or a derivatives clearing organization.

4. **Financial integrity of transactions.** The board of trade shall establish and enforce rules or terms and conditions providing for the financial
Appendix 2: Registered Derivatives Transaction Execution Facilities

integrity of transactions entered on or through the facilities of the board of trade, and rules or terms and conditions to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

**CORE PRINCIPLES**

1. *In general.* To maintain the registration of a board of trade as a derivatives transaction execution facility, a board of trade shall comply with the core principles specified in this subsection [Section 5a(d) of the Act]. The board of trade shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles.

2. *Compliance with rules.* The board of trade shall monitor and enforce the rules of the facility, including any terms and conditions of any contracts traded on or through the facility and any limitations on access to the facility.

3. *Monitoring of trading.* The board of trade shall monitor trading in the contracts of the facility to ensure orderly trading in the contract and to maintain an orderly market while providing any necessary trading information to the CFTC to allow the CFTC to discharge the responsibilities of the CFTC under the Act.

4. *Disclosure of general information.* The board of trade shall disclose publicly and to the CFTC information concerning: (a) contract terms and conditions; (b) trading conventions, mechanisms, and practices; (c) financial integrity protections; and (d) other information relevant to participation in trading on the facility.

5. *Daily publication of trading information.* The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for contracts traded on the facility if the CFTC determines that the contracts perform a significant price discovery function for transactions in the cash market for the commodity underlying the contracts.
Appendix 2: Registered Derivatives Transaction Execution Facilities

6. **Fitness standards.** The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members, and any other persons with direct access to the facility, including any parties affiliated with any of the persons described in this paragraph.

7. **Conflicts of interest.** The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the derivatives transaction execution facility and establish a process for resolving such conflicts of interest.

8. **Record keeping.** The board of trade shall maintain records of all activities related to the business of the derivatives transaction execution facility in a form and manner acceptable to the CFTC for a period of five years.

9. **Antitrust considerations.** Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid: (a) adopting any rules or taking any actions that result in any unreasonable restraint of trade; or (b) imposing any material anticompetitive burden on trading on the derivatives transaction execution facility.
APPENDIX 3:
The Commodity Futures Trading Commission (CFTC) Market Surveillance Program

Futures prices are widely quoted and disseminated throughout the US and abroad. Business, agricultural, and financial enterprises use futures markets for pricing information and for hedging against price risk. The goals of the CFTC’s market surveillance program are to preserve these economic functions of the futures and option markets under its jurisdiction by monitoring trading activity to detect and prevent manipulation or abusive practices, to keep the commission informed of significant market developments, to enforce CFTC and exchange speculative position limits, and to ensure compliance with CFTC reporting requirements.

The Market Surveillance Mission

The primary mission of the market surveillance program is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for all active futures and option contract markets, the CFTC’s market surveillance staff monitors the daily activities of large traders, key price relationships, and relevant supply and demand factors in a continuous review for potential market problems.

Despite the great diversity among the underlying commodities on which futures contracts are based, from a surveillance perspective markets can be grouped according to their settlement provisions.

Physical-delivery commodities. Futures contracts that require the delivery of a physical commodity are most susceptible to manipulation when the deliverable supply on such contracts is small relative to the size of positions held by traders, individually or in related groups, as the contract approaches expiration. The more difficult and costly it is to augment deliverable supplies within the time constraints of the expiring futures contract’s delivery terms, the more susceptible to manipulation the contract becomes.
Appendix 3: The CFTC Market Surveillance Program

Pertinent surveillance questions for such markets are the following:

(i) are the positions held by the largest long trader(s) greater in size deliverable supplies not already owned by such trader(s)?
(ii) are the long traders likely to demand delivery?
(iii) is taking delivery the least costly means of acquiring the commodity?
(iv) to what extent are the largest short traders capable of making delivery?
(v) is making futures delivery a better alternative than selling the commodity in the cash market?
(vi) is the futures price, as the contract approaches expiration, reflecting the cash market value of the deliverable commodity?
(vii) is the price spread between the expiring future and the next delivery month reflective of underlying supply and demand conditions in the cash market?

An excellent barometer for potential liquidation problems is the basis relationship (i.e., the cash and futures price difference). When the price of the liquidating future is abnormally higher than underlying cash prices or both the futures and underlying cash price are abnormally higher than comparable cash prices, there is ample reason to examine the causes and to assess the motives of traders holding long futures positions.

Financial instruments. Futures contracts that require the delivery of a financial instrument generally are less likely than futures on physical commodities to be subject to manipulation in the form of squeezes. This assertion is based on the premise that the underlying cash markets for financial instruments tend to be deeper, more liquid, more transparent, and more readily arbitraged than physical commodity markets. Nonetheless, certain of the questions specified above still pertain, particularly when the above-stated assumptions do not hold. For example, when the particular financial futures contract provides for a deliverable supply that either is of finite size or is a narrow segment of the broader cash market for the underlying financial instrument, all the
questions raised in the prior section on physical commodities would apply.

In addition, price aberrations in the cash market for the underlying financial instrument may provide an indication of (or an opportunity for) an attempted manipulation. Surveillance staff monitor cash prices for the financial instrument specified for delivery on the futures contract in relation to cash prices for non-deliverable instruments that would be close, or identical, substitutes in the cash market. Relatively high prices for deliverable, as compared to nondeliverable, financial instruments may be an indication of an attempt to remove deliverable supplies from the futures market as part of an attempted manipulation. Also, to the extent participants in the markets take positions vastly beyond their financial means or capacity to take delivery or make settlement, this may be a sign of manipulative activity.

Several financial products involve US Treasury or Agency instruments (e.g., bonds or notes). The CFTC surveillance staff, therefore, maintains open lines of communication with, among others, the US Treasury Department, the Federal Reserve Bank of New York, and the Securities and Exchange Commission.

*Cash-settled markets.* The size of a trader’s position at the expiration of a cash-settled futures contract cannot affect the price of that contract because the trader cannot demand or make delivery of the underlying commodity. The surveillance emphasis in cash-settled contracts, therefore, focuses on the integrity of the cash price series used to settle the futures contract. Since manipulation of the cash market can yield a profit in the futures contract, CFTC staff monitor futures positions of significant size and are alert for unusual cash market activities on the part of large futures traders, especially in the period of time that the final cash price for futures settlement is determined.

Pertinent surveillance questions for those markets are:

(i) as the futures contract expiration approaches, is the cash price moving in a manner consistent with supply and demand factors and/or with other comparable cash prices that are not used in the cash-settlement process?
Appendix 3: The CFTC Market Surveillance Program

(ii) do traders with large positions in the expiring future have the capacity to affect the cash price series used to settle the futures contract?

(iii) what information can be obtained from the organization that compiles the cash price series regarding how the price is determined for the period in question? Is anyone reporting prices that appear to be out of line with prices reported by others, and can it be determined if the party reporting those prices holds a futures position that would be affected favorably by those prices?

Special concerns related to equity futures. Generally, equities and derivatives markets likely will be closely linked through intermarket arbitrage. Therefore, effective surveillance of equity futures markets requires coordination among the exchanges trading the underlying equities and equity options to address intermarket trading abuses, such as manipulation, front running of customer orders and insider trading.

If the stock index underlying the futures and/or option contract is broad-based in terms of both the number and capitalization of the equities included in the index, intermarket price manipulation and insider trading (regarding information on individual stocks) concerns will be greatly reduced. Narrower indices and single-stock derivatives may require more aggressive surveillance and added protections with respect to misuse of information, especially to the extent that the market is, or acts like, a market in a single security. The CFTC cooperates with the Securities and Exchange Commission and encourages intermarket cooperation on surveillance issues.

Sources of Market Information

To accomplish its objectives, the CFTC market surveillance program uses many sources of daily market information. Some of this information is publicly available, including data on the overall supply, demand, and marketing of the underlying commodity; futures, option and cash prices; and data on trading volume and open contracts. Some of the information is highly confidential, including data from exchanges, intermediaries and large traders.
Exchanges report to the commission the daily positions and transactions of each clearing member. These data are transmitted electronically during the morning after the «as of» date. They show, separately for proprietary and customer accounts, the aggregate position and trading volume of each clearing member in each futures and option contract. These data are useful for quickly identifying the firms that clear the largest buy or sell volumes or hold the biggest positions in a particular market. The clearing member data, however, do not identify the beneficial owners of the positions.

To address this limitation, CFTC has at the heart of its market surveillance system a large-trader reporting system. Under this system, clearing members, futures commission merchants (FCM), and foreign brokers (collectively called reporting firm) electronically file daily reports with the CFTC. These reports contain the futures and option positions of traders that hold positions above specific reporting levels set by CFTC regulations—A list of current CFTC reporting levels can be found at the CFTC’s website. If, at the daily market close, a reporting firm has a trader with a position at or above the commission’s reporting level in any single futures month or option expiration, it reports that trader’s entire position in all futures and options expiration months in that commodity, regardless of size.

Since traders frequently carry futures positions through more than one FCM and since individuals sometimes control or have a financial interest in more than one account, the CFTC routinely collects information that enables its surveillance staff to aggregate related accounts. Reporting firms must file a CFTC Form 102 to identify each new account that acquires a reportable position. In addition, once an account reaches a reportable size, the account owner periodically is required to file a more detailed identification report, a CFTC Form 40, to further identify accounts and reveal any relationships that may exist with other accounts or traders.

To obtain more detailed and targeted information, CFTC may issue a “special call,” to a reporting trader or firm. The special call is designed to gain additional information on a participant’s trading and delivery activity, and may include the trader’s positions and transactions in the underlying commodity.
Appendix 3: The CFTC Market Surveillance Program

Regulatory Response When Problems Develop

Surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their critical expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advise the CFTC senior staff of potential problems and significant market developments at weekly surveillance meetings so that they will be prepared to take prompt action when necessary.

The market surveillance process is not conducted exclusively at the commission. Surveillance issues are usually handled jointly by the CFTC and the affected exchange. Relevant surveillance information is shared and, when appropriate, corrective actions are coordinated. Potential problem situations are jointly monitored and, if necessary, verbal contacts are made with the brokers or traders who are significant participants in the market in question. These contacts may be for the purpose of asking questions, confirming reported positions, alerting the brokers or traders as to the regulatory concern for the situation, or warning them to conduct their trading responsibly. This “jawboning” activity by the CFTC and the exchanges has been quite effective in resolving most potential problems at an early stage.

The CFTC customarily gives the exchange the first opportunity to resolve problems in its markets, either informally or through emergency action. If an exchange fails to take actions that CFTC deems appropriate, the commission has broad emergency powers under which it can order the exchange to take actions specified by CFTC. Such actions could include limiting trading to liquidating transactions, imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or closing a market. Fortunately, most issues are resolved without the need to use the CFTC’s emergency powers. The fact that the commission has had to take emergency actions only four times in its history demonstrates its commitment to not intervene in markets unless all other efforts have been unsuccessful.
Appendix 3: The CFTC Market Surveillance Program

Enforcement of Position Limits

The surveillance staff also monitors compliance with CFTC or exchange speculative-limit rules—see a separate backgrounder on Speculative Limits, Hedging, and Aggregation in Commodity Futures and Options available on the CFTC’s website. These rules help prevent traders from accumulating concentrations of contracts of a size sufficient to possibly disrupt a market. To monitor those limits, the market surveillance staff reviews daily large-trader reports for potential violations. Although bona fide hedgers are exempt from speculative limits, CFTC staff monitor hedgers’ compliance with their exemption levels. Commercial traders that carry futures and option positions in excess of CFTC speculative position limit levels are required to submit a monthly statement of cash positions. These statements show the total cash position of each trader, which reflects the amount of the trader’s actual physical ownership of each commodity and the amount of the trader’s fixed-price purchases and sales for which the trader has a legitimate cash risk. CFTC staff compares each trader’s cash position to the trader’s futures and option positions.

In summary, the CFTC has a comprehensive market surveillance program to detect and prevent corruption of the economic functions of the futures and option markets that it oversees.
11

Regulation of Demutualized Exchanges (Australia)

Claire Grose

11.1 Legislative Framework

The current legislative framework for regulation of securities and futures markets in Australia is set out in the Corporations Act 2001 (Act), a Commonwealth law which commenced on 15 July 2001. The Act replaces and largely replicates the national scheme of Corporations Laws of the Australian States and Territories which has operated in Australia for the last 10 years. The national scheme has effectively been re-enacted as a Commonwealth law for Australian constitutional law reasons.

The Financial Services Reform Act 2001 (FSR Act) will change some aspects of the current regulatory regime in a number of important ways. The FSR Act will commence on 11 March 2002. Accordingly this chapter will describe the current provisions and indicate important changes that are to be made to them by the FSR Act.

The Act prohibits the conduct of an unauthorised securities or futures market in Australia. It vests in the Minister extensive regulatory functions in relation to the approval and operation of securities and futures exchanges. These include powers to approve new exchanges, and control of amendments to the business and listing rules of the exchanges by means of notification and disallowance. The Minister also has the power to remove the authorisation of an exchange.

---

1 Special Counsel, Regulatory Policy Branch, Australian Securities and Investments Commission.
11.2 Australian Securities and Investment Commission’s (ASIC) Powers

In contrast with the regulatory powers of the Minister, which focus on the adequacy of the supervisory framework and conduct of the market operator itself, ASIC’s powers in relation to markets mainly focus on the conduct engaged in upon the regulated market by market intermediaries and listed entities.

ASIC can prohibit trading in certain circumstances. It also has powers to take action in relation to market misconduct including breaches of the continuous disclosure rules, insider trading, market manipulation, false and misleading trading and market rigging transactions, false and misleading statements and fraudulently inducing persons to deal in securities. ASIC regulates the conduct of licensed intermediaries in relation to their clients under the licensing provisions of the Act.

ASIC also receives notification of rule amendments from the exchanges and applications for authorization of new exchanges. At a practical level, ASIC reviews rule amendments and applications for new markets in detail and provides its views on them to the Minister.

11.3 Supervision by Market Operators

Both the current and the proposed legislation envisage that market operators play a supervisory role in relation to the markets they operate. This is an important mechanism in ensuring that the cost of the regulation to which the market is subject is borne by market participants and users.

The conduct of the market involves potentially three distinct areas of supervision:

(i) supervision of the market itself;

(ii) supervision of participants in the market (including their dealings with their clients); and

(iii) supervision of entities whose securities are traded on the market.

Under the Act, a regulated exchange has an obligation to provide assistance to ASIC, lodge with ASIC particulars of disciplinary action and provide ASIC with details in relation to serious contraventions of the exchange rules or of the Act.
11.4 Memoranda of Understanding (MOUs)

These legislative provisions are supported at a practical level by operational arrangements between ASIC and each regulated exchange documented in Memoranda of Understanding. ASIC and Australian Stock Exchange Limited (ASX) have entered into MOU arrangements in relation to markets, membership, companies matters and transfer of information matters. There is also a MOU dealing with arrangements for ASIC’s supervision of ASX as a self-listed entity.

The markets and companies MOUs deal with procedures for the referral of serious matters by ASX to ASIC for further investigation and action relating to conduct by market participants or disclosure by listed entities. The companies MOU sets out the arrangements agreed between ASX and ASIC to promote cooperation and assistance in monitoring and, where appropriate, enforcing provisions of the listing rules. It also deals with the role of ASIC in enforcing provisions of the Act relating to disclosure, accounting, corporate governance and related party matters.

The membership MOU sets out the arrangements agreed between ASX and ASIC to promote cooperation in monitoring, surveillance and enforcement actions in relation to ASX participating organisations.

ASIC and SFE Corporation Limited (SFE), formerly known as Sydney Futures Exchange Limited, have also entered into a MOU which covers procedures for the referral of serious matters by SFE to ASIC for further investigation and action relating to conduct by market participants.

11.5 Changes Due to Demutualization

In the lead up to the ASX demutualization and self-listing the self-regulatory responsibilities of regulated securities exchanges were reviewed. New provisions were enacted to:

(i) permit a securities exchange to self-list;
(ii) empower ASIC to supervise an exchange as a listed company on its own exchange;
(iii) separate participants’ rights of access to trading from membership of the exchange in a company law sense;
(iv) clarify an exchange’s role as a co-regulatory organization by
directly placing on it ongoing obligations to run an orderly and fair market;

(v) require an exchange to report to the Minister annually on its compliance with its ongoing obligations;

(vi) empower the Minister to give directions to an exchange to ensure it complies with the ongoing obligations;

(vii) enable the Minister to require an exchange to obtain an audit report on its annual regulatory report on its compliance with its ongoing obligations;

(viii) enable the Minister to require an exchange to prepare and give to ASIC a special report on the exchange's compliance with its ongoing obligations. The Minister may require an audit report on the special report.

This legislation also imposed a 5% shareholder limit on ASX. The statutory limitation restricts persons and their associates both Australian and foreign from owning or controlling more than 5% of the shares in ASX.

These provisions apply only to securities exchanges. This meant that when SFE demutualized, ASIC and SFE entered into a deed whereby SFE agreed to comply with contractual arrangements that are substantially the same as the ongoing obligations and reporting requirements of a securities exchange. The FSR Act extends these obligations and requirements to all licensed financial market operators.

Newcastle Stock Exchange (NSX) demutualized when its regulated market was revived in 2000. ASIC and NSX have entered into a comprehensive MOU covering similar matters to those dealt with in the various ASX MOU. Bendigo Stock Exchange is also a commercialised entity and ASIC is negotiating similar arrangements in relation to its market.

In demutualized exchange markets the relationship between the market operator and market participants may not be conducive to the market operator closely supervising the conduct of participants other than in their direct involvement in the market. The commercial objectives and activities of an exchange may also bring it into conflict with the listed entities that it also regulates.

The regulatory framework in which a market operates is (and will continue to be) largely determined by the approval process and the continuing scrutiny of that framework through the rule disallowance process.
11.6 New Legislation

The *FSR Act* provides a new regime for all financial products and services (particularly relating to disclosure of products and licensing of intermediaries), and overhauls the now outmoded provisions that apply to markets and clearing and settlement facilities.

The legislation places a ceiling on ownership of “public interest” exchanges such as ASX and SFE of 15% (with a power to approve holdings above the 15% limit), and at the same time introduces an explicit “fit and proper person” test for directors and executive officers and shareholders holding more than 15%. Interestingly, the legislation does not use the word “exchange” and all the assumptions of the old law relating to exchanges and their members have been replaced.

There are also further measures to strengthen the accountability of market operators for their market supervision obligations, including an obligation for ASIC to conduct annual “audit” reviews of a market operator’s supervision responsibilities. The *FSR Act* will require all market operators to demonstrate that they have appropriate arrangements in place to deal with all conflicts between the commercial interests and operating the market in a fair, orderly and transparent manner as part of the license approval process. All market operators must also show that they have on an ongoing basis sufficient resources (including financial, technological and human resources) to operate their markets properly and for the statutory supervision arrangements to be provided.

The new regime also contains a means for explicit recognition under the Australian regime of markets operating in Australia, but having their home base in other jurisdictions.

ASIC considers that current market supervisory arrangements in Australia are likely to continue to evolve in response to the pressures faced by markets around the world. It expects that there will be increased scrutiny of the framework of market supervision by market participants, by regulators in other countries as a pre-condition to the entering into cross border alliances and by international bodies in their reviews of how well individual countries are complying with international standards and principles.
PART II

Demutualization Case Studies
12 Australian Stock Exchange—The Conversion to a Demutualized Exchange: ASX’s Experience

David Holthouse

12.1 Introduction

The Australian Stock Exchange (ASX) was the first stock exchange to both demutualize and be admitted to its own official list of companies. This chapter examines, with a practical emphasis, the circumstances surrounding ASX’s own demutualization and listing. General themes of interest to other exchanges in our region relative to a demutualization decision will, no doubt, emerge during later panel discussions. The discussion in this paper addresses the topic under the following headings:

- Background to ASX's Demutualization
- Obtaining Member Approval
- Mechanism Used for Conversion
- Changes to the Corporations Law
- The Demutualization Process
- Memorandum of Understanding (MOU) with ASIC
- Listing and Demutualization Outcomes
- Subsequent Supervisory Development: ASX Supervisory Review
- Changes in ASX's Focus and Activities

1 National Manager, International Affairs, Australian Stock Exchange.
12.2 Background to the Australian Stock Exchange’s Demutualization

ASX was created in 1987 by the Australian Stock Exchange and National Guarantee Fund Act 1987, which deemed the Exchange to be incorporated under Australian companies law and to be a company limited by guarantee. ASX was formed by the amalgamation of six State-based exchanges located in Sydney, Melbourne, Brisbane, Perth, Adelaide and Hobart. Each of the State exchanges had a long history, being formed between 1871 and 1898.

ASX’s demutualization and listing process began in 1995 when the ASX Board formed a task force, comprised of ASX Board and Management representatives, to examine options to change the Company’s structure. Were the task force to consider it appropriate, then it was to formulate a proposal to change the relationship between ASX and its members and to remove the requirement that access to ASX’s markets should hinge on membership of the Exchange.

At the time that the topic of demutualization was being considered by ASX, the Exchange had two classes of members: Corporate Members (Member Organizations) and Natural Person Members (members). Neither class of members was able to transfer their rights to another party directly² (i.e., that is, there were no seats). Furthermore, Corporate Members were numerically in the minority, but they dominated trading.³

By way of background, seats were abolished by the old State-based exchanges during the period 1984 to 1986, by the process of buying back by the exchanges. Thereafter access to the market was available to any applicant who met ASX’s Business Rule requirements, which included the payment of a one-off fee at the time of initial application and an ongoing annual maintenance fee.

---

² It was possible, however, for a party to indirectly purchase the trading right of a Corporate Member through buying a controlling interest in the latter.
³ As at 30 June 1998 corporations were responsible for 99% of transactions on ASX’s markets, but were in a minority of 93 compared with 522 Natural Person Members. Members in both classes each had a single vote.
12.3 Obtaining Member Approval

On 24 September 1996, ASX distributed a Notice of Special General Meeting to its members, together with an explanatory memorandum. The Notice included a recommendation by the ASX Board for a demutualization proposal.

Members of ASX were asked to vote on a proposal to mandate the ASX Board to seek from the Australian Parliament legislation that would change the nature of existing membership rights and simultaneously convert ASX from a company limited by guarantee to a company limited by shares. In essence this meant that, in return for ceding mutual ownership and any control of ASX that mutual ownership may bestow, each relevant member would be allocated shares in ASX.

The proposal was put to members on the basis that the board of ASX believed that the membership should consider whether, in order to deal with future challenges, ASX needed to change the way it was owned and governed. There was no need to raise capital; nor was there a compelling reason to find a way to distribute direct financial benefits to members. Rather, it was put to members that key determinants for their consideration included assessments whether:

(i) competition was real and growing for ASX, and for the products and services it offered;
(ii) a non-mutual structure would equip ASX better than a mutual structure to meet competition;
(iii) members’ interests were diverging (and were unlikely to reconverge) and the same benefits were not necessarily derived by all members from the services provided by ASX;
(iv) members’ interests would not always coincide with those of ASX itself; and
(v) it is undesirable in the long term for control of an entity to reside with only one group of its customers.

The ASX Board and Management considered that each of these factors brought into question the suitability of the mutual form of

---

4 Under ASX’s constitution for the resolution to be passed there needed to be a 75% majority of votes cast at the members’ meeting in favor of the resolution.
ownership for ASX, and that collectively they represented a strong case for demutualization. Nevertheless, great care was taken to include objective analysis of both sides of the argument—for and against—in the materials provided to members.

On 18 October 1996 the members voted overwhelmingly to endorse alterations to the constitution of ASX, requiring the Board to seek the enactment of Australian Commonwealth legislation that would allow demutualization.

12.4 Mechanism Used for Conversion

The main resolution approved by ASX members was that a new article should be inserted into ASX’s Articles of Association which would mandate the board to approach government for legislation to convert ASX to a company limited by shares. The Article set out the components of the legislation that would be sought by ASX. The chief components were:

(i) conversion of the corporate status of ASX to a company limited by shares. At the time that the members’ resolution was passed, there were no legal means by which a company limited by guarantee could convert to a company limited by shares;

(ii) vesting of the shares in ASX, in its members; and

(iii) breaking the nexus in the Corporations Law between membership of ASX (as a corporation) and access to its trading facilities by, and regulation of, market participants.  

Ancillary elements of the legislation to be sought were:

(i) recognition of a new Memorandum and Articles of Association to be prepared by ASX in accordance with the guidelines and principles set out in the foregoing new Article. The guidelines and principles were essentially those appropriate for a listed public company;

---

5 Over 96% of members supported the recommendation. Members were entitled to one vote each.

6 The Corporations Law reflected a general assumption that membership of an exchange is limited to brokers or those with access to the securities-related services provided by the exchange.
(ii) recognition of amended ASX Business Rules to be prepared by ASX in accordance with the guidelines and principles set out in the new Article. These guidelines and principles were intended, to the extent appropriate, to replicate the existing systems and disciplinary principles and procedures of members and Member Organisations reflected in the Articles of Association and Business Rules of ASX prior to conversion;

(iii) recognition of every organisation which was a Member Organisation at the time the legislation took effect, as a trading Participating Organisation for the purposes of the new Memorandum, Articles and Business Rules;

(iv) recognition of every Natural Person Member at the time the legislation took effect, as an Affiliate for the purposes of the new Memorandum, Articles and Business Rules; and

(v) a statutory statement that the ASX Business Rules had a legally binding effect as between admitted trading participating organizations, affiliates and ASX itself.

12.5 Changes to the Corporations Law

Following the overwhelmingly positive vote by ASX members, management of ASX worked closely with the Australian Government to develop the legislation necessary to achieve the change in structure. This legislation was released in Bill form for public comment on 6 August 19977 and it came into effect on 16 December 1997.

New provisions were inserted in the Corporations Law, which clarified ASX’s responsibilities as a self-regulatory organization and ensured appropriate accountability to the Australian Securities and Investments Commission (ASIC) and to the government in carrying out those responsibilities. Obligations were imposed on ASX (and on securities exchanges generally) as follows:

(i) to the extent reasonably practicable, to do everything necessary to ensure that the market ASX conducts is an orderly and fair market;

---

(ii) to have adequate arrangements for monitoring and enforcing compliance with ASX’s rules;

(iii) to have adequate arrangements for the expulsion, suspension or disciplining of market participants for inappropriate conduct;

(iv) to have adequate arrangements for the settlement of transactions that result from trading in securities on a stock market ASX conducts; and

(v) to have adequate arrangements for investigating complaints by investors.8

The Australian Commonwealth Government Minister responsible for financial regulation in Australia (hereafter the Minister) was empowered to direct an exchange to do specified things that the Minister believed would promote compliance with these requirements.

An obligation was also introduced for annual reports to be provided by Securities Exchanges about compliance with these requirements. These reports must be prepared within three months after the end of each financial year and be provided to ASIC. The Minister may request that the reports be audited. Furthermore, at any time, the Minister may request a special report about compliance with ongoing requirements by an exchange, and may also require that the special report be audited.

In addition to clarifying the responsibilities of ASX as a self-regulatory organisation and ensuring appropriate accountability for the proper conduct of them, an ownership limitation was imposed on ASX. This limited persons and their associates (Australian and foreign) to having voting power in ASX not exceeding 5%.

The Law was also amended to allow ASIC to supervise ASX’s compliance with its listing rules in respect of ASX’s own listing.

12.6 The Demutualization Process

ASX undertook the following actions in the lead-up to demutualization and listing:

- It amended its listing rules on 1 July 1998 to introduce a special chapter dealing with its listing.

---

8 Corporations Law, section 769A.
• It rewrote its Memorandum and Articles of Association and its Business Rules. The amendments included a mechanism for downsizing the Board and changing the Board’s broker-dominated composition.

• It conducted roadshows and consulted extensively with its Members concerning these amendments and the issues pertinent to demutualization.

• It separated Board and management functions by reviewing the role of committees.

• It implemented a due diligence program for the conversion and listing of ASX including detailed briefings to Board and senior management and the establishment of data management processes for the due diligence process.

• It created employee share plans to incentivise and retain staff and developed rules concerning dealing in the securities of ASX by directors and staff.

• It introduced obligations on directors and staff designed to promote compliance with the continuous disclosure requirements of the listing rules.

• It developed a dividend policy and a policy on the use of cash balances.

• It issued a detailed Information Memorandum dated 28 August 1998 to support its listing.

• It made application to ASIC on 31 August 1998 for ASX to be demutualized.

It entered into an MOU with ASIC on 23 September 1998 under which ASIC was to administer ASX’s listing and the quotation of its securities in order to avoid the conflict of interest that may have arisen had ASX administered its own listing and quotation. The MOU is discussed further below.

ASX also made changes to its business structures to prepare for the transition to a for-profit company. In particular, ASX undertook a comprehensive review of its operating and management structure in preparation for listing. As a result, a new structure was adopted in May
1998, better to reflect the importance of customer service, quality and efficiency. Key changes included the creation of a separate Investigations and Enforcement Unit and the establishment of a Corporate Relations Division for liaison with analysts and investors.

Fortunately for ASX, the exchange already had in place many of the corporate governance mechanisms and annual reporting practices suitable for a large public listed company.

### 12.7 Memorandum of Understanding (MOU) with ASIC

As noted above, ASX and ASIC entered into an MOU in relation to ASX’s self-listing. This MOU set out the way that ASX, the Australian Settlement and Transfer Corporation Pty Ltd (ASTC)\(^9\) and ASIC relate to each other in monitoring ASX’s compliance as a listed entity with the Listing rules, the *SCH Business Rules* (ASX’s settlement rules) and the *Corporations Law*. The MOU also addressed ASIC’s supervision of ASX as a listed entity.

An important objective in negotiating the MOU was the desire to ensure consistency of outcomes and timing between ASX in its administration of the listing rules for other listed entities, and ASIC in its administration of the listing rules for ASX.

Some key aspects of the MOU include:

- ASIC is responsible for supervising ASX’s compliance with the listing rules. In relation to the continuing supervision of ASX as a listed entity, ASIC is responsible for exercising powers and functions that ASX has as a securities exchange in relation to other listed entities.
- ASX is not bound to monitor or enforce the listing rules in relation to itself.
- ASTC is responsible for supervision of ASX’s compliance with the *SCH Business Rules* and its application for admission to CHESS, as it is for other listed entities, and ASIC may direct ASTC to exercise certain powers and functions in relation to ASX.

---

\(^9\) ASTC is a wholly owned subsidiary of ASX and is responsible for the development and operation of ASX settlement system, CHESS.
ASX makes its announcements to ASIC in the same way that other entities make their announcements to ASX. Once cleared by ASIC, ASX’s announcements are to be released to the market through ASX’s own company announcement platform.

ASX will set appropriate parameters for generating surveillance alerts relating to dealings in its own securities. If required by ASIC, ASX will provide assistance and allow ASIC to analyse trading in ASX’s securities.

The structure is designed to allow independent supervision of ASX’s compliance with its listing rules, while at the same time utilizing the platforms and mechanisms ASX has established to practically accommodate supervisory activities.

12.8 Demutualization and Listing Outcomes

Demutualization of ASX occurred on 13 October 1998 and as part of the demutualization process former eligible members were issued shares in ASX. The issue of shares occurred on the following basis:

- Each of the 606 eligible former Corporate and Natural Person Members received 166,000 shares resulting in a total issued capital of 100,596,000 shares.10
- There was no “cash out” offer for members, and there were no additional shares offered or funds raised by ASX.
- There were no special restrictions placed on members concerning the sale of ASX shares.11
- There were no minimum shareholding requirements placed on members.

Following demutualization, ASX made an application to ASIC for admission to ASX’s own official list and for quotation of its shares. Listing of ASX and quotation of its shares occurred on 14 October 1998.

---

10 While ASX had both corporate and natural person members, all members were treated equally for share distribution purposes.
11 There was however a 5% individual ownership cap imposed by the Government and contained in the Corporations Law. This is in the process of being lifted to 15%.
12.9 Subsequent Supervisory Development: ASX Supervisory Review Pty Limited

A demutualized exchange needs to be constantly looking at ways of innovating, and of enhancing its reputation for integrity. In this context, earlier this year, ASX established an entity with a charter which, among other things, empowered it to review ASX’s supervisory activities. The new entity, ASX Supervisory Review Pty Limited:

(i) reviews the policies and procedures of the units in the ASX Group which have supervisory functions. This includes a review of the level of funding and resources provided by ASX for its supervisory functions;

(ii) provides reports and expresses opinions to the ASX Board on whether appropriate standards are being met and whether the level of funding and resources for supervisory activities are adequate;

(iii) as a result of these activities, provides assurance that the ASX Group adequately complies with its ongoing responsibilities as a market and clearing house operator, is conducting its supervisory activities ethically and responsibly, and is maintaining appropriate controls against employee conflict of interest; and

(iv) oversees supervision of those of ASX’s listed entities which have special identified conflicts and which select this option (the Review Group).12 The oversight function encompasses consultation on each supervisory decision which involves the exercise of discretion.

In addition to reporting to the ASX Board, ASX Supervisory Review’s reports are used to assist in the preparation of ASX’s annual regulatory report to the Minister and are made available to ASIC.

---

12 The “Review Group” will comprise entities which satisfy one of the following criteria: (a) their business is in direct competition with ASX’s business in a material way for ASX; (b) they hold a substantial shareholding interest in ASX; (c) ASX holds a substantial shareholding interest in them; (d) the entity “controls” an entity falling with paragraphs (a), (b), or (c). For this purpose “control” means the direct or indirect capacity to dominate decision making in accordance with AASB 1017: Related Party Disclosure; or (e) it is otherwise desirable for the entity to fall within the Group because of the potential for significant conflict of interest.
The Board of ASX Supervisory Review Pty Limited is comprised of a majority of nonexecutive, independent\textsuperscript{13} persons with complementary skills. Individual appointees are chosen from a panel nominated by ASX. ASIC has the power to veto any particular panelist. Proposed appointees are notified to the Minister prior to their appointment. Appointments are for a term of three years. Existing directors may be reappointed.

ASX considers this structure best promotes consistency of outcomes and timing while affording an extra dimension of transparency and accountability.

**12.10 Changes in ASX’s Focus and Activities**

Since demutualization ASX has experienced a number of significant changes in its focus and activities. These include:

(i) increased flexibility in decision-making;
(ii) increased customer focus; and
(iii) expansion of activities.

**12.10.1 Increased Flexibility in Decision-Making**

One of the most important changes that has accompanied demutualization is that ASX now has much greater flexibility in its decision-making. The Exchange is therefore better equipped to make timely decisions for market users, and to respond to changing circumstances.

Prior to demutualization, access to ASX’s market facilities was largely controlled by its existing market customers. Key criteria for admission to market participation comprised “membership” criteria and was set out

\textsuperscript{13} An independent director for this purpose is a person who: (1) is not and has not been in the previous two years an affiliate of ASX; (2) is not and has not been in the previous two years a partner, director, officer or employee of a Participating Organization of ASX or a related body corporate; (3) is not and has not been in the previous two years a director, officer or employee of ASX or a related body corporate; (4) does not have a material interest in ASX or a related body corporate; (5) is not a spouse, de facto spouse, parent or child of a person in any of the previous categories; and (6) is not and has not been in the previous two years a professional adviser to ASX or a related body corporate.
in the Articles of Association. A special resolution of the membership was required to broaden access to the ASX market. Much of ASX’s decision-making prior to demutualization was by brokers on committees. Following demutualization most of the decision-making responsibility was transferred to ASX management. Committees continue to exist, but their composition reflects competencies and experience required for the particular function and they are typically used for consultation and/or appeals from management decisions.\(^\text{14}\)

### 12.10.2 Increased Customer Focus

Another important change that has occurred is an increased customer focus. Prior to demutualization, as brokers were the owners of ASX, a disproportionate amount of time was spent serving their needs. Since demutualization, while brokers remain an important and valued customer, ASX has spent a great deal of time focusing on the needs of other customer groups such as listed companies and investors. This has resulted in changes in organizational lines to provide a better fit with customer groups, the appointment of various account managers for key customers, and more attention being devoted to marketing, education and information dissemination.

### 12.10.3 Expansion of Activities

Since demutualization ASX has examined ways of enhancing profitability, diversifying its revenue base and providing value-adding services to customers. This has resulted in ASX expanding into new but related businesses, including:

1. a joint venture arrangement involving a share registry business;\(^\text{15}\)
2. the acquisition of a 15% stake in a company that provides trading

---

\(^{14}\) As an example, decisions made in relation to admissions to ASX’s official list of companies used to be made by a Listing Committee comprised of some eight members, the majority of whom were brokers. As part of the demutualization process, decision-making authority was transferred to ASX Management. Management now has decision-making authority to admit new companies to the official list, whereas there is a Listing Appeals Committee to hear appeals on Listing Rule decisions.

\(^{15}\) On 20 March 2000 ASX and Perpetual Trustees Australia Limited (Perpetual) announced that they had formed a joint venture, incorporating the operations of Perpetual’s share registry division, Perpetual Registrars Perpetual is listed on ASX.
and order management services to professional financial market participants;\(^{16}\) and

(iii) the acquisition of a 50% stake in a company that provides an investor consultancy service.\(^ {17}\)

ASX has also announced a number of initiatives aimed at facilitating cross-border trading by investors. These have included:

(i) a two-way trading link with Singapore Exchange Limited, which is expected to be operational later this year; and

(ii) a one-way trading link into the United States market, utilizing Bloomberg’s TradeBook system.

### 12.11 Conclusion

This chapter has discussed the main steps that ASX took to achieve its demutualization and self-listing, which was a world first. The process was a complex one, taking more than three years from the time that the ASX Board first established a working group to consider ownership options. The process could not have been achieved without the strong commitment of the Board and of ASX Management. The outcome has been extremely beneficial for both ASX and the markets that it operates, and it places ASX in a strong position to respond to changes in its business environment.

The environment faced by exchanges that are in the process of demutualization can be markedly different. Nevertheless it is worthwhile noting that ASX’s demutualization and listing had the following features:

(i) demutualization was at the initiative of the Exchange—it was not mandated by government;

(ii) while ASX had both Corporate and Natural Person Members, circumstances were such that they could be effectively treated on the same basis for share distribution purposes;

---

\(^{16}\) On 19 September 2000 ASX announced that it had agreed to take a 15% stake in Bridge DFS Ltd. Bridge DFS subsequently listed on ASX.

\(^{17}\) ASX announced on 5 February 2001 that it had acquired a 50% stake in Orient Capital Pty Ltd, an unlisted company.
(iii) ASX did not have any “seats” on issue (i.e., brokers’ trading rights were not directly transferable);

(iv) demutualization did not involve the merging of separate entities;

(v) ASX had a Board and a Management team committed to demutualization; and

(vi) ASX already had in place many of the corporate governance mechanisms and annual reporting practices found in its large listed companies.

Demutualization and self-listing has been a good experience for ASX and its stakeholders; it continues to serve the Australian investment community well.
13.1 Introduction

Records of securities trading in Hong Kong date back to 1866 around the street corner in the heart of the present central business district. The first formal stock market was established in 1891. During the period between the two world wars, a second exchange was formed. The two exchanges merged after the Second World War to form the Hong Kong Stock Exchange in 1947. The rapid growth of the Hong Kong economy in the late 1960's led to the breakdown of the old tradition that stocks were investment vehicles reserved for the rich and elite upper class. The other stock exchanges were formed between 1969 and 1972—the Far East Exchange, the Kam Ngan Stock Exchange and the Kowloon Stock Exchange. There were neither securities laws nor rules and regulations governing the operations of a stock exchange at that time.

Prompted by the 1973 market crash and the need to strengthen market surveillance, the Government of the Hong Kong Special Administrative Region of the People's Republic of China set up a working party in 1977 to consider the unification of the four stock exchanges. As a result, the unified exchange or the Stock Exchange of Hong Kong, or SEHK, commenced business in April 1986. It was an arduous task for the then Hong Kong Government to push for the unification of the four exchanges. A condition of the merger was that every seat in each of the four former exchanges was given a seat in the SEHK. Another condition was that the

---

1 Deputy Chief Operating Officer, Hong Kong Exchanges and Clearing Limited.
unified stock exchange could not create any new membership. The total number of seats was 929, which explained why we had a large number of seats in the SEHK.

The Hong Kong Futures Exchange or HKFE was formerly the Hong Kong Commodities Exchange. It was established in 1976 and was an exchange for the trading of futures contracts of cotton, soy beans and a few other commodities. However, as Hong Kong had never been a commodities trading center and, in particular, garment producers that needed to hedge their position found that they were better off hedging their raw material costs in Chicago, turnover in the Futures Exchange was generally low. Around the time of the unification of the four stock exchanges, HKFE launched a new product, the Hang Seng Index Futures or the HSI Futures. It was a big success. It turned out that this single product is still the most actively traded product on our derivatives market trading. However, the risk management technique of the HKFE at that time was primitive and could not face the stringent test when worldwide stock markets collapsed in October 1987. Hong Kong market was the only one which had to close for four days in order to provide for a lifeboat arrangement so that the obligations of the Futures Exchange Clearing House could be honored.

After the stock market crash in October 1987, the Stock Exchange underwent fundamental reforms, including the establishment of more widely representative councils and strong, professional executive management teams, to safeguard the interests of all market participants and investors to operate and develop both markets effectively. The clearing house of the Hong Kong Futures Exchange also underwent major reforms in order to better cope with market risks. As can be seen, the history of the development of the securities and derivatives market in Hong Kong has long been marked by mergers and reforms. Looking back, the regulatory reform stimulated by the crash of 1987 set Hong Kong on the path to becoming a major financial centre.

13.2 Pre-Merger Period: Two Exchanges and Three Clearing Houses

Between 1986 and the merger of the various entities in 2000, the stock market, the futures market and the clearing houses in Hong Kong were established separately and operated as set forth in Figure 13.1.
13.2.1 The Stock Exchange of Hong Kong Limited (SEHK)

As stated above, SEHK commenced business in April 1986 following the merger of the then four stock exchanges in Hong Kong. It was established as a front-line, self-regulatory organization under a piece of law known as the *Stock Exchanges Unification Ordinance*. Under the ordinance, SEHK operates as a monopoly as it is the only exchange company recognised by the Hong Kong Government to establish, operate and maintain a stock market in Hong Kong.

The SEHK was incorporated under the *Companies Ordinance* in Hong Kong in the form of share capital. The authorized share capital was HK$1,200 divided into 1,200 “A” shares of HK$1 each. It was owned by its member brokers, who were required to hold at least one “A” share, which conferred membership and, thus, trading privileges. Each “A” share carried the right of one membership in the stock exchange. There were all along 929 shares outstanding held by registered dealers who operated stockbroking firms. The number is the same as the total number of seats of the four former stock exchanges before the merger in 1988. New entrants to the securities business in Hong Kong must acquire a seat or a membership from an existing member. Like other membership organisations, the limited supply of memberships created a value for the seats. The SEHK was governed by a Council, with the majority of the Council members being broker members of SEHK.

13.2.2 Hong Kong Futures Exchange Limited (HKFE)

The HKFE was established in 1976 and was licensed by the government as the exchange company to establish and operate the commodity exchange in Hong Kong under the *Commodities Trading Ordinance*. The Futures Exchange had approximately 135 members and
it was governed by a board which consisted of 12 members who were either representatives of HKFE members or independent persons.

13.2.3 Hong Kong Securities Clearing Company Limited (HKSCC)

The HKSCC is a Hong Kong company limited by guarantee and was owned 50% by the SEHK; the remaining 50% was held by a number of commercial banks. All members of SEHK must be participants of HKSCC. It operates the Central Clearing and Settlement System (CCASS) for transactions concluded at the SEHK. It also operates a depository providing custody and nominee services, and a registrar company.

For SEHK transactions, HKSCC operates a continuous net settlement (CNS) system in which it acts as the settlement counterparty to trades among Stock Exchange members. It also facilitates the settlement of transactions between brokers and custodians.

13.2.4 HKFE Clearing Corporation Limited (HKFECC)

HKFECC is a wholly owned subsidiary of the HKFE and it also acts as the clearing house to the HKFE. It is the settlement counterparty to all HKFE contracts.

13.2.5 SEHK Options Clearing House Limited (SEOCH)

SEOCH is a wholly-owned subsidiary of the SEHK established to serve as the stock options market’s clearing house. It acted as the counterparty to options trades with its members, calculates and collects margins, pays and collects options premia, and processes exercises and related settlements.

13.3 Merger and Proposal

Though major reforms had taken place since 1987, Hong Kong soon learnt that it must do more in order to secure its leadership within the region and to reinforce its position as a global financial centre. Against this background and, in particular, in response to the Asian Financial Crisis that occurred in October 1997, the Financial Secretary announced in his Budget Speech on 3rd March 1999 a comprehensive market reform
for the securities and futures market to enhance its competitiveness so as to meet the challenges of an increasingly globalized marketplace driven by the advancement of technology and the emergence of a growing population of sophisticated investors.

A proposed market structure was announced by the Hong Kong government in July 1999. The reform that took place included fundamental changes in the securities and futures regime by way of demutualization and merger of the two exchanges and three clearing houses mentioned earlier into a single holding company, the Hong Kong Exchanges and Clearing Limited (HKEx). The then existing members of the two exchanges approved the demutualization and the merger in September 1999. The merger required the approval of the stock brokers and futures brokers, who were also shareholders, of the respective exchanges. A proposal was put forward in that each share of the former exchanges would be exchanged for one trading right of the cash or futures market of the new entity plus a certain number of shares which would be traded on the Hong Kong Stock Exchange. In addition, members could sell their shares to the new company at a price. The proposal turned out to be a win-win situation for all members.

13.4 Reasons for the Merger

The demutualization and merger of the various exchanges and clearing houses in Hong Kong were necessary and imminent under the circumstances because of a number of factors set forth below:

13.4.1 Global Evolution

Exchanges around the world have been continuously undergoing reform because of the rapid evolution of the global securities and futures industry, the fierce competition faced by exchanges among themselves, and also, from independent trading systems which bypass traditional exchanges. National boundaries are no longer hurdles to the flow of funds and manpower. As technology advances, investments and businesses migrate to those markets with high transparency and liquidity, low transaction costs, diversified product base, sound regulation, high quality of service and robust infrastructure.
13.4.2 Trends of Integration

Exchanges worldwide are rethinking their strategies and operations to improve their services, reinforce their competitive positions and optimise their performance. Overseas, markets are rapidly integrating vertically (e.g., linking together trading, clearing and settlement functions into a single transaction chain) and horizontally (e.g., combining securities and futures products into a single organization) and developing alliances with other exchanges.

13.4.3 Competition on Trading

Further, as financial markets become more globalized and investors become more sophisticated, competition from further afield has also become an increasing challenge. Stocks of major listed companies on the Hong Kong Stock Exchange could be traded easily in London and, increasingly, also in New York even in the past few years. Financial and equity based derivatives are even less geographically bound and fierce international competition in this area can already be seen.

13.4.4 Technological Advances

Technological advances have led to significant changes in the landscape of both “on-exchange” and “off-exchange” transactions. Such technology improvements have lowered the entry barriers to establishing new exchanges, thus, enabling a widespread emergence of alternative and proprietary trading systems whereby trades were executed off traditional exchanges in recent years. It can seen that the new breed of electronic communication networks or “ECNs” in stock markets that have emerged have already siphoned an unknown amount of securities trading from traditional markets and intermediaries.

13.4.5 Opening Up of Markets

More governments and securities authorities are progressively opening up their national markets in order to attract international participation. They are beginning to understand that open door policies will improve the standard of the markets by making them more competitive and efficient, attracting larger and more diverse investors base and, at the same time, allowing for knowledge and skills to be transferred to the local markets.
13.4.6 Pressure from Investors and Financial Services Sector

Institutional investors and large, proprietary trading operations of investment banks and securities firms have become extremely powerful and more globalized. They are diversifying their trading through various markets and trading facilities, so as to minimize transaction costs and increase liquidity. Thus, competition among existing exchanges are keen. Also, demands from investors to have direct access to stock exchanges and representation in their governance prosper the growth of the alternative and proprietary systems.

13.4.7 Inherent Characteristics of Membership Organization

As the demands of the capital market have changed, Hong Kong’s old model of securities and futures market prior to the merger was progressively less suited to cope with the complex and competitive global environment. The old system also had a number of inherent problems. It could be seen from the structure earlier mentioned that the stock market and the futures market were both owned by their broker members and, thus, the development of both exchanges was subject to the interests of their respective members who were their shareholders.

Although the two exchanges could not distribute their profits to their respective members, interests of broker members did not necessarily coincide with those of both exchanges that conducted business as a market operator in the Hong Kong financial markets. Profit maximization was usually not a top priority item on the agenda for both exchanges. In a place where natural resources are almost nil, the importance of the financial services sector, including the securities and futures market, cannot be ignored. There is an issue of public interest here.

13.4.8 Conflicting Roles and Fragmented Market Structure

Also, before the merger of the exchanges, the two Exchanges performed four different roles (market operator, membership association, regulator and public body) that, sometimes in practice, conflicted with one another, compromised their conduct and, to a certain extent, impaired their overall performance. The growth of the securities market was impeded by restrictions on access, including the maximum number of trading seats available.

Shortcomings in the cooperation between the two Exchanges led to overlapping, as well as gaps, between the products and services offered
by them. In addition, Hong Kong’s capital market infrastructure had been functionally rather fragmented, with a securities transaction involving multiple procedures and parties, and, often, necessitating multiple systems and counterparty interfaces. This was inefficient and increased the risks and, in particular, systemic risks involved.

13.4.9 Rationalization in Technology

Because of historical development, there has been diversity in the use of technology. Merger of the various entities provides opportunities and synergy to seek for certain standardization in order to save maintenance and upgrading costs. There is potential for further integration of technological platform. For example, the Traded Options, which used to be a product of the Stock Exchange, has its trading system migrated to the Futures Exchange Trading System on 8 August 2001. Upgrading of other systems is under consideration and will have regard to both the cash and derivatives markets in mind.

13.5 Market Reform

13.5.1 New Structure

The demutualization and merger of the stock and futures exchanges and their clearing houses became a reality in March 2000. The market reform required that the SEHK to become a wholly-owned subsidiary of HKEx; at the same time, the HKFE and the HKSCC also to become the wholly-owned subsidiaries of HKEx. The new integrated exchange, HKEx, was finally established on 6th March 2000 pursuant to a new piece of legislation, the Exchanges and Clearing Houses (Merger) Ordinance. The corporate structure of the HKEx Group (ignoring nominee interests), immediately following implementation of the overall proposal, is shown in Figure 13.2.
It was believed that the success of the reform depended largely on the creation of an appropriate framework in which the new consolidated entity, HKEx, operates. That framework must enable HKEx to pursue efficiently its profit-driven commercial goals on the one hand and effectively perform its public functions on the other. The framework is also expected to enhance HKEx to reinforce Hong Kong’s position as a global financial centre. Various checks and balances were also built in the proposed framework of HKEx whereby different public interests vested in it, as the sole operator of the securities and futures market of Hong Kong, were safeguarded.

Immediately upon occurrence of the merger, members of both exchanges exchanged their shares in the respective exchanges for shares in HKEx. Each SEHK share and HKFE share was cancelled in exchange for 800,000 and 1.4 million shares of HKEx respectively. Authorizations to trade on or through the facilities of both Exchanges were unaffected by the new arrangements and shareholders of both exchanges, who were trading members immediately prior to the merger, automatically became SEHK and HKFE Participants accordingly. Taking into account that there were 929 SEHK shares and 230 HKFE shares, the consideration represents an exchange ratio between the SEHK and HKFE members of 70:30 respectively. Since the HKSCC is a company limited by guarantee which has no issued shares and, thus, no financial value in the membership, its members have not received any allocation of shares in HKEx in respect of the HKSCC.

In addition, the HKEx Board determined to establish a moratorium on the issue of new trading rights (except for those rights that may be issued in respect of alliances with other stock exchanges or futures
exchanges) for a period of two years from the date of the merger. For a further period of two years after the merger, no new trading rights will be issued for less than HK$3 million per SEHK trading right or for less than HK$1.5 million per HKFE trading right. New trading rights issued by HKEx (other than those automatically conferred on SEHK shareholders and HKFE shareholders on the date of the merger) will not be transferable.

13.5.2 Listing of HKEx

HKEx was subsequently listed on its own marketplace three months later on 27th June 2000. Then the existing members of both exchanges were offered the opportunity to receive cash, i.e., HK$3.88 per each share of HKEx, in place of some or all of the shares in HKEx to which they were entitled, subject to the overall aggregate limits on the amount of cash being made available respectively to the members of the two exchanges. The overall aggregate limits for the SEHK and the HKFE are HK$935.2 million and HK$400.8 million, respectively.

In Hong Kong, the SEHK has been the front line regulator responsible for the approval of listing of companies. In this instance, there was a conflict of interest, or at least, a perceived one, between HKEx’ intention to list on its subsidiary and the approval thereof, though such approvals are normally given by a committee independent of the management and shareholders of HKEx. Accordingly, the Securities and Futures Commission (SFC) took up the processing and handling of the HKEx’s listing application, like the Hong Kong Exchanges handling all other listing applications. At the time of listing, HKEx’s shares attracted wide interest from retail and institutional investors. The highest market price of HK$18.95 for Hong Kong Exchanges was more than four times its valuation during the demutualization and merger. Its market capitalization was HK$18.6 billion and its P/E ratio (based on 1999 earnings) was 35.8 times at the time of listing.

During all of last year, HKEx went through an organizational restructuring to streamline and integrate its business and support functions. Hence, the total number of staff for all the organizations was reduced from 1,050 to the current level of 860. The initial integration phase, involving most of the operations, was completed by the end of last year.

13.5.3 Board of Hong Kong Exchange and Clearing Limited

The board of HKEx has been entrusted to shape policies on major strategic, financial, regulatory, risk management, commercial and
operation issues. The size of the HKEx board is not big; it comprises only 15 directors, of which 14 are nonexecutive in nature. Out of the 14 nonexecutive directors, 8 were appointed by the Financial Secretary of the Government of the Hong Kong Special Administrative Region of the People's Republic of China to be “public interests directors,” i.e., to serve the interests of the investing public or the public interest. The rest of the six other directors are labeled “shareholders return directors” and they are entrusted to serve the shareholders of the HKEx. It is believed that such a board size and composition facilitate discussions and decision-making, minimize the need for sub-committees and leave the operational and commercial execution role to the management.

Business Perspective

Although HKEx is required to perform its public functions, shareholders interests also need to be served. In view of the profit driven nature of the organization, five different business units have been set up within HKEx to pursue different business goals and implement various business strategies. In this regard, all business units have taken proactive roles in promoting various services and products offered by respective units of HKEx to existing and potential market practitioners and users. In this regard, the cash business unit has introduced a number of tradable cash products, in particular, the Exchange Traded Funds. Currently, the Tracker Fund of the Hong Kong Government and two iShares that track the indices of Taiwan and Korean stocks are all such funds being traded on the Hong Kong Stock Exchange.

As for the Derivatives Business unit, it has facilitated the trading of Hong Kong Interbank Offered Rate (HIBOR) Futures Strips since September 2000. Such kind of trading enables market participants to trade consecutive futures contracts in a single transaction. Also, trading of a smaller HSI Futures, known as mini-HSI Futures, was also introduced.

There is also an e-Business and Information Services Unit that offers various services to information vendors. This can be said to be a new business unit that was created after the merger in view of the prosperous electronic businesses. The unit introduced an Internet “Framing Quotation Service” in December 2000 that allowed exchange participants and other website operators to offer stock quotation services on their websites without the burden of taking up the business and technical commitments as an authorized information vendor. The unit has also been working with some TV operators to offer an on-screen ticker display on television screens.
13.6 Conclusion

To conclude, maintaining the status quo was not an option for Hong Kong. Exchanges around the world are being forced to adopt new performance-driven organizations to launch upon a path of transformation. Strategies to compete and survive are represented by a host of demutualizations, public offerings, mergers of cash and derivative markets and clearing operations, and newly forged cross-border alliances. In short, exchanges are becoming increasingly client-and profit-driven business organizations in order to sharpen their appeal to users. HKEx is not alone.

Without such reforms as described, the Hong Kong securities and futures industry will not be able to maintain its competitiveness and face global challenges. This will also adversely impact on the broader interests of the economy and Hong Kong’s status as a regional and an international financial center.

Meanwhile, the Government of the Hong Kong Special Administrative Region of the People’s Republic of China will continue to pursue its established policy objectives to improve and strengthen the clearing infrastructure in Hong Kong through the integration of the current sector-based clearing and settlement systems to improve risk management, enhance market stability and integrity, and generally better protect investor and public interests.
14.1 The Need for Reform

In his budget speech on 3 March 1999, the Financial Secretary of Hong Kong announced a three-pronged reform programme for the securities and futures markets in Hong Kong. This reform programme comprised:

- fundamental change in the market structure accomplished through the demutualization and merger of the exchanges and clearing houses;
- enhancement of the financial infrastructure to improve risk management, increase efficiency, and reduce cost; and
- regulatory and legislative reform to improve the supervisory framework and protection of market participants.

This chapter is concerned only with the demutualization and merger of the exchanges and clearing houses. This project, which began in earnest only a few months before the Financial Secretary’s speech, was substantially completed just over 15 months later upon the listing by way of introduction of the shares of Hong Kong Exchanges and Clearing Limited (HKEx) on the stock market operated by its wholly-owned

---

1 Director, Corporate Finance, Securities and Futures Commission, Hong Kong, China.
subsidiary, the Stock Exchange of Hong Kong Limited (SEHK). Today, HKEx is the parent company of SEHK, the Hong Kong Futures Exchange (HKFE) and their respective clearing houses. Despite the relative speed with which the reform was implemented considerable and continuous work was undertaken by the government, the exchanges and clearing houses and their respective advisers, and the Securities and Futures Commission (SFC) to ensure the success of the project.

**Government Support and Pressure**

A policy paper entitled *A Policy Paper on Securities and Futures Market Reform*—which was largely drafted by staff of the SFC—was issued by the Government of the Hong Kong Special Administrative Region of the People’s Republic of China at the time of the budget speech. This outlined the rationale and need for reform. The government stated that it was not prepared to let Hong Kong fall behind in the continuously changing international environment and that this reform therefore needed to happen quickly. It set out the following timetable within which the project was to be completed:

- **3 March 1999**: financial Secretary announces the proposal in Budget Speech and Policy Paper issued.
- **30 September 1999**: members of the two Exchanges to agree valuations of merging entities (SEHK and HKFE) and merger ratio (see next section below), and vote upon the demutualization.
- **31 March 2000**: enactment of enabling legislation and implementation of merger.
- **30 September 2000**: listing of HKEx on SEHK.

The policy paper stressed that the government did not underestimate the difficulty of achieving the requisite 75% majority of votes in each of the meetings of the members of the exchanges required in connection with the merger. However, given the importance of the reform to the strategic and competitive position of Hong Kong as an international financial center and the benefits accruing to members of the exchanges, the government was hopeful that the members of the exchange would reach agreement on the terms of their relative interests in the new holding company and achieve the necessary majority to
approve the schemes of arrangement. The government acknowledged that there would undoubtedly be difficulties along the way but was satisfied that all obstacles to integration could be overcome with the cooperation of the members of the bodies concerned.

The government recognized the complexity of the task involved. To ensure that the proposed reform was implemented swiftly and smoothly and that the exchanges received the advice and assistance they required from the government, the project was driven by a team within the Government’s Financial Services Bureau. As the securities and futures market regulator, the SFC was also closely involved. In particular, the commission sought to ensure that the existing market structure continued to operate effectively during the period of transition, that the procedures to implement reform were fair and transparent and conducted in accordance with all applicable legislative and regulatory requirements and accepted principles of good corporate practice, and that the new market structure would fully reflect the important public role to be performed by the HKEx.

The government made it clear that failure to implement reform was not an option. The significant changes occurring in leading markets worldwide, with upgrades of infrastructure and technology, made it essential for Hong Kong to implement reform in order to maintain its competitive position and face global challenges. The policy paper stated: “The government will spare no effort to work with the Exchanges and Clearing Houses to effect these important strategic reforms. These are reforms dictated by global market forces, as well as domestic voices for change. If market participants are unable or unwilling to effect such reforms in the expeditious manner dictated by the pace of change in the global market, then in the larger interests of Hong Kong, the government will pursue alternative action that will achieve the primary objectives of these reforms.

This may include, among other things, review and necessary reform of the current market environment and governance structures of the Exchanges and Clearing Houses in order to induce competition, promote investor interests and, above all, ensure that the interests of the Exchanges and the securities and futures market as a whole are sufficiently safeguarded and suitably balanced as against those of the members. Meanwhile, the government will continue to pursue its established policy objectives to improve and strengthen the clearing infrastructure in Hong Kong through the integration of the current sector-based clearing and settlement systems to improve risk management, enhance market stability and integrity, and generally better protect public interests.”
14.2 The Reform Process

14.2.1 Relative Interests in NewCo

Implementation of the demutualization and merger required the then members of the exchanges to exchange their shares in their respective entity for shares in the new company that was to become known as HKEx (NewCo). This required valuation of the businesses of the exchanges as then constituted and/or of NewCo following the merger of those businesses. Valuation of the exchanges permitted the fixing of a ratio for the relative interests which the current members of each of the existing exchanges collectively would have in NewCo.

The exchanges each appointed external financial advisers to advise them in relation to the appropriate methodologies to apply in valuing the exchanges and to assist generally in implementing the demutualization. There had to be transparency, consultation and due process for the valuation of the relative interests of the exchanges and the relative proportion of shares in NewCo. The government proposed that the exchanges and their members (and their respective external financial advisers) should consult together and reach agreement on this between themselves.

Merrill Lynch (appointed by SEHK) and Morgan Stanley (appointed by HKFE) were instructed to value the businesses of the two exchanges and negotiate their respective interests in NewCo. This exercise began with an exchange of information, cross due-diligence and a discussion of valuation methodologies. The parties agreed that the best basis for valuation of both exchanges was discounted cash flow (DCF) and negotiated the valuation drivers, terminal values and discounts. The government’s financial adviser, HSBC, and its business consultant, McKinsey & Co., monitored the parties’ progress, provided assistance and kept the process on track. One significant area of contention was the treatment to be given to HKSCC, the securities clearing house (see section below on Clearing Houses), and the extent of any value attributable to SEHK, which generates most of HKSCC’s revenues.

The final proposal put to members of the exchanges in the context of the scheme of arrangement (which valued the exchanges’ respective shares in HKEx as SEHK : HKFE (70 : 30)) was as follows:

- For each SEHK share : 805,000 HKEx shares.
For each HKFE share: 1,393,500 HKEx shares.
Cash alternative at HK$3.88 per share for specified number of shares.

The government’s agreement that the exchanges could impose a moratorium on new trading rights for two years; thereafter they could be issued by SEHK for HK$3 million (US$385,000) and by HKFE for HK$1.5 million (US$192,500).

The sensitive subject of how to deal with Hong Kong’s fixed commission structure for securities transactions which provides a minimum income for stockbrokers was left for later discussion between HKEx and the government.

14.2.2 Procedures Required

Consistent with the principle that the implementation of the reform should, in so far as practicable, follow normal commercial and legal procedures, once agreement had been reached on the exchanges’ relative attributable interests in NewCo, the demutualization and merger was implemented principally by two parallel schemes of arrangement, one applying to SEHK and one to HKFE. Each scheme of arrangement would be conditional on the other proceeding.

The schemes of arrangement followed the normal procedure applicable under the *Companies Ordinance* and took account of the requirements of applicable codes—including compliance with the Takeovers Code—and established regulatory procedures. Meetings of the members of each of the exchanges were convened to consider and vote on the relevant scheme of arrangement. The majority necessary to approve the resolution proposing the scheme was a majority in number of the members representing three-fourths in value of the shares present and voting (whether in person or by proxy). When the resolutions were passed, an application was made to the Court for the sanction of the schemes of arrangement. Following sanction by the Court and satisfaction of other conditions to which the merger was subject (such as the reorganization of the membership of HKSCC, SEHK’s clearing house (see below), and the passing of appropriate legislation to repeal and replace, or amend, provisions of existing ordinances), the schemes of arrangements became effective and the demutualization and merger of the market operators under NewCo was implemented.

The negotiation of the terms apportioning the exchanges’ respective interests in NewCo and the recommendation to members as to how to
vote in relation to the schemes of arrangement were two of the critical stages of the process towards merger which were undertaken by the management and boards of the exchanges and their respective advisers.

14.2.3 The Clearing Houses

HKSCC forms an integral and important part of the operations of Hong Kong’s securities market generally and of SEHK’s operations in particular, and its inclusion in the merged business of NewCo was essential and seen to enhance the value of NewCo as a whole. At that time, HKSCC was a company limited by guarantee which had no issued shares and, accordingly, no shareholders or owners. Its members were SEHK and five banks (Bank of China, Bank of East Asia, Hang Seng Bank, HSBC, and Standard Chartered Bank), each of which had undertaken to contribute up to a specified amount (HK$25 million in the case of SEHK and HK$5 million in the case of each of the banks) in the event that HKSCC was wound up while it was a member or within one year thereafter. None of the members of HKSCC had any right to receive any dividends or other distributions of profit nor a right to receive anything on a solvent liquidation of the company.

As there was no financial value in the membership of HKSCC it was reasonable that its members would not receive any allocation of shares in NewCo in respect of HKSCC. Accordingly, during the transition leading to the integration of HKSCC into NewCo, consideration had to be given to relieve the five member banks of their guarantee obligations in respect of HKSCC and for NewCo to put in place replacement arrangements so that creditors were not prejudiced.

The SEHK Stock Options Clearing House (SEOCH) and the HKFE Clearing Company (HKCC) are the other two clearing houses currently recognised by SFC. Both of them are wholly-owned subsidiaries of their respective Exchanges. SEOCH serves as the clearing house for the stock options trade under the SEHK while HKCC serves as the clearing house for all futures trades of HKFE. These two clearing houses remained wholly-owned subsidiaries of the respective exchange (see diagram below) throughout the demutualization and merger.

Following the merger, all three clearing houses are now being fully integrated as a stand-alone clearing entity that will operate in parallel with the trading operators. The integrated clearing entity will provide centralised clearing and settlement services for all trades on the securities and futures market (Figure 14.1).
14.2.4 Advisers to Government

As the government had quite internationally put itself in the driver’s seat in order to see this reform through, it needed to appoint professional advisers to assist it in discharging its role. The government’s advisers were as follows:

- **Financial**: HSBC Investment Bank
- **Business**: McKinsey & Co.
- **Accounting**: KPMG
- **Legal**: Allen & Overy

Between them, these advisers had considerable involvement and input into the project from start to finish. HSBC Investment Bank was appointed to oversee and facilitate the negotiations between the two exchanges on valuation of their respective shares in NewCo. They also proposed and structured a cash-alternative element to the financial deal, which was to be offered to exchange members by NewCo in exchange for the members’ shares in their respective exchange. Furthermore, for purposes of achieving consistency in the documentation prepared for members of the exchanges in the context of the two schemes of arrangement, and to ensure that the government remained in control of the transaction, HSBC drafted the circulars to shareholders which described the proposed transaction, outlined the proposed new structure.
and organization of NewCo, and set out the voting procedures and terms to implement the schemes of arrangement. The consequence of this was that the two exchanges’ circulars were substantially similar except for the letters from the board of directors and the financial adviser.

McKinsey & Co. acted as adviser to the government in relation to the proposed structure of the NewCo group. They had numerous meetings with the senior management of the exchanges and clearing houses, the SFC and government to determine what business model could best balance the potentially conflicting profit motive of NewCo—requiring it to act in the best interests of its shareholders—with the public interest, and reflect NewCo's role as a public utility responsible for providing and maintaining the securities and futures markets in Hong Kong. McKinsey & Co. developed a blueprint which was outlined in detail in a second policy paper entitled *Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre* issued by the Financial Services Bureau of the government in July 1999. A discussion of the principal checks and balances, which were put in place to deal with conflicts of interest are described in the above Chapter 5 prepared by the Securities and Futures Commission (SFC) entitled *Demutualization of Exchanges: The Conflicts of Interest*.

KPMG was responsible for developing the pro-forma financial statements for NewCo to be provided to the members of the two exchanges in the circulars to be issued in the context of the schemes of arrangements, and for advising HKEx on the accounting methodology to reflect the merger of the various entities which would comprise the HKEx Group, and generally for liaising closely with the creditors of the entities involved in the merger.

Allen & Overy acted as legal advisers to the government and HKEx throughout the reform process. They drafted new constitutions for HKEx and its new subsidiaries, which reflected both the group’s new profit making motive and the checks and balances required to safeguard the public interest. They also drafted the schemes of arrangement and company secretarial documentation needed to record the implementation of the merger particularly from HKEx's perspective. The exchanges each appointed their own legal advisers to provide them with the legal advice they required throughout the process.

Throughout the fifteen or so months it took to structure, organize and implement the reform, the SFC was closely involved with the government and its advisers and generally gave regulatory input where this was required. Numerous policy issues arose in the context of the structure of the new holding company (not least as regards the nature of
the checks and balances required to safeguard the public interest), the review and rationalisation of the division of regulatory responsibilities between SFC and the exchanges (see next section below), the drafting of implementing legislation, and the formal approval of changes to constitutions, rules and codes, and arrangements governing the conduct of business of the Exchanges and Clearing Houses.

### 14.3 Rationalized Market Regulation

Following the publication of the government’s policy paper in March 1999, senior management of the SFC, the two exchanges and HKSCC conducted a review of the then current regulatory framework governing the securities and futures market and of the possible alternative options for the future division of regulatory functions between SFC and HKEx. The review focused on three main areas, namely market surveillance, supervision of intermediaries and listing and corporate finance functions.

Working groups (consisting of staff of the SFC and exchanges) set up to look at each area of review felt unable to make any recommendations as to which of the options presented in their respective reports was best for the future. This was due to a reluctance on the part of the executives and staff of the two exchanges and HKSCC to be seen to be advocating changes to the current regime before the members of the two exchanges had voted in favour of demutualization and merger. Also, the exchanges and HKSCC thought that they were not well placed to consider the future business strategy of HKEx, and that as the future division of the regulatory functions between SFC and HKEx would feature in that business strategy, this should properly be left to another authority which was able to consider such matters from HKEx’s perspective.

The government and the SFC accepted those concerns, and acknowledged the need for HKEx’s business strategy to be considered before any definitive decision as to the division of the regulatory functions was made. However, to advance the discussion, the government asked the commission to indicate the market regulator’s view as to the future division of the regulatory functions between the SFC and HKEx. On the basis of the SFC’s recommendations, and following discussions between the government and its advisers and under the Co-ordinating Committee on Market Structure Reform—a committee set up by the government consisting of the Chairmen of the exchanges and the commission, representatives of the broking community, and government to consider
the public interest aspects of the proposed reforms—chaired by the Secretary for Financial Services, a model was produced. The paragraphs below summarize the model recommended by the SFC and endorsed by the government for the division of regulatory functions between the SFC and HKEx following the merger. This structure is now in place.

14.3.1 Market Surveillance

In relation to market surveillance, the division of functions remains largely intact, albeit with clearer delineation and refinement of respective responsibilities in order to reduce areas of overlap and inefficiency. The separation of functions between HKEx and SFC is being formalized by the introduction of clear written procedures.

As a commercial organization, HKEx's surveillance functions have become more business-oriented. Thus, its market surveillance unit focuses on trading operations and risk management, which include: (a) enforcement of trading and clearing rules and detection of trading malpractices by users (liaising with the SFC as necessary in relation to those which may involve statutory offences), (b) maintenance of market transparency by monitoring price and turnover movements on a real-time basis and requiring prompt disclosure of price sensitive information, (c) assisting in the risk management process by monitoring exceptional concentrations in positions and unusual price fluctuations, (d) interaction with market participants, including handling of disputes in relation to trading matters, and (e) cross-market surveillance of HKEx's users. As a participant in the Intermarket Surveillance Group (an international group of exchanges set up to exchange information on surveillance of trading clearing activities), HKEx contributes information in respect of the markets under its operation and conducts surveillance for a number of specific types of cross market manipulation.

With wider statutory powers, SFC, as the oversight regulator, is primarily responsible for detecting market malpractices with statutory implications. The SFC's market surveillance activities therefore include: (a) scrutinizing market activities to detect potential breaches of laws relating to the securities and futures market, (b) conducting investigations of possible statutory offences that fall within its jurisdiction, including those commenced on referrals from HKEx, other agencies and complaints from the public, and (c) overseeing the surveillance actions undertaken by HKEx and performing cross-market surveillance of activities between HKEx markets and non-HKEx markets.
14.3.2 Intermediaries Supervision

In relation to Intermediaries Supervision, most of the functions formerly performed by the exchanges in the prudential regulation of their members have been moved to the SFC. However, HKEx continues to monitor particular aspects of the business of intermediaries so that it may assess and manage the risks inherent in the operations of its subsidiary business units.

Prior to the merger, the exchanges were primarily responsible for the routine inspection of their members’ businesses, for monitoring their compliance with conduct rules and the liquid capital requirements and for ensuring that their members have in place proper systems of management and control. The commission, however, retained a shared responsibility for all of those matters and was often required to act in response to regulatory concerns, particularly where the necessary response extended beyond the scope of exchange’s authority. Transferring the primary responsibility for those matters to SFC removed duplication and overlap and ensured that a comprehensive response to regulatory issues could be made by the commission as primary regulator.

This change is set against the background of risk management and the enforcement of compliance with proper trading practices. HKEx still needs to retain a capacity to ensure that its risk management measures are adequate and that its trading rules are properly complied with.

14.3.3 Listing/Corporate Finance

In relation to Listing/Corporate Finance, the division of functions remains substantially as before the merger, albeit with improvements in efficiency within SEHK and in the coordination of functions undertaken by both the SFC and SEHK. This necessarily involved a re-examination of the allocation of resources within the SEHK Listing Division and an examination of its functions and work processes. At the time of the policy paper, the SFC contemplated entering into a new Memorandum of Undertaking with HKEx which would clarify the standards to be met by SEHK (and HKEx) in performing its functions in this area and provide for greater interaction between the two bodies. However, this has not yet been done.

As contemplated in the policy paper, and in order to remove the conflicts of interest which would arise if SEHK were to supervise its own holding company, SFC has become responsible for all matters regarding
HKEx which would, in the case of any other listed company, be dealt with by the Listing Division of SEHK.²

14.4 Implementing Legislation: Exchanges and Clearing Houses (Merger) Ordinance

Legislation was required to implement certain aspects of the reforms and introduce a new regulatory framework to cover HKEx. A short summary of the principal provisions of the legislation are set out in the Appendix. The legislation fell broadly into two categories, namely: (i) the introduction of new regulatory checks and balances which required a statutory backing to instill the appropriate spirit of compliance, and (ii) consequential amendments flowing from changes made to the then existing regulatory framework.

As well as considering in detail what changes should be brought about by new legislation, much time was spent by the SFC and exchanges reviewing the rules of the exchanges and Clearing Houses to determine what impact the proposed new regulatory framework would have on the trading and clearing rules. For example, the transfer to the SFC of responsibility for the supervision of brokers, the introduction of the concept of a “trading right”, and the redesignation of brokers as “exchange participants” all required changes to be made to the relevant rules and the introduction of new provisions in SFC’s Code of Conduct for Persons Regulated by the SFC.

14.5 Key Issues Arising from Hong Kong’s Experience with Demutualization

The following paragraphs describe some of the main areas of difficulty which were encountered during Hong Kong’s demutualization. These provide some flavour of the regulatory questions which may arise in other jurisdictions and recommendations as to issues to be considered during the demutualization process.

² The procedures put in place in this area are described in Chapter 5 on Hong Kong’s framework for dealing conflicts of interest (p. 87) (Part III of the SFC’s chapter dealing with conflicts of interest which has been prepared for this course).
14.5.1 Extent of Regulatory Control Over Exchanges/Clearing Houses Fees and Charges

Consider the competition laws/authority, the competitive environment of the exchange/clearing house, the scope of approval if applicable and factors to consider for approval, and control over exchange/clearing house budget. In a freely competitive market with a competition authority, regulatory involvement may be unnecessary (but Hong Kong lacks a competition authority and the exchange has exclusive rights to operate a stock market in Hong Kong).

14.5.2 Preparation of Accounts as Necessary for a Public Company

Practices of private or mutual bodies are likely to raise or reveal many issues. It is necessary to begin the work early to avoid surprises and resolve issues well ahead of listing.

14.5.3 Issues Unique to a Company Limited by Guarantee

Hong Kong and Australia's experience was that there was no legal mechanism for conversion of a company limited by guarantee (being the corporate structure of ASX and HKSCC before their respective demutualizations) to a company limited by shares. This was addressed in both countries by new statutory provisions.

14.5.4 Governance and Public Interest Duties

Consider whether any pre-existing public interest duties should be expanded (in Hong Kong, the exchanges’ duties were expanded to the HKEx holding company level). Consider whether changes should be made to the governance structure (in Hong Kong there was concern over achieving a diverse shareholder base leading to government appointment of 50% of the HKEx board but to be phased down over time).

14.5.5 Risk Management

Consider the need for increased regulatory involvement and maintaining value added participation by market players. The regulator may wish to have a say if there is any proposal to reduce/vary risk management reserves. The new governance structure may exclude
market participant specialists who are themselves at risk to exchange/clearing house operations and have a strong self interest in maintaining state of the art risk management (in Hong Kong they participate instead via consultative committees).

14.5.6 Conflicts of Interest

Consider having the statutory regulator make all listing decisions where the exchange/clearing house or holding company lists on itself or an affiliate. Secondly, consider conflicts of interest of the listed group where it may make decisions affecting its competitors or business associates (including listing, admission, service provision, pricing). New provisions may be appropriate depending on the competitive environment, adequacy of competition laws and pre-existing regulatory powers. Consider an MOU for conflict identification, recording/auditing, resolution (e.g., statutory regulator may make the decision in appropriate circumstances).

14.5.7 Revised Allocation of Regulatory Functions

Consider whether the demutualized exchange will continue to have a commitment to any pre-existing self-regulation and if self-regulation is to continue whether new arrangements are necessary to reinforce this. If regulatory functions are to be reallocated, consider the need for an MOU and begin work early to ensure smooth transition. Will the demutualized exchange be willing to give up a function if it means giving up control over a material source of income (e.g. over the number of new companies coming to listing)?

14.5.8 Ownership Restrictions

Consider whether ownership restrictions should apply to the listed body or its exchange/clearing house affiliates. This may affect valuation and have governance implications.

14.5.9 Auditing of Financial Condition of SRO

If financial intermediaries are routinely audited, query why an exchange also should not be required to meet specified capital or other financial requirements.
APPENDIX 1:  
Summary of the Exchanges and Clearing Houses  
(Merger) Ordinance

This Appendix contains a summary of the Exchanges and Clearing Houses (Merger) Ordinance which was enacted in February 2000 just a week or two prior to implementation of the demutualization and merger in March 2000.

Recognition of Exchange Controller

Section 3 prohibits a person from being the controller of an exchange company or clearing house unless the person is a recognized exchange controller (REC). A controller is defined to include, among others, any person who either alone or with any associates controls the exercise of more than 35% of the voting power at any general meeting of the company. The Commission may recognize a person as a REC and attach conditions to such recognition. The Financial Secretary may exempt persons from the recognition requirement. A contravention of section 3 or failure to comply with a condition to recognition is an offence. The Bill also specifies that HKEx shall be deemed to be a REC on commencement of the ordinance.

Section 4 provides for withdrawal of recognition of a REC by the Commission. Section 5 provides that the interest of a REC in an exchange or clearing house cannot be increased or decreased except with the approval of the Commission.

Person Not to Become Minority Controller

Section 6 provides that a person shall not become a minority controller of a REC or any exchange company or clearing house except with the approval of the Commission in consultation with the Financial Secretary. A minority controller is defined to include a person who either alone or with any associates is entitled to exercise 5% or more of the voting power at any general meeting of the company. The Commission can attach conditions to the approval of a minority controller. A contravention of section 6 or failure to comply with a condition to approval is an offence.
Appendix 1: Summary of the Exchanges and Clearing Houses (Merger) Ordinance

Duty to Ensure Fair and Orderly Market, Etc.

Section 8 imposes duties on a REC and an exchange company to ensure fair and orderly markets. It also imposes duties on a REC and a clearing house to manage risks prudently. In performing these duties the relevant bodies must act in the interests of the public, having particular regard to the interests of the investing public. These public interest duties prevail over any other interests the body is required to serve. A no liability provision applies for the good faith performance of section 8 duties.

Section 9 requires the REC to establish a risk management committee to formulate risk management policies for consideration by the REC’s Board. The Financial Secretary may appoint five of the seven members of the risk management committee and HKEx may appoint two, one of whom must be a shareholder elected director of HKEx.

Section 10 requires that the rules and amendments to the constitution of a REC must be approved by the Commission. Section 11 requires the chairman of an REC to be approved by the HKSAR Chief Executive. Section 12 requires the CEO and COO of a REC to be approved by the Commission.

Provision Where REC Seeks to be Listed Company

Section 13 requires the Commission to make rules and arrangements to avoid conflicts of interest where an REC or its subsidiaries seeks to be a listed company. This would include rules providing for the Commission to make listing rules decisions—and to receive related fees—in relation to a REC that seeks listing or is listed. Section 14 enables the Commission to give directions to a REC to remedy any conflicts of interest.

Fees to be Approved By Commission

Section 14 provides that no fee of a REC or its subsidiary exchange or clearing house can have effect unless the fee is specified in the body’s rules and approved by the commission. In considering such fees, the commission must have regard to: (1) the level of competition, if any, in Hong Kong for the matter for which the fee is imposed, and (2) the level of fee, if any, imposed by other exchanges and clearing houses in or
outside Hong Kong for the same or similar matter to which such fee relates.

Section 20 enables the Financial Secretary to appoint not more than eight persons to the Board of HKEx. HKEx will have an initial Board of 15 directors. From the HKEx annual general meeting in 2003, the Financial Secretary can appoint no more Board members than those elected by the HKEx shareholders.

Section 22 provides for the conversion of Hong Kong Securities Clearing Company (HKSCC) from a company limited by guarantee to a company limited by shares. This is done by special resolution of HKSCC approved by the Commission.

Section 23 provides that members of the exchanges who are registered dealers on the commencement date are deemed to be exchange participants of the exchanges.

Consequential Amendments

Schedule 1 provides a variety of remedial measures where a person has violated the exchange controller or minority controller sections 3, 4, or 6. These include freezing shares, restricting voting rights, and court-ordered sale of shares.

Schedules 2 and 3 provide for persons to be deemed to be, or not to be, associates for the purposes of sections 3 and 6, and for persons to be deemed not to be exchange controllers or minority controllers (e.g., a recognized clearing house).

Throughout the eleven *Hong Kong Securities and Futures Ordinances* references to members of the exchanges have been changed to “exchange participants.”

The Commission’s additional powers to issue restriction notices and suspension orders to an exchange or clearing house (sections 50 and 51 of the *SFC Ordinance*) have been extended to apply to an REC.

HKEx is specified as a public body under the *Prevention of Bribery Ordinance*.

Definitions of “trading right” have been added to the *Securities Ordinance* and the *Commodities Trading Ordinance*. The compensation fund provisions of these ordinances have been amended to require compensation fund deposits from holders of trading rights instead of...
exchange members/shareholders and allowing claims for compensation to be made against exchange participants.

Qualification requirements for exchange members under the Securities Ordinance and the Commodities Trading Ordinance have been deleted (e.g., requirements to be registered dealers engaged in the sole business of dealing in Hong Kong).

A requirement that the exchange enforce compliance with the Financial Resources Rules has been deleted (since this function was transferred to the Securities and Futures Commission).
15.1 Introduction

Singapore Exchange Limited (SGX) was the first demutualized, integrated securities and derivatives exchange in Asia Pacific. It was formed on 1 December 1999 by the merger of two well-established and respected financial institutions—the Stock Exchange of Singapore (SES), which traded securities, and the Singapore International Monetary Exchange Limited (Simex) which traded futures.

In 1998, the government of Singapore commenced a process to demutualize the SES and Simex. Before that, each exchange was owned by its members. The demutualization was to enhance competitive positioning and respond to the global trend.

This chapter outlines the process for the demutualization and listing of SGX, and discusses some of the general concepts.

15.2 Drivers for Change: The Rationale for Demutualization and Merger

The forces that brought about change for the creation of SGX were:

- **Globalization.** Increasingly, issuers and investors are migrating to markets that provide the greatest liquidity and best execution.

---

1 Executive Vice President, Head, Risk Management and Regulation, Singapore Exchange Limited.
Exchanges find themselves having to compete among themselves and against new players. The traditional value of an exchange is being eroded by the proliferation of electronic communications networks (ECNs), which are positioning themselves as virtual exchanges and providing a single electronic access point to multiple markets. A combined exchange offered better size and product range to compete.

- **Blurring of product distinctions.** As the differences between securities and derivatives products have become more blurred, the ability of different markets to compete has increased. A combined entity would be able to align securities and derivatives business strategies more closely, minimize operating costs by sharing overheads, and increase its value-positioning against other exchanges (in Singapore’s case, foreign competition).

- **Technology.** New technology allows new players to compete. Moreover, platforms are expensive. If they can be shared across products (i.e., securities and futures), this has cost and customer advantages.

- **Issuers have become more sophisticated and demanding.** There is still “stickiness” to equities, making trading in the home market more likely than in a foreign market, but it has become much easier for capital raisers to access other markets² and some companies, especially “blue chip” companies, no longer look to raise capital in their domestic markets alone. A main driver of the decision where to list is the cost of capital. Therefore, companies may look to list in regional or other exchanges that can provide them with a large investor base and high liquidity.

- **Investors are more sophisticated.** With better market knowledge and access to both information and markets through the Internet, investors are looking for more innovative products.

- **International competition.** International brokers are now trading in a variety of markets, which make them sensitive to cost differences and the relative inefficiencies of competing exchanges.

---

² There are two aspects of access for capital seekers: practical (i.e., delivering a prospectus and receiving the applications) and regulatory (i.e., registering the prospectus).
As a result of this aggressive operating environment, and global trends, it was felt that the exchanges had to reposition themselves to survive and better compete. Moreover, the exchanges had to make strategic decisions that, in mutual exchanges, are not always possible because of the misalignment of the exchange's interests with those of the broker-members. Often the exchanges needed to make strategic choices to serve the broader interests of the financial sector. Therefore, there was a need to revamp corporate governance and management structures so that the combined exchange could respond more quickly to profit opportunities.

15.3 Impact of Demutualization

Demutualization has a dramatic impact. It is likely to result (sooner or later) in changes in corporate mindset to emphasize shareholder value and customer focus, and for operating discipline. Listing of the demutualized exchange is not a necessary part of this process, but it hastens the change because of the exposure to market disciplines. Table 15.1 identifies some of the main differences between the corporate structures of a mutual and a for-profit company that influence the change.
### Table 15.1. Corporate Structure of a Mutual and a Demutualized Exchange

<table>
<thead>
<tr>
<th>AREA</th>
<th>MUTUAL EXCHANGE</th>
<th>DEMUTUALIZED EXCHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
<td>Members who trade on the exchange.</td>
<td>Public shareholders. These may include members, but trading rights and ownership are separated.</td>
</tr>
<tr>
<td>Aims of the Exchange</td>
<td>Usually, to maintain:</td>
<td>Usually to:</td>
</tr>
<tr>
<td></td>
<td>• an efficient, low-cost, trading environment;</td>
<td>• maximize gains from shares;</td>
</tr>
<tr>
<td></td>
<td>• “risk-minimized” settlement; and</td>
<td>• grow earnings and dividends;</td>
</tr>
<tr>
<td></td>
<td>• quality regulatory framework.</td>
<td>• improve product range and distribution; and</td>
</tr>
<tr>
<td>Composition of board</td>
<td>• The board usually comprises mostly or solely member representatives.³</td>
<td>• protect brand quality (including by having a quality regulatory framework).</td>
</tr>
<tr>
<td>and decision-making</td>
<td>• Decisions are usually made on one member, one vote basis.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Decision making power is vested with the board.</td>
<td></td>
</tr>
<tr>
<td>Acquisitions and alliances</td>
<td>• Not usually a priority.</td>
<td>• Likely to be a priority, given a desire to maximize growth.</td>
</tr>
<tr>
<td>Capital management</td>
<td>• Not usually a priority. Mutual exchanges may maintain high levels of capital</td>
<td>• A key priority as management attempts to maximize shareholder value. It may be undesirable for the exchange to maintain high cash/liquid reserves as it can weigh down the company’s return on assets.</td>
</tr>
<tr>
<td></td>
<td>backing on the basis of “better safe than sorry” and to meet statutory</td>
<td></td>
</tr>
<tr>
<td></td>
<td>requirements.</td>
<td></td>
</tr>
</tbody>
</table>

³ Not SES board, which comprised four member representatives and five nonmember representatives (viz. art 69).
15.4 The Merger Act

SES and Simex were “mutuals.” Access to the SES was restricted to its 33 members. The Simex was owned by the 35 clearing members and access was restricted to them, the non-clearing members (whose number was restricted to 472 seats) and the 147 individual non-clearing members with trading permits.

To effect the demutualization and merger of SES and Simex, the Singapore government passed the Merger Act. The SGX was formed to own the exchanges and their related clearing houses. Under the Act, the terms of the demutualization of each exchange and the merger were fixed and did not involve approval by the members.

The Act also provided that the shares of the transferee holding company (SGX) could be listed or quoted on a stock exchange if such arrangements as were required by the Monetary Authority of Singapore (MAS) were entered into for:

- dealing with possible conflicts of interest that may arise from the listing or quotation of securities of SGX, or
- ensuring the integrity of trading of securities of SGX.

The acquisition of substantial shareholdings in SGX are regulated.

The Act provided that MAS may give directives to the transferee holding company, of either a general or specific nature, for ensuring fair and orderly securities and futures markets or for ensuring the integrity of, and proper management of systemic risks in, the securities and futures markets. This is a very wide power that extends to imposing requirements on officers or employees of SGX. The Act creates an offence of non-compliance with such requirements without reasonable excuse.

---

4 The Exchanges (Demutualization and Merger) Act 1999.
5 Section 13 of the Merger Act.
6 Section 15 of the Merger Act.
7 Subsection 14(1) of the Merger Act.
8 Subsections 14(3) and (4) of the Merger Act.
15.5 The Process of Demutualization

The SES had 34 shares issued. Simex had 40 shares issued. These shares were cancelled and new shares issued to a transferee holding company (SGX). SGX was established with two subscriber shares of S$1.00 each. On the transfer date, SGX acquired the entire share capital of the SES, Simex and Securities Clearing and Computer Services Pte Limited (SCCS). The share capital of SES, Simex and SCCS was cancelled and new shares in these companies issued deemed to be fully paid up by SGX. In this way, the entire assets of SES and Simex were transferred to SGX.

To compensate the SES shareholders, Simex shareholders and Simex seat holders, the transferee holding company (SGX) issued shares to each. The value of the shares was based on slight discounts to the estimated market value of shares, and seats, at the time, taking into account that former share and seat values would decline once commissions were liberalized and access to the exchanges opened up. The values attributed were:

- S$6,000,000 to each SES share (except for one share held by a shareholder in involuntary liquidation);
- S$115,000 to each Simex share; and
- S$170,000 to each SIMEX seat.

The value of the new shares was fixed by the Minister under the Act. The aggregate value of SGX shares issued to shareholders of SES and Simex, and to Simex seat-holders, was approximately S$308.34 million in exchange for the entire share capital of SES, Simex and SCCS.

This structure held until the IPO of SGX, when a special purpose company (SEL Holdings Pte Ltd, ultimately owned by Temasek Holdings (Private) Limited) was established to subscribe for such number of SGX shares at par as the Minister directed. The shares it subscribed for were

9 Fixed to be 1 December 1999.
10 The Securities Clearing and Computer Services Pte Limited, was a wholly subsidiary of SES.
11 Simex seats were abolished upon the merger.
13 The net asset values of the entities combined in the merger, which were adjusted to fair values as at 1 December 1999, exceeded S$308.34 million. The excess was taken directly to equity and reflected on the SGX consolidated balance sheet as general reserves.
held for the benefit of the Financial Sector Development Fund, and cannot be voted. Except to a limited extent (covering expenses) the proceeds of the sale of those shares in the IPO were not received by SGX.

15.6 The Singapore Exchange’s Initial Public Offer

SGX undertook a capital restructuring to ensure that its offer price was in a customary range for shares traded on the Exchange, and that existing shareholders would hold issued shares with an aggregate value14 at the offer price equal to the dollar value specified under the Merger Act.

After the restructuring, SGX had an authorized capital of 100 billion shares of S$0.01 each and issued share capital of 1 billion shares, out of which former SES shareholders, Simex shareholders and Simex seat holders held 280.3 million shares and the rest (719.7 million shares) were sold at par to a special purpose company. The special purpose company then made a public offering of SGX shares to new investors, the proceeds of which, after paying the expenses and fees associated with the demutualization and listing, were paid into a Financial Sector Development Fund for the purpose of developing talents and infrastructure for Singapore’s financial structure. A total of 291.7 million shares were retained by the special purpose company for the benefit of the Financial Sector Development Fund and cannot be voted. The detailed steps involved were:

(i) 61,670 issued ordinary shares of par value S$1.00 were subdivided into 6,167,000 shares of par value S$0.01 each.

(ii) 274,150,906 bonus shares of par value S$0.01 each were distributed to existing shareholders.

(iii) 719,682,094 shares were subscribed for by SEL Holdings. After these steps there were 1 billion shares on issue of par value S$0.01 each.

(iv) From the shares held by SEL Holdings, 319,700,000 shares were offered as follows:

---

14 S$308,340,000.
• 278,000,000 existing shares of par value S$0.01 each comprising: 88,000,000 Offer Shares at S$1.10 each (75,000,000 by way of retail public offer and 13,000,000 reserved for employees and others); and 90,000,000 Placement Shares at S$1.10 each to institutions.

• 41,700,000 shares reserved in an over allotment option.

From the shares held by SEL Holdings, 150,000,000 shares were offered to strategic investors as a strategic private placement. Strategic investors were invited to take up significant long-term stakes in the new exchange through the strategic private placement. The strategic shareholder group included existing shareholders, local financial institutions and other institutions, which have long-term interest in ensuring Singapore’s success as an international financial centre.

After the over-allotment option was exercised, the selling shareholder (SEL Holdings) was left with 250 million shares.

The Minister under the Merger Act directed the number of shares the selling shareholder subscribed for, the number of shares it sold, and the offer price. He took advice from the financial advisers to the offering. The advisers conducted a book-building exercise before arriving at the price.

To ensure that the shareholder base is adequately diversified, any shareholding of more than 5% in the integrated exchange requires MAS’ approval. This is similar to arrangements in other exchanges that have demutualized (examples are ASX and Amsterdam).

### 15.7 The Structure of Singapore Exchange

There are 10 operating divisions of SGX: five service divisions\(^\text{15}\) and five market divisions.\(^\text{16}\) The five market divisions are wholly-owned subsidiaries of the parent company, SGX. Since a goal of demutualization was to turn the legacy exchanges into a commercially driven organization that could respond more quickly to competition and profit opportunities, the new organization’s structure had to support that, so SGX’s

\(^{15}\) Corporate Strategy & Marketing, Finance & Administration, Human Resource, Information Technology, and Risk Management & Regulation. Two other departments also service SGX: Legal and Internal Audit.

\(^{16}\) Securities Trading, Securities Clearing and Depository, Derivatives Trading, Derivatives Clearing and IT Solutions (which offers securities processing and IT services to the financial sector).
profit-making businesses were organized as separate wholly-owned subsidiaries.

The figure below shows the structure of SGX (Figure 15.1).

**Figure 15.1. SGX Structure after Demutualization and Merger**

This structure allowed them the flexibility to pursue specific development objectives. To achieve synergy and minimize operating costs, the service divisions were structured to be carried out at the parent company level. The regulation of the businesses is now carried out at parent company level. This has the benefit of allowing an overall strategy to be employed, consistent with protection of the SGX brand. This advantage is also consistent with having central corporate strategy planning, which SGX does.

The securities clearing function and the derivatives clearing function are housed in separate subsidiaries. This is to help manage the risks, which are higher for derivatives than securities. Theoretically, a “corporate veil” legally shields the parent company and other subsidiaries

---

17 Currently there is no single IT platform for integrated cash and derivatives trading, so little synergy is available by combining the two subsidiaries, but that may become more important when an integrated engine becomes operationally available and cash and derivatives trading share a common trading engine.

18 The clearing houses undertake some risk management functions that might be regarded also as an aspect of regulation (e.g., derivatives clearing house undertakes margin calls).

19 Corporate Strategy and Marketing is a service division under SGX.
from the risk of contagion in the event of a failure of one of the clearing houses. Separation also helps meet a perception that integrating the two exchanges has resulted in a riskier marketplace. On the other hand, a single clearing house would facilitate cross-margining and more efficient use of collateral, as well as pooling resources for operational efficiency.

In reality, of course, in the absence of an extreme event the parent company would be likely to support its clearing subsidiary. Otherwise the loss of confidence may end its ability to run a market. However, there is some comfort to be drawn from being able to choose, and the perception is improved.

The legal barriers make design of the capital structure of the group more important. The subsidiaries must be adequately capitalized, and not dependent on the parent company to continue.

15.8 The Governance of Singapore Exchange

Corporate governance usually improves with demutualization for a number of reasons, including:

- The board of directors becomes more diversified. As a mutual, the board will often largely reflect the single group of owners. Their perspective is that of a broker, although their interests are not always uniform. A more diversified board represents a greater diversity of business views.

- The priority of the board shifts from brokers' interest to shareholder value. This changes the organization in many ways and, significantly, introduces customer focus. There is a widening of the groups recognized as customers.

- The idea of shareholder value introduces new disciplines to management. Hopefully, the culture shifts to a service culture. This is partly dependent on the ability of management to act as agents of change and of staff to embrace change. The social culture probably plays a role as well.

- Staff can be rewarded in line with improved efficiencies. It is usual for a mutual not to distribute profits and use any reserves to even out good and bad years. The leveling effect also applied to staff salaries, so staff may expect regular pay increases and promotions regardless
of the company’s performance. Profit distribution changes that and allows better rewards in good times and for productivity gains.

- Market disciplines will apply, particularly if the entity lists. Because the company is paying a return on capital it can be measured against other investments doing the same.

Brokers become one of the significant stakeholder groups of the new organization. At SGX, broker interests have been balanced with other interests. Broker interests represent no more than half the SGX Board.\(^{20}\) An independent director chairs the SGX Board and there are nine other nonexecutive directors. The only executive director is the Chief Executive Officer. The Board meets every two months and supervises the management of the business and affairs of SGX.

The SGX Board’s responsibilities are similar to any listed company’s board, and include:

(i) to approve the annual budget and major funding and investment proposals;

(ii) to review the financial performance of the company;

(iii) to approve the company’s corporate and organizational strategic plans;

(iv) to appoint key managerial personnel.

To facilitate effective management, certain functions have been delegated by the board to various board committees. Board committees should include:

- *A nominating committee.* The nominating committee comprises at least four directors from the SGX board and is responsible for reviewing all nominations for appointment and re-appointment of the directors of SGX and the Chief Executive Officer.\(^{21}\) MAS must approve the appointment of persons to the nominating committee.

- *An audit committee.* The audit committee comprises four members, all of whom are independent nonexecutive directors and is

\(^{20}\) SGX has 11 directors, of whom four represent broker interests.

\(^{21}\) Directors are elected at each annual general meeting of shareholder on a rotational basis.
responsible for nominating the external auditors, reviewing the audit plans of the internal and external auditors, ensuring the adequacy of the company’s control systems, reviewing the interim and annual financial statements, and reviewing legal and regulatory matters that may have a material impact on the financial statements, related exchange compliance policies, and programs and reports received from regulators.

- An appeals committee. The appeals committee comprises six directors and non-directors and conducts hearings on appeals against the decisions of the Office of the CEO, and the Business Conduct Committee, the Clearing House Committee and the Disciplinary Committees of the securities and derivatives trading divisions.

- A compensation and management development committee. The compensation and management development committee comprises seven directors, of whom a majority are nonexecutive, and reviews all matters concerning the company’s senior management remuneration program and administers the company’s Employee Share Option Plan.22

15.9 Listing and Conflict of Interest

While many demutualized exchanges are listed,23 it is not an essential aspect of the demutualization process. It is a separate decision, which should be made for similar reasons to those of any company considering a listing.24 In SGX’s case the reasons have been given as follows:

“A listing will confirm our commitment to run the exchange on a commercial basis, providing a high-calibre service to the securities and derivatives markets of Singapore, the region, and the world. A listing also facilitates the forging of alliances with other exchanges around the world, as well as with entities in related industries such as information technology.”25

---

22 SGX annual report 2000.
23 Including Australian Stock Exchange, Euronext, London Stock Exchange, Singapore Exchange, Stockholmsbourse (as part of OM Group), Deutsche Bourse.
24 Advantages include capital raising, access to capital in the future, exit strategies for shareholders, higher profile, better management incentives, alignment of employee benefits to profits etc. Disadvantages include, cost, public scrutiny, additional regulatory requirements, etc.
A demutualized, unlisted exchange may more closely resemble a mutual exchange because the brokers simply own shares rather than having a membership interest. Indeed, the legacy exchanges, SES and Simex, were shareholding structures. But usually ownership and trading rights are separated in a demutualization, so there is no necessary reason for brokers to continue to own the shares. Over time, they may sell. If there is a market, this process is hastened, which gives effect to one of the drivers for change, namely the desire for broader ownership. If the exchange raises capital, listing will introduce new investors.

Listing creates a conflict of interest because the exchange is, usually, the listing authority. However, it should not admit and supervise itself. In Singapore, this issue was resolved in a similar way to Hong Kong and Australia. The government regulator, MAS, has stepped in to perform the listing and supervisory function for the self listed exchange. This is set out in section 13 of the Merger Act and in a Deed of Undertaking executed by MAS, SGX and SGX-ST (the equities market arm of SGX). Under the Deed, MAS is authorized, instead of Singapore Exchange Securities Trading Ltd (SGX-ST), to make all decisions and take action (or require SGX-ST to take action on behalf of MAS) in relation to SGX that would be taken by SGX-ST in the case of other corporations listed on SGX-ST. SGX and SGX-ST jointly and severally undertook that they will abide by and comply with the decisions and action taken by MAS.

Under the Deed, MAS is authorized, instead of Singapore Exchange Securities Trading Ltd (SGX-ST), to make all decisions and take action (or require SGX-ST to take action on behalf of MAS) in relation to SGX that would be taken by SGX-ST in the case of other corporations listed on SGX-ST. SGX and SGX-ST jointly and severally undertook that they will abide by and comply with the decisions and action taken by MAS.

SGX successfully listed on 23 Nov 2000.

Except in relation to self listing, and perhaps decisions that may directly affect the exchange's share price, the listing of the exchange does not introduce conflicts of interest where there were none; the conflicts are simply different. There are conflicts in a demutualized but unlisted exchange or in a mutually-owned structure. The Chairman of MAS is reported as saying running the stock and futures exchanges as a business and acting as a regulator of the exchanges at the same time poses no conflict of interest for SGX. The two roles are not incongruent, because an exchange seeking to attract listings and investors gains from sound regulation and effective enforcement. The Chairman was addressing a particular potential conflict, namely the profit motive versus expenditure on regulation of the market. On the other hand, commentators in the same paper have argued that SGX suffers from conflicts regarding its

---

26 SGX-ST became a party to facilitate the implementation of the arrangements.
27 For example, in a member-owned exchange, broker directors may be motivated to maximise the profits of the brokers at the expense of the exchange.
“contradictory roles as a regulator and a profit-driven entity.” The commentator was addressing the conflict between admission standards and earning fees from new listings, and of disclosure standards of the exchange compared to other listed entities, although in respect of the latter the commentator confuses disclosure as a listed company with giving reasons for regulatory actions as an SRO.29

The types of conflicts that may be faced are broad, and particular conflicts can arise quickly. They include conflict of interest regarding regulation of:

(i) brokers, as the exchange enters new business opportunities which start to compete with the brokers traditional businesses,
(ii) listed entities for similar reasons,
(iii) the market generally, since there is increased pressure to reduce spending on activities that do not make profits, notably regulation.30

Exchanges are traditionally self-regulatory bodies. They are “self” regulatory because brokers oversee their peers, such as in disciplinary committees. They are probably not self-regulatory in relation to listed entities, although traditionally exchanges have undertaken this regulation role.31 Demutualization changes the basis for the claim to self-regulation, because the exchange is no longer organized around the brokers, but it need not change the practice. It is still usual to have a broker-manned tribunal for hearing disciplinary actions against brokers. The exchange may even retain other broker-manned committees (e.g., listing committee). However, there is often cost or time pressure to reduce the committee structures that mutuals relied on.

The strategies for dealing with each conflict usually need to be different, depending on the individual circumstance of the exchange and the conflict itself. Each conflict should be analyzed to assess whether it is a real or perceived conflict, the likelihood, and potential consequences of the event happening, the strength of the response needed, the structures already in place, etc.

29 The Hock Lock Siew column, the Business Times, 2 February 2001.
30 In October 2000, 84% of the FIBV member exchanges surveyed considered market surveillance as part of the product line of exchanges. This shows that exchanges have viewed the exchanges’ supervisory work as integral to the operation of the exchange. (Poll taken at the FIBV Annual Meeting.)
31 Originally on the basis that the brokers were deciding what securities they wanted to trade.
In Singapore’s example, the Merger Act set up two general structures: a power of direction in the MAS, and a Conflicts Committee at exchange level which is required to report conflicts to the MAS. SGX and SGX-ST have undertaken\(^{32}\) to comply with a procedure for dealing with possible conflicts of interest or conflicts of interest that may arise from the listing or quotation of SGX shares on the SGX-ST. This is set out in the Appendix.

Perhaps the arrival of demutualized and listed exchanges has brought about a thorough re-examination of the whole conflicts issue.

### 15.10 Conclusion

Globalization and the use of technology are changing the way exchanges operate and compete. Exchanges today face competition from proprietary trading systems, such as ECNs, and investors are more sophisticated and demanding as they seek to execute trades directly, want convenient low-cost access, and look for a variety of cash and derivative instruments.

These challenges are forcing exchanges to be more commercial, which in turn is causing them to consider their constitutional structure. Often, they are deciding that the mutual structure does not provide the flexibility to meet these challenges because it is geared toward maintaining members’ interests. On the other hand, demutualization allows trading rights to be separated from ownership and therefore allows exchanges to be driven as business entities. Listing, a separate decision, takes that a step further by speeding up the process of separation and sharpening the focus on shareholder value.

However, for an exchange to reap the benefits of demutualization, it must plan the appropriate organization structure, risk management strategy, corporate governance model, business model, and ownership structure. The experience of SGX is one case study, but different exchanges will have different issues to be addressed. Therefore, the answer is not to be found in a single model, but in a range of responses which take into account the history of the exchange, its place in the economic structure of the country, the state of market development, the existing ownership position, the intended goals, and public policy. The government, the statutory regulator and the exchange each have a role to play in the decisions.

\(^{32}\) Clause 4 of the Deed of Undertaking.
APPENDIX 1:
Procedures to Deal with Conflicts of Interest

The Board of Singapore Exchange (SGX) will appoint a “Conflicts Committee” to consider possible conflicts of interest or conflicts of interest that may arise from the listing or quotation of SGX shares on SGX-ST. The Conflicts Committee will comprise not less than three senior management executives of SGX of whom at least one must be a director of SGX. The head of Risk Management and Regulation Division of the SGX will be the Conflicts Committee Secretary (who shall not be a Committee Member).

SGX will obtain MAS’ approval for appointment of Committee Members.

SGX shall use its best endeavours to ensure that the staff of SGX or of any subsidiary of SGX are alert to, and identify, conflicts of interest or possible conflicts of interest which may arise in the course of the performance of regulatory functions in relation to the listing of SGX shares on SGX-ST. All relevant facts giving rise to any conflict of interest or possible conflict of interest shall be brought to the attention of the Conflicts Committee and the Conflicts Committee Secretary at the earliest possible opportunity.

Where the Conflicts Committee has determined that a conflict of interest or possible conflict of interest does or may arise it shall notify MAS of all relevant facts including any proposals for resolving the matter in a manner which assures the proper performance of any relevant regulatory function. SGX and SGX-ST shall provide any further particulars that MAS may reasonably require for purposes of determining whether the regulatory function can be discharged without its intervention.

Where SGX has been notified by MAS of its determination that a conflict of interest or possible conflict of interest does or may exist, SGX shall:

- provide such information requested by MAS with respect to its present and proposed interest and all those of any subsidiary of SGX;
- comply with, or procure that its subsidiaries comply with, any direction given by MAS; and
Appendix I: Procedures to Deal with Conflicts of Interest

- facilitate MAS’ exercise of all or any of the powers and functions otherwise exercizable by SGX or any subsidiary of SGX to the exclusion of any such company.

The following matters shall be referred directly to MAS instead of the Conflicts Committee:

- complaints received concerning insider trading in SGX shares; or
- market surveillance reports indicating that insider trading in SGX shares could have taken place; or
- investigations into possible insider trading in SGX shares; or
- the receipt by SGX-ST of a listing application from an applicant whom SGX regards as that is a competitor of SGX.
16.1 Introduction

On 1 January 1993, the Stockholm Stock Exchange did something novel—it became a for-profit share company with brokers and listed companies as shareholders. Today, demutualization is becoming the norm. Seventeen securities and futures exchanges have demutualized, and at least twelve more have set the machinery in motion. It would be surprising if there were any exchange for which the question of whether to demutualize is not at least on the radar screen.

The process toward exchange demutualization may seem inevitable, but it is not one to be taken lightly. It raises any number of issues for the markets, its stakeholders and its regulators.

16.2 An Overview of the Toronto Stock Exchange (TSE)

The TSE can be broadly broken down into three broad lines of business: equities trading, listings and the sale of market data. In addition, TSE supports these business lines through market regulation, information technology, marketing and investor education programmes and internal administration. Previously, TSE operated derivative and unlisted over-the-counter trading markets. Pursuant to an agreement among the Canadian stock exchanges, these businesses were transferred to the

---

1 Director, Global Market Initiatives, Toronto Stock Exchange.
Montreal Exchange (ME) and the Canadian Venture Exchange (CDNX)\(^2\) respectively. The TSE is now the sole Canadian exchange for senior equity issuers, the CDNX is the sole market for junior issuers and the ME is the sole derivatives market.

Earlier this year, TSE and CDNX reached an agreement whereby the TSE will purchase all of the outstanding CDNX shares, but will continue to operate it as a separate venture exchange. The deal has received shareholder approval and is subject to regulatory approval.

### 16.2.1 Equities Trading

An electronic equities market such as the TSE consists of three major components: trading stations providing access to the trading system, the trading system itself and a system to clear and settle trades. Of these, the stock exchange traditionally focused on the first two; clearing and settlement is performed by the Canadian Depository for Securities, of which TSE is a part owner together with the other Canadian exchanges and other participants. When the Computer Assisted Trading System (CATS) was first launched,\(^3\) TSE was also the exclusive provider of trading stations. This is no longer the case; the move to an open access (gateway) environment has allowed third parties to use a standard message protocol (STAMP) to build trading stations, and the TSE no longer provides trading stations.

Trading on the TSE occurs in a continuous auction market with a fully electronic, visible order book. The original CATS trading engine was replaced this year by a new engine adapted from the one operated by the Paris Bourse. Liquidity is maintained by combining the efficiency of an electronic agency market with registered traders who commit capital to moderate short-terms gaps in liquidity.

The continuous market cannot, however, serve all investor needs. The TSE’s order book generally cannot provide the levels of liquidity required to execute large block trades. Furthermore, the transparency of the continuous market runs counter to the block market’s need for pre-trade anonymity and non-disclosure to avoid market impact.

Block trades are generally negotiated in the upstairs market, which provides less visibility and operates on a non-continuous basis. The TSE regulates upstairs trading by requiring the trade to be executed the

---

\(^2\) The entity formed from the merger of the Alberta Stock Exchange and the Vancouver Stock Exchange.

\(^3\) CATS was the world’s first fully electronic order-entry and execution service.
exchange as soon as it is matched. Trades in the upstairs market must comply with TSE rules (such as rules governing short sales) and must be within the context of the market, meaning that any better-priced orders in the book must be filled in full before the trade can be completed.

### 16.2.2 Listings

The TSE is the largest equities market in Canada, listing all major Canadian issues. TSE maintains a prestigious, high profile brand as a well-regulated, liquid market with well-capitalized member firms. Companies seeking to list on the stock exchange do so in order to access low cost capital and associate with a widely recognized market and a reputable peer group.

TSE maintains the quality of the stock list in order to maintain the credibility of the TSE market, protect investors’ interests and instill investor confidence. In addition to vetting all listing applicants for compliance with the stock exchange listing requirements, TSE regulates financings and certain other aspects of companies’ ongoing operations.

### 16.2.3 Market Data Services

Market Data services include real-time market data—among those, the TSE’s market-by-order display of all orders in the Book—and historical data and publications. Real-time data is provided to vendors who resell it to end-users in Canada and around the world.

### 16.2.4 Market Regulation

The TSE is recognized by the Ontario Securities Commission (OSC) as a stock exchange under the *Securities Act* (Ontario). Although a stock exchange is not defined in the *Act*, a recognized exchange is obliged to regulate the business and conduct of its members. In addition, TSE is granted certain regulatory authority by virtue of the *Toronto Stock Exchange Act*.

The TSE’s regulation effort is dedicated to maintaining the integrity of the TSE market and effective regulation of equity markets and trading generally. Following consolidation of the TSE’s member regulation functions with the Investment Dealers Association of Canada (IDA) in

---

4 “Member” regulation consists of the non-trading aspects of a broker’s operations and includes sales compliance, regulation of advertising and capital and margin rules.
1997, the stock exchange focused solely on market regulation, with all TSE members being required to be members in good standing of the IDA. The TSE’s regulatory program focuses on three types of market regulation, as well as the regulation of listed companies described above.

**Overall market regulation.** The TSE oversees members’ trading operations and market activities in order to maintain effective, centralized, market regulation. Such regulation, which is not restricted to trading on the stock exchange, is a role generally played by a primary market and addresses general issues of trading ethics and investor protection in the markets.

**Supervision of TSE markets.** The TSE sets rules governing the operation of its market, monitors trading activity, and administers and enforces the rules through its regulatory policy, market surveillance and enforcement functions.

**Membership**\(^5\) **approvals.** The TSE sets standards governing qualification for membership and access to its markets, and vets applicants for compliance with these standards.

### 16.3 The Development of Mutual Exchanges

Exchanges evolved from informal trading sessions in coffeehouses to organizations competing globally for market share. The governance structures that worked well in the early days increasingly became a hindrance, as exchanges more and more needed to react quickly to domestic and international developments.

#### 16.3.1 Monopolies and Mutualization

In 1861, when the Toronto Stock Exchange (TSE) was initially founded,\(^6\) telecommunications were in their infancy, brokers were local and exchanges were locally focused, as were most other businesses of the time. There were more than 200 exchanges in North America in the 1800s, but it was not an era of robust competition. An exchange’s customer base was local and it did not face meaningful competition from exchanges in distant cities.

---

\(^5\) As noted below, firms admitted to trading are now known as “Participating Organizations.”

\(^6\) TSE was not incorporated until 1878.
In an environment with little competition, a mutual ownership structure is effective in that the owners have an incentive to control its expenses and to motivate it to deliver innovative, cost-effective services because they are also the primary customers. The alternative would be for the government to regulate the exchange as a monopoly provider, setting (or approving) the rates it charges.7

16.3.2 Exchanges as Self-Regulatory Organizations

The model chosen by TSE, which was the model adopted by most, if not all markets of the time was a self-governing one reflecting an enlightened self-interest on the part of participants. Markets would not be successful if participants did not have confidence that they would be treated fairly and honestly by their broker and that the market itself operated fairly. Exchanges restricted access, set rules and regulations governing the business conduct of their members and set rules or procedures designed to ensure that bargains would be honoured (the “credit ring”). The very first minutes of the TSE stated that applicants were to be approved by the membership “for the purpose of securing the confidence of the public in the Association.”8 Even today, the requirements for new applicants for membership on virtually every exchange can be boiled down to two essential characteristics: demonstrating that the applicant is “fit and proper” and creditworthy.

Self-regulation has the following benefits:

- **Ethical standards.** SROs have the ability to impose ethical standards which go beyond those which can be imposed by statutory laws.

- **Accountability.** Self-regulators are directly accountable to their members—and often the government—for actions taken or not taken. Thus, the SRO system carries a built in motivation to take the regulatory course which is the most effective and least disruptive to market efficiency.

- **Acceptability.** Self-regulation operates in an environment where there

---

7 This was the role of government in overseeing exchange rules that limited competition, most notable of which were rules in many markets fixing the commissions that members could charge their customers.

is a willingness to accept regulations promulgated by professional peers as the necessary and appropriate action for the common good of the group. Self-regulation is not limited to the SRO, but extends to firms and users. The credibility of the SRO staff, as well as the opportunity to participate means that changes that impact business are more likely to be accepted than commission rules.

- **Sensitivity.** Self-regulators have the business sensitivity to know when a regulation will be workable and beneficial to the investors and users of the markets.

- **Participation.** The opportunity of persons and organizations who are subject to the regulations to participate at all levels of the self-regulatory process makes it easier to accept new regulations which often means restrictions or impediments to legitimate business activities.

- **Checks and balances.** Self-regulation has a built-in system of checks and balances. The persons and organizations which must comply with the regulations, such as companies who list their securities, and members and investors who do business on the exchanges, are less reluctant to make their views known to the SRO with whom they have a business relationship.

- **Responsiveness.** Self-regulators are able to identify and comprehend complex problems at an early stage and can respond with a solution or approach to meet the specific or particular development or problem situation. This ability to respond to developments as they are occurring often can ameliorate or lessen potential problem situations before they reach a crisis stage.

- **Expertise.** Self-regulators also have a reservoir of expertise in the offices and staff of their member organizations which can be drawn upon at different levels and stages of the self-regulatory process. Thus, SROs have a closeness to, and familiarity with, the field of financial activity to be regulated.

- **Cost effectiveness.** Self-regulation, which often operates as a part of a voluntary membership organizational structure, has a built in incentive to minimize the cost of regulation to investors and users of the markets.
• **Effective use of government resources.** Self-regulation permits the government to devote its resources to activities which cannot be adequately served by self-regulation, such as criminal proceedings, legal actions on insider trading and manipulative practices by non-members.

• **Good business sense.** Self-regulation makes good business sense for both those concerned about investor protection and those subject to the regulation.\(^9\)

Regulation of listed companies came later than regulation of members. Listed company regulation is not, strictly speaking, self-regulation as the exchanges are not organizations of public companies. The jurisdiction over listed companies is contractual, based in the listing agreement pursuant to which the company agrees to comply with applicable exchange rules.

Originally, the concept of “listing” didn’t exist for many exchanges, which traded any and all financial instruments. The TSE was originally established to “facilitate the negotiation or bills of exchange, stocks, shares, debentures and other loans.”\(^10\) As they grew, markets became successful enough that they could charge for the privilege of being admitted to trading. Selective admission also became a form of quality control, which improved investor confidence in the market as issuers were required to meet certain minimum requirements.

In addition to setting entrance requirements, exchanges also began to impose ongoing requirements to maintain a listing. It was the New York Stock Exchange (NYSE), not government, that first required listed companies in the United States to prepare annual financial statements and mail them to shareholders.\(^11\) When the newly-formed US Securities and Exchange Commission first adopted continuous disclosure requirements for public companies, they largely copied the NYSE rules already in place.\(^12\)

---


\(^9\) Id.

\(^10\) Id.


16.3.3 The Increasing Role of Government Oversight

Like most if not all exchanges at the time, the TSE originally operated without government regulation or oversight. What regulation existed governed primary issues of securities by companies. The stock market crash of 1929 gave rise to allegations of market manipulation and unfair trading practices. The exchanges were criticized as private clubs that were more concerned with the welfare of their members than of the public.\(^\text{13}\) The United States Securities Exchange Act of 1934 gave the SEC the power to regulate national securities exchanges. In 1945, the Ontario Securities Commission was given the explicit power to regulate stock exchanges operating in the province.\(^\text{14}\)

However, the initiatives in most jurisdictions—until recently, the United Kingdom remained almost a purely self-regulatory system with minimal government oversight—did not replace the exchanges with the government as regulator. The regulatory regime recognized the self-regulatory function of the markets. The role of the securities commission was to oversee the regulation by the market, not to perform the day-to-day task of front-line broker and market regulation. The role of government was to keep the SRO honest, ensuring that it always resolved the inherent conflict of interest in favour of the public.

The TSE’s regulation of market participants seeks to maintain the credibility of the TSE’s market, protect investors’ interests and instill investor confidence. In addition to listed company regulation, TSE oversees members’ overall equity trading operations and market activities. Such regulation, which is not restricted to trading on the stock exchange, addresses general issues of trading ethics and investor protection in the markets. In addition, TSE sets rules governing the operation of its market, monitors trading activity, and administers and enforces the rules through its regulatory policy, market surveillance and enforcement functions. Finally, TSE establishes criteria for access to its market as a member.

The TSE is overseen by the OSC to ensure that it operates in the public interest. OSC must approve any TSE rules that raise “public interest” issues—as that term is defined in the protocol between OSC and TSE dated 23 October 1997—in advance of implementation. In addition, the commission has a general power to make any order with respect to the TSE that it deems necessary in the public interest, and can review any direction, decision, order or ruling of TSE at the request of its Executive

\(^\text{13}\) Id. at 1464.
\(^\text{14}\) Daniels Report, supra note 8, at 33.
Director or any person directly affected by such direction, decision, order or ruling.

16.4 Consolidation, Globalization and New Competition

The first telecommunications breakthroughs in the 1800s, the telegraph and the telephone, made it easier to deal on a distant exchange. National exchanges emerged, and smaller ones were taken over, relegated to regional or niche status or closed. As one example, the TSE merged with the smaller Standard Stock & Mining Exchange in 1934.

Lately, the markets have witnessed the growth of electronic trading, which the TSE pioneered with its CATS system. In fact, electronic trading itself has changed. What started out as proprietary, closed electronic systems now have open architecture—allowing anyone to plug into them. The Internet is now emerging as both an order routing and trading platform.

Today, investors are increasingly taking a greater interest in foreign securities. Investment is more and more on a sectoral, rather than national, basis. Large Canadian companies have long interlisted on US markets—the NYSE, the American Stock Exchange and NASDAQ. The TSE’s primary competition comes not from other Canadian exchanges but from US markets.

The presence of large, liquid American markets in the same time zone presents an enormous competitive challenge for TSE. The number of Canadian-based interlisted issuers (CBIs) has grown from 137 in 1989 to over 270. Although the TSE has competed successfully and is the dominant market for senior Canadian issuers, it would not take a large shift in market share in trading in CBIs to tilt the balance to competing American markets. If this happened, the US markets would challenge the TSE to become the primary price discovery mechanism for Canadian issuers, attracting even more order flow.

16.4.1 Alternative Trading Systems (ATSs)

The past few decades has seen the growth of institutions from relatively small players to dominant players in the markets today. Institutional investors have unique needs not met by traditional trading structures. In particular, they have a need for anonymity in trading as well as for dealers to commit large amounts of capital. The result has
been the growth of the upstairs market, where trades are matched by dealers and reported to exchanges.

More recently, niche ATSs or Electronic Communication Networks (ECNs) such as Instinet, Posit and the Arizona Stock Exchange have appeared, providing tailored services to meet institutional investor needs. Retail investors now have virtually direct access to the liquidity pool. They also have access to more information through the Internet and increasingly, the desire to make their own decisions. As access becomes more direct, this could be viewed as exchanges competing with brokers as a means of access to the liquidity pool. Brokers are already being forced to rethink their role and concentrate on value-added services.

To serve retail investors, other ECNs such as Island have been launched to provide a limit order book that NASDAQ, a dealer market, does not provide.

The TSE currently allows members to operate the equivalent of ECNs, provided those ATSs are confined to independently matching block orders, comply with applicable TSE trading rules and are integrated with the TSE order book. The Canadian Securities Administrators\textsuperscript{15} are expected to shortly issue rules allowing ATSs to operate outside the exchange framework.\textsuperscript{16}

16.5 The Demutualization Decision

In 1998, the TSE’s Board of Governors undertook a strategy development process which involved an assessment of the TSE’s capabilities and competitive position, a review of the experiences of other exchanges, a survey of the TSE’s constituents’ needs and attitudes, and a consideration of governance alternatives. This process was motivated by a recognition that the TSE’s future was threatened and that a strategic direction was required to enable the TSE to succeed in the future.

The result of this process was a strategy blueprint, entitled \textit{A Blueprint for Success},\textsuperscript{17} which was released to members (and to the public) in October 1998. A cornerstone to executing the strategic directions articulated in the blueprint was a new ownership and governance structure for the TSE.

\textsuperscript{15} Securities regulation in Canada is on a provincial basis. An action by the “Canadian Securities Administrators” denotes joint harmonized action by the various provincial commissions.

\textsuperscript{16} Two versions of proposed ATS rules have previously been issued for comment.

\textsuperscript{17} Available at <http://www.tse.com/tse_inc/index.html>.
The *Blueprint* identified the trends that are affecting the TSE’s business and the challenges facing the TSE in the current marketplace. The report integrated the analysis derived from those trends and challenges with an understanding of the TSE’s products and market position.

The *Blueprint* identified and recommended, among others, the following initiatives designed to enhance the TSE’s product and service offerings and assist the TSE in being responsive to the competitive marketplace of which it is a part:

(i) invest in core and new trading modalities;
(ii) continue to act as an integrator of post-trade market information;
(iii) continually update its offering with new products and services;
(iv) improve the market support function; and
(v) improve its value proposition for listed companies.

In order to implement these initiatives, The *Blueprint* recognized the need for a different governance model than the one currently in place and recommended a new ownership and governance model for the TSE with the following elements:

(i) for-profit instead of not-for-profit;
(ii) shareholder structure instead of member-seatholder structure;
(iii) separation of access from ownership; and
(iv) initially designating at least half of the seats on the Board for directors from outside the brokerage community.\(^\text{18}\)

\(^{18}\) At the time, 10 of the 15 seats on the Board were reserved for representatives of member firms. Four governors were “public governors” and the President and CEO of TSE was an ex-officio member.
16.5.1 Rationale

The TSE’s not-for-profit, cooperative governance structure, which once served it well, had become more of a hindrance than a benefit. A mutual ownership structure has inherent inefficiencies. Mutual entities often lack, or have ill-defined, strategic goals and business purposes. Their structure can give rise to potential conflicts of purpose between organizational needs and the needs of members (or groups of members).

In the case of the TSE, vigorous competition from American stock exchanges and the threat of competition from ATSs exerted a higher level of discipline on management to provide cost-effective services to its stakeholders than its mutual ownership structure.

The Board recommended that the TSE become a for-profit, demutualized company for the following reasons:

- **Focused governance model.** A for-profit entity with a business-minded governance structure best allows the TSE to keep its mandate clear and accountability focused, which will assist the TSE in meeting its competitive challenges.

- **Divergences of interests.** A governance structure that made sense years ago is no longer appropriate today as members themselves no longer belong to a homogenous group. Indeed, both the size of members and the markets in which they compete are becoming more diverse. Since the TSE has historically attempted to resolve issues by consensus, the current governance model is becoming an increasingly slow and cumbersome method of making decisions. Action is delayed by lengthy consultation, making it difficult for the TSE to respond quickly and decisively to changes in the market.

- **Serving the TSE’s customers.** By limiting ownership to members, the TSE has not been as flexible and proactive in responding to all of its customers’ needs. A business model of ownership will provide the TSE with the platform from which to meet these needs more effectively.

- **Access to capital.** The not-for-profit cooperative structure has limited the TSE’s access to capital, apart from raising its fees, to levies on its seatholders.

- **No rationale for continuing with a seatholder structure.** Originally, a “seat” on the TSE was just that: a seat on the trading floor. At the
time, physical presence on the floor was the only means to trade on the TSE. Later, a seat became an entitlement to have a certain number of traders on the floor, and restrictions on the number of seats reflected the limited real estate available for trading. In an electronic exchange, these concerns are no longer relevant. Any member can have as many traders accessing the trading system as it has trading stations, and does not have to acquire more seats to increase its complement of trading personnel.

16.5.2 The Demutualization Process

Demutualization required member approval. This was obtained, and as of 1 April 2000:

- TSE became The Toronto Stock Exchange Inc., a for-profit corporation. Members became shareholders and the Board of Governors was renamed the Board of Directors.

- TSE is no longer a seat-based, member-owned company. Seats were exchanged for shares on the basis of 20 shares per seat.

- Share ownership is constrained. No person or persons acting jointly or in concert may beneficially own or control more than 5% of the outstanding shares unless the prior consent of the OSC is obtained. A member that received more than 5% of the outstanding shares pursuant to the seat exchange was “grandfathered,” but is not able to exercise more than 5% of the votes outstanding. This actually slightly increased the voting power of those members—previously, members that held more than three seats (out of 127 at the time) were restricted to three votes.

- For two years, shares of TSE cannot be transferred unless the consent of the board of directors or of a majority of shareholders is obtained. After this date, resales will be restricted by securities legislation unless TSE files a prospectus or relief from applicable prospectus requirements is available.

- Access to the TSE’s trading system is now based on contract, not ownership. Brokers granted access to trading are now known as “Participating Organizations” rather than members. Existing members at the time of demutualization were given access and are not required to remain shareholders of TSE Inc. in order to trade.
• TSE continues to approve new applications for trading privileges. However, applicants only have to execute a Participating Organization Agreement to be able to trade. They are not required to own shares of TSE Inc. Conversely, access rights do not entitle Participating Organizations to participate in the ownership or governance of the TSE.

• The number of member governors who are not affiliated with a member was increased so that they form 50% of the Board. Previously, the Board nominated these “public” governors subject to confirmation by the Ontario Ministry of Finance. Today, they are elected by shareholders at the annual meeting.

Demutualization required several steps after member approval was obtained:

• Demutualization was approved by the OSC and the Ontario Minister of Finance—as part of the process, the TSE had to submit a new recognition order to the OSC for approval setting out the terms and conditions under which TSE would be permitted to continue to operate as an exchange,¹⁹ and

• The Ontario Legislative Assembly passed legislation providing for the continuance of the TSE under the Ontario Business Corporations Act (previously, TSE had been incorporated under special purpose legislation).²⁰

16.6 Market Regulation by a Demutualized Exchange

Maintaining a well-regulated marketplace is a source of competitive advantage and is vital to maintaining the TSE’s credibility and reputation. This is especially important given that the TSE’s primary competitors are the NYSE and NASDAQ, which have comprehensive self-regulatory programs.

However, one of the greatest concerns arose because some firms believed that TSE would use its regulatory powers to hinder business

¹⁹ A draft version of the recognition order was previously issued for public comment.
²⁰ The TSE Act, as amended remained on the books to confer on TSE the power to regulate its market.
activities by firms it believed to be its competitors. Although those concerns exist in a not-for-profit environment, these firms believed that they would be exacerbated if TSE operated on a for profit basis.

To alleviate those concerns, the TSE restructured market regulation to eliminate perceived conflicts of interest. The TSE’s regulatory operations are a discrete division or entity, independent of the operation of the equities trading business, in order to foster enhanced confidence of market participants in the integrity and credibility of the regulatory program, and to address concerns about potential conflicts of interest between the TSE's role as a provider of trading services and a regulator. Although these conflicts exist within any self-regulatory organization, the separation of functions should ensure that they are addressed in a more formal and transparent manner. This restructuring has a number of elements.

The TSE has established a new management and governance structure for regulatory services (TSE RS). The Board retains ultimate policymaking, oversight and corporate authority for TSE RS. A new board-level Regulation Committee has been established to oversee regulatory operations. The committee is comprised of a majority of independent representatives, including representatives from all types of participants in the TSE market, including ATSs. TSE RS has an ultimate reporting responsibility to the OSC, the terms for which are defined in the OSC’s new recognition order for TSE.

Prior to demutualization, TSE did not charge for regulatory services, as they were bundled with other services. Demutualization changed this. One the one hand, the TSE’s services must be self-supporting and priced competitively, to ensure that operations are run with appropriate business disciplines. On the other hand, it was considered inappropriate to run regulation services on a for profit basis. Therefore, participants are now charged a separate fee for regulatory services, based on a cost-recovery model. In this way, participants are able to monitor and see the cost of market regulation.
16.7 Next Steps

The TSE has announced that it intends to become a public company in the next 6 to 12 months, depending on market conditions, although it has not determined exactly what form that will take. An IPO is possible, but the exchange does not need to raise capital at this time.

TSE has proposed further spinning off Regulation Services as a separate entity that would initially be jointly owned with the IDA (RS Inc.). In conjunction with this, Regulation Services has proposed a set of “universal” market integrity rules that will apply to trading on all marketplaces, including ATSs.21 It is hoped that this structure will make it more acceptable to ATSs to have Regulation Services as a regulator, and the model is flexible enough to provide for the representation of other markets within the governance structure of RS Inc.

16.8 Conclusion

It is too soon to definitively list the impacts of demutualization. As the TSE is not yet a public company, it has not totally divorced ownership from “membership.” However, it is developing a more business-focused approach and is more flexible than in the past. It is unlikely that a decision to take over CDNX could have been made and followed through so quickly in a mutualized environment where a consensus had to be developed. Certainly, nothing has occurred to cause management to regret the decision to demutualize.

---

21 Fuller details can be found on the TSE Regulation Services website (http://tsers.com/) under “Publications—Regulatory Notices—Notice 2000-017.”
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.

---

1 Special Counsel and Consultant, Philippine Stock Exchange, Inc.
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

<table>
<thead>
<tr>
<th>GROUP</th>
<th>COMMITTEE (FUTURE ROLE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office of the President</td>
<td>• Management Audit &amp; Finance (Audit, Nominations &amp; Remunerations)</td>
</tr>
<tr>
<td></td>
<td>• Social Committees (Social Club)</td>
</tr>
<tr>
<td>Corporate Services</td>
<td>• Business Development (Strategic Advisory)</td>
</tr>
<tr>
<td></td>
<td>• Futures Exchange (Strategic Advisory)</td>
</tr>
<tr>
<td></td>
<td>• Building (Strategic Advisory)</td>
</tr>
<tr>
<td>Integrity Group</td>
<td>• Business Conduct &amp; Ethics (Broker Disciplinary)</td>
</tr>
<tr>
<td></td>
<td>• Floor Trading &amp; Arbitration (Broker Appeals)</td>
</tr>
<tr>
<td></td>
<td>• Policy Committees (Business Rules)</td>
</tr>
<tr>
<td>Capital Markets Group</td>
<td>• Membership Committee (Broker Advisory)</td>
</tr>
<tr>
<td></td>
<td>• Listing Committee (Listing Appeals)</td>
</tr>
<tr>
<td>Clearing &amp; Settlement Group</td>
<td>• Securities Clearing (Strategic Advisory)</td>
</tr>
<tr>
<td>Technology Services</td>
<td>• Technology (Strategic Advisory)</td>
</tr>
</tbody>
</table>

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.
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

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

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.
PART III

Structure of Mutual Exchanges
18.1 Ownership Structure

The Colombo Stock Exchange (CSE) has a mutual ownership structure and is organized in the form of a company limited by guarantee and incorporated under the Companies Act of Sri Lanka and licensed by the Securities and Exchange Commission of Sri Lanka to operate as a Stock Exchange in Sri Lanka. It functions as a not-for-profit organization.

The Securities and Exchange Commission of Sri Lanka was established with the passing of the Securities Council Act No. 36 of 1987 by Parliament. The Act has been since amended and today the Securities and Exchange Commission is well equipped to regulate the capital market in the country.

CSE is a member of the International Federation of Stock Exchanges (FIBV) and the South Asian Federation of Exchanges (SAFE). The stock exchange was incorporated on 2 December 1985 by seven subscribing members and since then has admitted eight more members. To date it has a membership of fifteen. CSE took over the operations of the Colombo Stock Market in 1985 from the Colombo Brokers Association (CBA) which governed the activities of the Colombo Stock Market from 1896-1985. The CBA was an association of brokers and not an incorporated body.
18.2 Listing Data

Table 18.1. Listing Data of the Colombo Stock Exchange

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of new listings during the year</td>
<td>14</td>
<td>9</td>
<td>7</td>
<td>17</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>No. of new companies listed during the year</td>
<td>14</td>
<td>9</td>
<td>6</td>
<td>6</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>No. of listed securities as at end of the year</td>
<td>234</td>
<td>251</td>
<td>247</td>
<td>259</td>
<td>262</td>
<td>271</td>
</tr>
<tr>
<td>No. of listed companies as at end of the year</td>
<td>226</td>
<td>235</td>
<td>239</td>
<td>240</td>
<td>237</td>
<td>239</td>
</tr>
</tbody>
</table>

18.3 Corporate Governance

The Board of Directors is the policy making body of the CSE and consists of nine directors. Members are represented on the board of the stock exchange by five directors who are elected at the annual general meeting (AGM). The chairman of the board is elected from among the five elected directors. The chairman serves for a period of three years. An additional four directors are appointed to the board by the Minister of Finance (the Finance Ministry portfolio is held by the President of Sri Lanka). Thus, of the nine directors, five are elected by the members and four are appointed by the government.

Board meetings are held regularly. The Exchange Secretariat is headed by the Director General. The Director General participates at all board meetings and at AGMs and extraordinary general meetings (EGMs), and is accountable to the board for the operations of the CSE (Figure 18.1).

All divisional heads report directly to the Director General.

The matrix organization structure that has been adopted ensures the participation of the different divisions in formulating strategy and working towards achieving common goals and objectives. This avoids sub-optimization of objectives at the divisional level.
Figure 18.1. Organizational Chart of the Colombo Stock Exchange

18.4 Business of the Exchange

The core functions and services of the Colombo Stock Exchange (CSE) could be categorized as follows:

- listing companies to raise debt and equity capital, convertibles, warrants, asset securitizations, etc.;
- providing trading facilities for the secondary trading of all securities that are listed;
- providing on-line market data and other market related products;
- posting trade clearing, settlement, registration and depository facilities for all secondary market transactions;
- transferring of technology to other exchanges; and
- training.

The vision, mission and the corporate strategy is given below in brief. The stock exchange has developed the corporate strategy for the next three years in line with the vision and mission of CSE and with an ambition to play a more significant role in the Sri Lankan capital market.
18.5 The Vision, Mission and Corporate Strategy

The CSE shall contribute to the wealth of the nation by creating value through securities.

In particular, the mission of the stock exchange is to:

- actively pursue strategies that contribute to the growth of the capital market;
- provide facilities to trade equities, debt, derivatives and commodities futures and options;
- promote a corporate culture that encourages commitment, creativity and teamwork;
- maintain a balanced and responsive regulatory framework that will enhance market integrity and investor confidence; and
- focus on customer orientation, strive for organizational excellence and promote professionalism within the industry.

The current CSE corporate plan has organized and prioritized the development activities of the stock exchange under six key objectives:

(i) promote new issues and new products by attracting new issues, developing the secondary market for government bonds and facilitating the risk management through the introduction of new products;

(ii) broaden investor base concentrating on building the local institutional investor base, improving the dissemination of information and investor confidence;

(iii) enhance the efficiency and effectiveness of the stock exchange and the Central Depositary System by restructuring CSE to a more commercially focused organization;

(iv) develop the stock broking industry by promoting the emergence of full service brokers and enhancing professionalism within the industry;
(v) harmonize strategy with statutory and other government institutions through better interaction and coordination with related capital market institutions; and
(vi) pursue international initiatives through alliances and other strategic linkages.

18.6 Trading Rights

Trading rights are currently given only to member firms. Trading rights are given by virtue of gaining membership in the CSE. Ownership in member firms could change subject to the approval of the CSE and the Securities and Exchange Commission, and foreign ownership of up to 100% of the equity of member firms is permitted.

18.7 Regulatory Framework

The exchange is governed by its Memorandum and Articles of Association. In addition, the exchange has the rules and regulations detailed (Table 18.2).

18.8 Self-Regulation

The CSE is a self-regulatory organization. In addition, the activities of the stock exchange are subject to the monitoring and supervision of the Securities and Exchange Commission of Sri Lanka.

A separate division headed by a Senior Manager is entrusted with the responsibility of market monitoring and surveillance. This includes monitoring the continuing listing requirements of listed companies, compliance by member firms of the member regulations and on line market monitoring and surveillance. The Securities and Exchange Commission similarly supervises and monitors all these activities, independent of the stock exchange.

A system of regular audits by the CSE and Securities and Exchange Commission is in place to ensure that the necessary regulations are complied with.
### Table 18.2. Regulatory Framework

<table>
<thead>
<tr>
<th>Listing rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Criteria for Admission</td>
</tr>
<tr>
<td>- Contents of a Prospectus</td>
</tr>
<tr>
<td>- Criteria for Admission</td>
</tr>
<tr>
<td>- Initial Listing Application</td>
</tr>
<tr>
<td>- Additional Listing Applications</td>
</tr>
<tr>
<td>- Contents of a Prospectus</td>
</tr>
<tr>
<td>- Memorandum and Articles of Association or other Corresponding Documents</td>
</tr>
<tr>
<td>- Trust Deeds and Debentures</td>
</tr>
<tr>
<td>- Stock Option Schemes</td>
</tr>
<tr>
<td>- Continuing Listing Requirements</td>
</tr>
<tr>
<td>- Corporate Disclosure</td>
</tr>
<tr>
<td>- Enforcement</td>
</tr>
<tr>
<td>- Fees</td>
</tr>
<tr>
<td>- Sponsors</td>
</tr>
<tr>
<td>- De-Listing of Entities</td>
</tr>
</tbody>
</table>

**Rules governing the ATS**

**Rules governing the activities of the CDS**

**Rules governing the activities of Brokers**

- Business Conduct
- Conditions of Sales (Debt, Equity)*
- Capital Requirements of a Member Firm
- Client-Broker or Inter-Broker Dispute Resolution
- Staff Trades
- Appointment of Agents
- Branch Office/Sales Outlet
- Rule for Disciplinary action against Member Firms
- Diversification of Broker Activities (Margin Lending by Member Firms, Member Firm Trading on its Own Account)

**Rules governing the broker-client relationship**

*The “Conditions of Sale” cover the broker client relationship. All brokers are required to follow this uniform set of rules.*
The board of CSE has also set up five sub-committees to deal with administrative and regulatory aspects of the stock exchange. A representative of member (broker) directors and nonmember (broker) directors serve on these committees that are appointed by the CSE board. The committees are:

- Rules & Bylaws Committee;
- Finance, Research & Development Committee;
- Arbitration & Disciplinary Committee;
- Audit Committee; and
- Client-Broker or Inter-Broker Dispute Resolution Committee.

18.9 Statutory Regulatory Role

The Securities and Exchange Commission of Sri Lanka was established by the Securities Council Act No. 36 of 1987 and is the government regulator for the capital market in Sri Lanka. This was one of the first Securities and Exchange Commission to be set up in the South Asian region.

The Commission was established for the following purposes:

- regulating the securities market in Sri Lanka;
- granting licenses to stock exchange, stock brokers and stock dealers who engage in the business of trading in securities; and
- setting up a compensation fund.

The objectives of the Securities and Exchange Commission of Sri Lanka are as follows:

- creating and maintaining a market in which securities can be issued and traded in an orderly and fair manner;
- protecting the interest of investors;
- operating a compensation fund to protect investors from financial
loss arising from the failure of a licensed broker or dealer to meet his contractual obligations; and

- regulating the securities market and ensuring that professional standards are maintained in such a market.

### 18.10 Investor Protection

One of the key objectives of the Securities and Exchange Commission is investor protection. The Securities and Exchange Commission and the CSE are committed to maintaining a fair and orderly market.

Colombo has a fair reputation internationally as a well-regulated market. Investor protection operates on two tiers. Investors can lodge a complaint if they believe that they have been unfairly treated. The complaint should in the first instance be made to the Compliance Officer of the Member Firm. If the investor is dissatisfied with the decision of the member firm, the investor can refer the complaint to the Exchange and as a third recourse, he/she can refer the complaint to the Securities and Exchange Commission.

The CSE and the Securities and Exchange Commission both have surveillance divisions that track market movement to identify evidence of insider trading, front running, churning, etc. Inquiries are conducted and, if necessary, the offenders can be charged under the *Securities and Exchange Commission Act*. The market surveillance system with a database of trading records maintains details of transactions and enables investigations into market manipulations.

A settlement guarantee fund and a compensation fund are in place. Additionally stockbrokers also provide a cash deposit and a bank guarantee to the CSE to be used in the event of a settlement failure. In addition to this the brokers are also required to be sufficiently liquid and to maintain minimum levels of net capital. This minimizes the risk of a settlement failure.
18.11 Funding of the Colombo Stock Exchange

The stock exchange does not distribute profits; any operating surplus is used to develop the infrastructure of CSE and the capital markets in general. The asset position of the CSE is currently SLRs260 million (approximately US$4.3 million).

The key sources of income are the transaction fees; annual listing fees; quotation fees payable on new listings; and membership subscriptions from broking firms.

The main items of expenditure are the establishment costs (including rent, insurance, electricity, etc.); staff costs; and information technology costs (includes the costs of depreciation maintenance and development).

18.12 Stock Exchange Seeks to Demutualize

A project team consisting of CSE and Securities and Exchange Commission officials has been appointed to study and report on the following issues:

(i) legal issues;
(ii) regulatory issues; and
(iii) market aspects.

The team is currently in the process of collecting data and formulating the necessary statutory changes to the Memorandum and Articles, and identifying and formulating a suitable model for the CSE. It is expected that the CSE will be demutualized by 2003.

The ownership structure of CSE has not been decided upon but it is envisaged that one of the objectives of demutualizing is to broaden the base of the ownership structure.
19.1 Introduction

There are currently two stock exchanges and one futures exchange in Malaysia, which are the Kuala Lumpur Stock Exchange (KLSE), the Malaysian Exchange of Securities Dealing and Automated Quotation Bhd (MESDAQ) and the Malaysia Derivatives Exchange (MDEX). The KLSE and MESDAQ have recently commenced efforts to merge to form a single Malaysian exchange for the capital market. MESDAQ was incorporated in May 1997 as a company limited by guarantee, and its main objective is to provide a market for high-growth and high-technology companies to raise capital, and to promote the development of technology-intensive industries. MDEX is already a wholly owned subsidiary of the KLSE.

19.2 Ownership Structure of the KLSE

KLSE is a public company limited by guarantee incorporated in 1976 under the Companies Act 1965. It has no shareholders and no share capital, only members, with membership comprising of two classes—voting and nonvoting, as defined in Article 1 of the KLSE’s Articles of Association.

Voting members are made up of companies that carry on the business of dealing in securities, which are stockbroking companies. Nonvoting members may either be dealing members or nondealing members. Dealing members refer to executive directors of the member companies, who hold a dealer’s representative license, while nondealing members include individual and corporate shareholders, and nonexecutive directors of the member companies.
As at 30 June 2001, KLSE had 369 members, comprised of 56 voting members and 313 nonvoting members. Of the nonvoting members, 116 are dealing members while 197 are nondealing members. The nondealing members are comprised of 124 nonexecutive directors, 11 individual shareholders and 62 corporate shareholders.

A nine-member committee headed by an executive chairman oversees the affairs of KLSE. Four out of the nine members, including the executive chairman are appointed by the Minister of Finance, while the remaining five are elected from the voting members.

19.3 Listing Data

As at 30 June 2001, 809 companies were listed on the KLSE. Of these, 512 companies were listed on the main board and 297 were listed on the second board. In total, these companies had a market capitalization of RM403.5 billion (main board—RM387.2 billion, second board—RM16.3 billion).

19.4 Corporate Governance

The KLSE’s Articles of Association provide that the composition of its board of directors shall not be fewer than six and not more than nine persons. Under section 8(3) of the Securities Industry Act 1983 and article 9.2(a) of the Articles, the Minister of Finance may appoint no more than four persons to be on the board to represent the interest of the public. Under section 8(4) of the same Act, one of the four appointed board members shall be the executive chairman of the board. The length of service of the appointed board members is determined by the Minister of Finance.

The Articles also state that for board members not appointed by the Minister of Finance (elected board members), a candidate shall be nominated by no fewer than two member companies. Election for the board members shall be carried out at the annual general meeting. A member company has a vote for each position available but may only vote once for each candidate.

1 The Second Board of KLSE, which complements the Main Board, was established in November 1988 to enable smaller companies with strong growth potential to seek a listing on the Exchange.
The board shall appoint two independent persons to conduct the ballot. All voting papers and proxies shall be examined and counted in the presence of KLSE’s President, the two independent persons and all member companies at the annual general meeting. The decision of the independent persons shall be final and conclusive. However, if the independent persons are unable to agree, the decision of KLSE’s President shall be final and conclusive. If two or more candidates receive an equal number of votes, the chairman of the board shall have the casting vote.

At every annual general meeting, a third of the elected board members shall retire. The longest serving elected board members shall retire first unless there is an agreement among them. Retiring elected board members are eligible for re-election but shall not hold office more than six years.

Under article 15.1(1) of the Articles, the board shall appoint a president upon such terms and conditions as the board thinks fit. The responsibility of the president shall be to manage the day-to-day affairs of KLSE. In addition, the board may delegate its power to sub-committees under article 11.2(1) of the Articles.

19.5 Business of the Exchange

KLSE operates as a group of companies, which collectively service the securities industry. The following are the KLSE’s subsidiary and affiliate companies and their respective functions:

- KLSE-Bernama Real-Time Information Services (KULBER), which compiles and disseminates real-time share price and other relevant financial and economic information to information vendors and other subscribers;
- Labuan International Financial Exchange (LFX), an offshore financial exchange based in Labuan that is wholly owned by KLSE;
- Malaysian Central Depository (MCD), which operates the Central Depository System (CDS), the KLSE’s electronic settlement system which eliminated the movement of physical scrip;
- MDEX, which offers equity derivatives, financial derivatives and commodity derivatives;
• Malaysian Share Registration Services (MSRS), which undertakes the function of a share registrar;

• Research Institute of Investment Analysts Malaysia (RIIAM), which carries out the responsibility of upgrading the investment research standard in Malaysia and enhancing the level of knowledge of the investing public through courses, seminars and workshops; and

• The Securities Clearing Automated Network Services Sdn Bhd (SCANS), which is the central clearing house of KLSE.

19.6 Trading Rights

Trading on the KLSE—an order-driven market—was fully computerised in 1992 with the full implementation of the System on Computerised Order Routing and Execution (SCORE) automated trading system, whereby a central computer engine is responsible for matching all orders. SCORE eliminated the need for a trading floor at the Exchange’s premises (Figure 19.1).

The business of trading in securities is carried out by the KLSE members/stockbroking companies. Before a person can trade in the shares of KLSE listed companies, he/she will first need to open a trading account with one of the stockbroking companies, and a person can only buy or sell shares through a licensed dealer or remisier.

According to the Securities Industry Act 1983 (SIA), no person shall carry out the business of dealing in securities unless he/she holds a dealer’s license. The dealer’s license is issued by the Securities Commission to the stockbroking company and is not transferable. The SIA also allows a dealer’s representative license to be issued to individual stockbrokers (directors of a stockbroking company), corporate nominees representing corporate members of the KLSE, employees of stockbroking companies and remisiers, who are not employees of a stockbroking company but are engaged by the company to carry on the business of dealing in securities on its behalf.

Stockbroking companies are equipped with the KLSE’s enhanced broker front-end system, WinSCORE, whereby each dealer operates from an integrated terminal providing real-time market information dissemination as well as order and trade routing and confirmation.
The KLSE is a self-regulatory organization which governs the conduct of its members and member stockbroking companies in securities dealings. KLSE regulates its members through its Memorandum and Articles of Association (M&A) and Rules of KLSE. The Memorandum sets out the objectives of a Company and the Articles govern the internal affairs of KLSE as well as regulate the KLSE’s relationship with its members.

KLSE has monitoring and risk management systems, which incorporate internal procedures and principles to enable it to deal with default risk, settlement risk and major market disruptions. In this regard, KLSE has formulated specific rules for the purpose of managing risks, which were developed in consultation with the Securities Commission.

In managing default risk and protecting investors, a Compensation Fund has been established under Section 61 of the SIA. If a person has suffered monetary loss due to defalcation or fraudulent misuse by a director, officer, employee or representative of a member company, or the insolvency of a member company, that person may make a claim from the Compensation Fund. The SIA also requires member companies upon
being licensed to make contributions to the Compensation Fund in every financial year.

In addition to the Compensation Fund, a standby facility has been established by both the Securities Commission and KLSE to minimize systemic risks arising from the failure of any stockbroking company in meeting its obligation to the clearing house. Clearing members who face tight liquidity problems may apply for this facility either up to a maximum of RM10 million per day or the net settlement amount for that particular day, whichever is lower. The maximum amount that a clearing member may borrow in aggregate is RM20 million within one settlement cycle.

As an aspect of its management of systemic risk, KLSE continuously and diligently monitors the risk exposures of its members. With the implementation of the new risk-based Capital Adequacy Requirements (CAR), members of the stock exchange are also able to compute and monitor their own risk exposures to ensure that their liquid capital is sufficient to absorb those risks.

With regard to managing market disruptions, KLSE has incorporated in its rules the requirement to establish procedures to deal with crisis and emergencies, which include the requirement to inform the Securities Commission of any crisis or emergency. The stock exchange is also required to enhance its disaster recovery and emergency procedures from time to time and to conduct regular maintenance and checks on the overall integrity of their systems.

In addition, the move to shorten the settlement cycle is one of many reforms introduced by the Securities Commission to reduce settlement risk. With the implementation of the shorter settlement cycle by KLSE, the settlement date has been changed to three days after trade date (T+3). This means that a seller will need to deliver the sold securities on the third business day after trade date. Similarly, the buyer will have an obligation to pay for the securities on the third business day after trade date.

The securities clearing house, SCANS, also has arrangements in place to manage risk arising from default of clearing members. Failure on the part of the clearing members to meet their obligation reflects the credit risk to be assumed by SCANS, which, if not properly contained, could affect the market and the liquidity in the market. In managing default risk, SCANS is empowered by its rules to decide on what steps it may take in the event of a default by a clearing member.

Other than the aforementioned external risks, KLSE is also exposed to internal risks, which is its own internal operational procedures. Within KLSE, the Group Internal Audit Department (GIAD) has been set up to assess the various functions and control systems of the KLSE group, and
appraise their effectiveness with regard to compliance with laws, regulations and procedures, and advise management of their status and conditions.

19.8 Statutory Regulatory Role

The role of the securities market regulator, which is the Securities Commission, is outlined in laws governing the Malaysian capital market that is, the Securities Commission Act 1993 (SCA), and SIA and Futures Industry Act 1993 (FIA).

The SCA sets out the functions of the Securities Commission while the SIA and FIA focus on the equity and futures market respectively.

The SCA grants the Securities Commission the role of the sole regulatory authority to regulate the Malaysian capital market and empowers the Securities Commission to supervise and monitor the activities of exchanges. By virtue of the SIA and FIA, the Securities Commission is also empowered to approve the Business Rules of exchanges and amendments thereof.

The Securities Commission has no shareholding in and Memorandum of Understanding with the exchanges and there is no regulation that grants any power to the Securities Commission to regulate the solvency of the exchanges.

19.9 Stock Exchange Seeking to Demutualize

In February 2001, the Securities Commission released a Capital Market Masterplan (CMP), to provide the capital market with a blueprint for growth and development for the next decade. As part of the development process for exchanges, the CMP recommended that given the increased dynamism and competitive pressures of the global marketplace, a single Malaysian exchange be established through consolidation of all existing exchanges, and that the single Malaysian exchange should demutualize and list on the stock market by 2003.

As such, KLSE has embarked upon a concerted implementation programme for the consolidation, demutualization and listing of KLSE to be effected within the timeframe stipulated in the CMP, details of which are still being discussed and considered by the relevant parties.
20.1 Overview

The two stock exchanges in the People’s Republic of China are located in Shanghai and Shenzhen. The Shanghai Securities Exchange was established on 10 December 1990. The Shenzhen Stock Exchange was officially established in 1991, after a half year pilot period and has been in operation since 1 December 1990. As of 2000, 596 securities traded on the Shenzhen Stock Exchange, 557 of which were stocks. Market capitalization of these stocks was around CHY2,116 billion. Meanwhile, 707 securities traded on the Shanghai Securities Exchange, 665 of which were stocks. Market capitalization of these stocks was approximately CHY2,693 billion. At present, no foreign company can be listed on the stock exchange market in the People’s Republic of China. In addition, foreign investors were prohibited from trading A Shares, which were only open to resident investors. However, foreign investors can trade B Shares, which were initially designed to meet foreign investment demands in 1991 and trading was opened up to resident investors in the beginning of 2001.

Over the past ten years, the securities market has developed rapidly in the People’s Republic of China. The table below provides a statistical overview over the past 10 years, and clearly reflects the steady expansion. So far, stock trades are not permitted to be executed off board in the People's Republic of China under the Securities Act. Trades executed in the OTC market represent a very small amount (Table 20.1). Therefore,

---

1 Postdoctoral Researcher, Shenzen Stock Exchange.
stock exchanges will play a key role in the securities market in the predictable future.

20.2 Business Operation

The business operations of stock exchanges are made up of all the aspects of the capital market infrastructure and can be divided into four categories:

In the trading area, two exchanges operate electronic cash markets based on centralized order matching systems. Through the powerful central match computer systems, two exchanges can process the average two million daily transactions. In 2000, total turnover in Shanghai reached CHY3,157 billion while Shenzhen surged to CHY2,945 billion. Currently, there are no derivatives traded on these two stock exchanges, after an unsuccessful trial period during 1993-1995 conducted by the Shanghai Securities Exchange. However, the China Securities Regulatory Commission (CSRC), the regulatory body in the People's Republic of China, is evaluating the possibilities of setting up index futures for the stock exchanges. Since 2000, the CSRC has worked on a plan to launch a
new market, the second board market designed for high-tech firms, on the Shenzhen Stock Exchange.

All trades of listed securities executed in the stock exchanges are cleared and settled through relevant clearance and settlement systems. Settlement is implemented by computerized book-entry to the participants’ stock accounts, without any physical movement of share certificates. Money settlement is carried by electronic payment instruction for broker-custodian accounts. The settlement time period for all trades is only T+1.

The information processing divisions in stock exchanges provide services for the processing and marketing of market information. In 2000, the Shenzhen Stock Exchange set up an independent subsidiary company, which acted as a market information provider, to explore and develop information-based products and to increase revenue generated from selling market information. However, revenue generated by the company was not as good as expected until now.

The information technology division maintains and updates the market system and the telecommunications technology.

### 20.3 Governance Structure

The exchanges’ governance structure has gone through several stages over the past 10 years. At the beginning stage, before 1992, the local municipal government controlled the power and authority of the exchanges since most market participants were from the local area and nationwide regulations had not been built up. During the period from 1992 to 1997, the local government and the CSRC jointly administered the exchanges. At the end of 1997, the exchanges’ administration was finally transferred to the CSRC while the two exchanges’ markets evolved into national markets.

In accordance with the Securities Act enacted in 1999, the two stock exchanges are non-profit, member-owned and self-regulatory organizations with independent legal status to provide facilities for centralized auction trading. Members own the property rights, but distribution of any profits or surplus during the operation period is highly restricted. Stock exchanges are required to stipulate in their constitution rules to guide and supervise regular operations. The constitution and any amendments should be approved by the CSRC before they are put into effect.
20.3.1 Membership and General Member Meeting

Any securities firm with independent legal status and with the approval of concerned authorities can apply for membership qualification in the exchanges. Therefore, there are no individual members in stock exchanges in the People's Republic of China; all members must be corporate members. During the beginning stage in 1991, there were only local members in the two exchanges due to the weakness of communication system. With the establishment and development of the exchanges’ telecommunications system in 1992, more non-local members joined. At the peak of 1995, there were 553 members in Shanghai and 532 in Shenzhen. In the same year, the Banking Act was enacted, which restricted banks from engaging in the securities business. Most members affiliated with banks had to withdraw, thus, the number of stock exchange members declined. In 2000, there were 310 members in Shanghai and 326 in Shenzhen. Since China entered WTO in 2001, CSRC recently amended the Securities Exchanges Rule to align with specific commitments as a member of WTO. Pursuant to amended Securities Exchanges Rule, foreign securities institutions may apply to be special members of two exchanges and engage directly in B-share business.

Membership is a prerequisite to exchange market access. Only members have permission to purchase trade seats in stock exchanges and access to the central match computer system. Every member should purchase at least one trading seat. Currently, there are 5,391 seats in Shanghai\(^2\) and 1,545 in Shenzhen. Trading seats can be transferred among members.

The general member meeting is a supremely powerful body of stock exchanges. The general member meeting has authority to draw or amend the constitution and to elect or dismiss member directors of the board. At least two-thirds of the members should participate in the meeting, and at least half of the participants must agree on a draft, for validation. Each member has exactly one vote regardless of its position in the market.

---

2 The Shanghai Stock Exchange still has a reserved trading floor, so it has 3,001 physical seats on the trading floor. However, the Shenzhen Stock Exchange has ceased with a trading floor in 1997, so there are no physical seats. All seats in Shenzhen are invisible seats.
20.3.2 Board and Board of Directors

The exchange board is a decision-making body. The tenure is three years. The board is composed of 7-13 directors, including the chairman, president, and 1-2 deputy chairmen. The fraction of non-member directors on the board is at least one-third, and at most half. Member directors are elected by general membership meetings. Non-member directors are appointed by the CSRC. The chairman and deputy chairman are elected by the board, but nominated by the CSRC. The chairman of the board cannot simultaneously act as the president. Obviously, the CSRC has tremendous influence on the exchanges’ boards of directors.

The main responsibilities of the board are to set or amend an exchange’s operation rules, and to sanction or deny business plans and budgets submitted by the president of the exchange. The board holds at least one meeting each quarter.

20.3.3 President and Management Team

According to relative laws and the exchanges’ constitutions, the president is empowered to manage regular operation of the exchange under the direction of the board. In reality, the president, vice presidents and assistant presidents constitute the official panel in charge of daily business. The president and vice presidents are directly appointed by the CSRC. Their tenures are three years. The appointment and dismissal of senior staff at the exchanges should be filed with the CSRC. The appointment and dismissal of the heads of the accounting and human resources departments should be approved by the CSRC. Although the CSRC has the same authority in the exchanges’ management teams as does the board, it is the president and the official panel under his/her leadership that decide a wide range of issues. This fact is often taken as evidence to confirm that the president and management team play more critical roles in the exchange’s governance than the board does.

20.4 Regulatory Function

The stock exchange in the People’s Republic of China is a self-regulatory organization. Its self-regulatory function is complementary to government regulation by the CSRC and is a very important part of the regulatory framework in China. Before 1997, while the securities market
in China was still in the early stage of market formulation, the exchanges were confronted with how to develop the market. Their efforts were focused on technology innovation, investor service and market exploration. Since the securities market in the People's Republic of China was in a stage of steady development in 1997, the power of the exchanges was transferred to the CSRC. The exchanges’ self-regulatory function was then addressed. This was reflected in *Stock Exchange Rules of 1997* and the *Securities Act* of 1999. The exchanges’ self-regulatory functions include regulations on trading, the members of the exchanges and listed companies.

### 20.4.1 Listing Qualification Authority

If a company applies for listing on the stock exchange, this application should be approved by the CSRC in accordance with the *Securities Act*. Although strictly speaking, the CSRC should pass the authority to the exchanges to deal with listing applications since ability to list is dependent on ability to make a public offering and the CSRC approves public offerings, listing qualification authority is in fact vested in the CSRC rather than the stock exchange in which the stock company applies for listing. If a company is approved to publicly offer new shares, its shares are also approved to be listed on a specific stock exchange.

### 20.4.2 Trade Surveillance

Pursuant to the *Securities Act*, the stock exchanges should keep real-time surveillance on routine transactions. If any abnormal trading activity is detected, the exchange should promptly report it to the CSRC and assist in any further CSRC investigation. Because all transactions on the exchange are executed electronically through a computer system, real-time surveillance systems in the exchanges are also based on this system. For example, the on-time surveillance system in Shenzhen Stock Exchange automatically picks up data from the match system and the settlement system, allowing it to process 4-6 million transactions per day. Last year, the on-time surveillance system in Shenzhen detected 476 abnormal transactions, 19 of which were seriously detrimental and reported to the CSRC.
20.4.3 Self-Regulation on Members

The exchange is a self-regulatory organization and thus all members should accept self-regulation by the exchanges. Self-regulation of members focuses on their trading activities. Because almost all securities firms in the People’s Republic of China are members of two exchanges, the exchanges’ influence is industry-wide. The two exchanges have stipulated a series of rules and guidelines to guide members’ trading and brokerage businesses. The exchanges’ member departments periodically review members’ trading activities.

20.4.4 Regulation of Listed Companies

Pursuant to the exchanges’ listing rules, the exchanges are empowered to regulate their listed companies’ routine operations, especially pertaining to information disclosure. The exchanges should supervise listed companies’ relative information disclosure properly, accurately and completely. Information disclosure is a legal basis for protecting investors’ interests and is also indispensable for a trustworthy exchange market.

While the self-regulatory function of the exchanges is emphasized in the Securities Act, the solvency of the exchanges is also emphasized. To cushion impacts of the exchanges’ operational risks, the two exchanges are requested to set up operational risk funds in accordance with the Securities Act of 2000. The operational risk funds are extracted from the exchanges’ revenues until CHY800 million are reserved.

20.5 Outlook on Demutualization

Over the past ten years, there has been a trend among exchanges to consider alternative governance structures from the traditional non-profit or cooperative models. In addition to the growing number of new for profit trading systems being developed in the securities markets, like Tradepoint in the United Kingdom and Island in the United States, many stock exchanges that have historically operated on a non-profit or cooperative basis are either contemplating transforming themselves into for profit companies, or have already done so. This is occurring in Stockholm, Denmark, Italy and the UK. Some exchanges even have listed
themselves on their own markets, such as the Australia, Hong Kong, and Singapore exchanges.

Moreover, we found that the current demutualization trend should be interpreted as a natural response to a fiercer competitive environment faced by stock exchanges. Because the interests of stock exchange members are diversifying in the changing environment, the costs of collective decision-making in a non-profit or cooperative stock exchange are likely to be burdensome relative to what would be incurred by a for-profit stock exchange.

Secondly, the competition among stock exchanges has forced non-profit or cooperative stock exchanges to increase information technology investment, seriously burdening these exchanges’ cash flow. The for-profit exchange may be able to raise money more efficiently than the non-profit or cooperative exchange.

Thirdly, an efficient management team is now more and more important to a stock exchange in a competitive environment. A non-profit or cooperative exchange is typically allowed to pay a reasonable compensation to its management. Nevertheless, a for-profit company exchange, especially a public company exchange, can establish an incentive scheme for management thereby aligning their interests as much as possible with those of the owners.

Lastly, the traditional governance structure of member-owned stock exchange only reflects interests of the members (usually financial intermediaries). However, a stock exchange that finally wins out in a competitive environment, should fully reflect the interests of brokers, dealers, investors, listed companies, regulators and other market participants. A company exchange is adaptable to negotiate such conflicts of interests. Furthermore, we believe there were also specific reasons for demutualization of different stock exchanges.

Despite the worldwide demutualization trend of stock exchanges, the two stock exchanges in the People’s Republic of China are not seeking to demutualize or transform ownership structure as of yet. As mentioned above, the self-regulatory function of the two exchanges is currently being emphasized, so the concern is that demutualization or for-profit transformation may weaken the self-regulatory function. The current administrative structure of the two exchanges, the CSRC and the management team appointed by the CSRC have the capability to control the exchanges’ decision-making process although the two exchanges are member-owned. The costs of decision-making are negligible. Cash flows generated by the two exchanges are strong enough to allow for investment in information technology and technology innovation. Therefore,
financial pressure has not been so urgent up to now. Also, stock trades are not allowed to be executed off board in the People's Republic of China. Moreover, the securities market is isolated from the overseas’ market. Actually, the two exchanges are in relative monopoly positions. Therefore, demutualization in mainland People's Republic of China is not so urgent.

The People's Republic of China is joining the WTO and the Chinese securities market will eventually join the world market sooner or later. A solid competitive environment is inevitable and the stock exchanges in the People's Republic of China will have to compete globally for a prosperous future. Therefore, we will keep a close watch on the demutualization trend worldwide.
21.1 Ownership Structure of Taiwan Stock Exchange Corporation

Pursuant to Taiwanese Securities and Exchange Law (SEL), a stock exchange may be organized in either membership or company form. A membership stock exchange is a non-profit juridical person, while a company type stock exchange is a company limited by shares.

For the establishment of a stock exchange, a permit or approval must be obtained from the Securities and Futures Commission (SFC) before the registration.

The Taiwan Stock Exchange Corporation (TSEC) was set up in 1961 in the form of private company limited by shares with the restriction on the duration of a operation and funded by various private and state-owned enterprises.

Article 124 of the SEL: A company-type stock exchange shall be a company limited by shares.

Article 125 of the SEL: The article of incorporation of a company-type stock exchange shall contain, in addition to those requirements of the Company Law, the following particulars:

- the seats in the centralized securities exchange market of brokers and dealers and their qualification; and
- duration of existence.

The duration of existence referred to in the second bullet of the preceding paragraph shall not exceed a period of ten years; should the

---

1 Vice-President, Research and Planning, Taiwan Stock Exchange.
development of local securities transactions warrant, an application for extension may be filed with the competent authority within three months prior to expiration of the duration.

21.2 Listing Data

Public-issued companies that want to be listed on the exchange and raise capital from the public through TSEC must meet certain criteria with respect to their financial and operational conditions to qualify as listed companies. The applicant companies are screened by TSEC staff and listing screening committees according to the relevant listing criteria based on the SEL.

At present, common stocks, preferred stocks, government bonds, corporate bonds, foreign bonds, beneficial certificates, covered warrants and Taiwan Depository Receipts are available to trade on the TSEC. Related regulations governing the listing of warrant bonds and preferred stocks with warrants have been established. The exchange traded fund (ETF) is under a feasibility study and will soon be submitted to SFC.

As of the end of July 2001, there are a total of 539 companies listed on TSEC with the market capitalization of NT$7,170 billion (US$204.8 billion).

21.3 Corporate Governance

TSEC is a private corporation with the shareholders meeting as its highest policy-making body, under which are three supervisors and a board of directors composed of fifteen directors, whose major responsibility is to oversee business operations. As stipulated by the SEL, at least one third of the directors are securities professionals appointed by the SFC. These directors do not have to be shareholders of TSEC as required under the Company Law. The remaining positions are elected from among the shareholders at the shareholders meeting.

The term of office for directors and supervisors is three years, and they may be re-designated or re-elected. The directors choose among themselves a chairman of the board of directors who represents TSEC. The supervisors choose among themselves one resident supervisor.
Article 126 of the SEL: Securities firms, their shareholders, and managers shall not serve concurrently as managers of a company-type stock exchange. At least one third of the directors and supervisors of a company-type stock exchange shall be non-shareholder experts appointed by the competent authority.

21.4 Business of the Exchange

In accordance to Article 98 of the SEL, the business of a stock exchange is to provide a centralized securities exchange market. A stock exchange shall not operate nor invest in any other businesses without the approval of the competent authority.

Pursuant to the Articles of Incorporation of TSEC, the operational scope includes setting up a marketplace and facilities for contracting brokers and dealers to operate the business of centralized securities trading, clearing and settlement, and any other relevant business or investment in a related institution as approved by SFC.

TSEC now has fifteen departments/offices under the supervision of three senior executive vice presidents (that is, Listing, Trading, Clearing, Market Surveillance, Audit, System Development, Computer Operation, Market Information, International Affairs, Public Relations, Research & Development, Finance, Administration, Secretariat and Internal Audit).

The following are securities related institutions, approved by the SFC, invested in by TSEC:

- Taiwan Securities Central Depository Company
- Fuh-Hwa Securities Finance Co., Ltd.
- Taiwan Futures Exchange
- Taipei International Finance Center Company
- Taiwan Ratings Corporation
- Taiwan-CA.com Inc.
- R.O.C. over-the-counter Securities Exchange
21.5 Trading Rights

According to Article 129 of the SEL, securities brokers and dealers engaged in transactions of a company-type stock exchange shall enter into a contract with the stock exchange for the usage of the centralized securities exchange market; the contract, together with other relevant materials, shall be registered with the competent authority for its records.

Article 5 of TSEC Operational Rules stipulates that participants in trading on TSEC shall be limited to securities brokers and securities dealers (collectively securities firms) that have executed a contract for the usage of the centralized securities exchange market (market usage contract). Securities firms that have the permission of the competent authority to concurrently engage in other securities businesses or related businesses, or securities underwriters that have engaged TSEC to process business matters shall execute their businesses in accordance with the relevant rules and regulations.

21.6 Risk Management

21.6.1 Common-Bond Settlement Fund

Based on Article 153 of the SEL, if any transacting party fails to fulfill its delivery obligations for securities transactions undertaken by members of a stock exchange or by securities brokers or dealers in a stock exchange, the stock exchange shall designate other members or other securities brokers or dealers to deliver the securities in substitution. The resultant price differences and the expenses incurred therefrom shall be indemnified by the settlement and clearing fund; in case the fund is insufficient, the stock exchange shall advance payment and thereafter claim such compensation from the breaching party.

According to Article 154 of the SEL, a stock exchange may set aside a default damage reserve out of the fees charged from securities transactions to cover the payments specified in the preceding article; the method of assessing the reserve, the rate of assessment, the conditions for suspension of the lodgment, and the method of custody and management of the reserve shall be prescribed by the competent authority. Claimants in cases arising from transactions on the centralized securities exchange market shall have preferential rights to the securities
clearing and settlement fund as specified in Articles 108 and 132 in the following order of priority:

(i) the stock exchange;
(ii) the principal in consigned transactions; and
(iii) securities brokers or dealers.

In the event the securities clearing and settlement fund is insufficient to meet such claims, the unsatisfied portion of the claims may be compensated for in accordance with the provisions of Paragraph 2 of Article 55 of the SEL.

**Article 55 of the SEL:** Following the incorporation and registration process, a securities firm shall, in accordance with the regulation prescribed by the competent authority, deposit an operation bond.

Creditors whose claims arise from the specially approved business of a securities firm shall have preferential right of payment from the deposited operation bond referred to in the preceding paragraph.

Therefore, as required by the SFC, TSEC makes quarterly cash contributions, equal to 20% of the amounts of handling fees, to a default damages reserve which would be used to settle shortfalls that might result from defaults by securities firms.

In May 1996, the SFC approved the mutual responsibility system for the securities settlement fund put into effect September 2, 1996. The fund is administered by a deposit in the name of TSEC Common-Bond Settlement Fund Committee with a total deposit of approximately NT$8 billion from contributions by securities firms and TSEC.

The enabling rules include Article 153 of the SEL, Article 10 of Regulations Governing Securities Firms, Article 20 of Regulations Governing Stock Exchanges, TSEC Rules governing the Administration of Common-Bond Settlement Fund and TSEC Operational Rules Governing the Increase of Deposit of Settlement Fund.

According to Article 10 of Regulations Governing Securities Firms, securities brokers are required, upon establishment, to maintain a securities settlement fund, with TSEC, in NT$15 million cash plus NT$3 million for each branch office. Within ten days after the end of each quarter, each broker is also required to deposit additional cash to the fund, equal to a certain ratio (decided by the SFC each year) of entrusted trading value of the previous year. After establishment, the prior deposit of NT$3 million for each branch office shall be lowered to NT$2 million in the
following year. For a securities dealer, NT$10 million shall be deposited with TSEC upon establishment.

Pursuant to the TSEC Rules Governing the Administration of Common-Bond Settlement Fund, TSEC shall establish a special settlement fund of NT$1 billion. When TSEC default damages reserve reaches NT$1 billion, TSEC shall cease contributions to this reserve and, instead, deposit periodically such contributions to a special settlement until these additional contributions reach NT$2 billion.

When a securities firm defaults, its obligations and related expenses shall be settled by its own contributions to the fund and income thereon. If such fund is insufficient, TSEC shall advance the settlement from the aforementioned additional contributions to the special settlement fund, and any shortfall shall be paid by TSEC and the securities firms proportionately based on the amounts of the contributions by TSEC to the special settlement fund and the contributions by the securities company to the common-bond settlement fund. After settlement, the securities firm and TSEC shall replenish their respective funds in due time.

21.6.2 Securities Investors Protection Fund (SIPF)

This fund was established in accordance with *SFC Administrative Ordinance*, to be used to compensate securities investors unpaid credits for the purpose of protecting securities investors interests and strengthening the stock market, with the fund size of NT$1.03 billion, to protect investors in case of broker default.

The SIPF was established by the main securities institutions of the market and administered by a board of appropriation. This board was organized by these institutions and the fund is financed by the contributions from each of these institutions. In case of a broker default, the board of appropriation will meet to discuss the issues of legal matters, including issues of investors claiming procedures.

Only investors who have properly completed their settlement obligations and are unable to receive their entitled rights due to broker default can file their claims with the board. The limitation on each account is NT$1 million, and NT$100 million for the accounts of each broker.
21.7 Statutory Regulatory Role

The SFC, under the Ministry of Finance, is responsible for the development, regulation, and supervision of the capital market and is also the regulator of the futures industry. The statutory mandates of the SFC are to facilitate national economic development and to protect investors’ interests. To achieve these goals, the SFC has laid out four general policy directives:

(i) to foster the sound development of the capital markets and to encourage fund raising through the offering of securities to the investing public;

(ii) to improve the operation of the securities and futures markets and to ensure a fair and efficient market environment;

(iii) to promote the development of the securities services industry and to facilitate the flow of savings into investment; and

(iv) to regulate certified public accountants and to enhance their professional standards.

The SFC exercises its authorities through the mandates of the Securities and Exchanges Law and the Futures Trading Law. According to Article 127 of the SEL, a company type stock exchange shall not issue bearer stocks. Transferees of its shares shall be limited to the securities firms incorporated under this law. The shareholding percentage of each securities firm in the stock exchange shall be prescribed by the competent authority (up limit is 5%).

The SFC stipulated rules Governing Administration of Stock Exchanges pursuant to Articles 93, 99, 102, 137 and 154 of the SEL to regulate the establishment, management, supervision, etc., of stock exchanges.

21.8 Stock Exchange Seeking to Demutualize

Since TSEC was organized in the company form in 1961, no demutualizing plan is needed. However, according to Article 127 of the SEL, the stocks of a company-type stock exchange shall not be listed on its own centralized securities exchange market or on a stock exchange owned by any other person.
22.1 Thai Capital Market Structure

22.1.1 Regulatory Framework

Thailand’s financial market is supervised by three main organizations: (1) The Ministry of Finance (MOF); (2) the Bank of Thailand (BOT); and (3) the Securities and Exchange Commission (SEC). The MOF is responsible for the country’s overall economic and fiscal policies. The Ministry is also a major shareholder of state enterprises. Therefore, it plays an important role in Thailand’s privatization policies and plans.

The BOT, like the central banks of many other countries, is in charge of monetary policy. It supervises commercial banks and finance companies, as well as oversees the capital flows and foreign exchange rate of the local currency.

The Thai SEC is more directly involved with the country’s capital market. It is a relatively new body, set up by virtue of the Securities and Exchange Act of 1992 (SEA). The Act empowered the Office of the Securities and Exchange Commission to be established as an independent state agency responsible for supervision and development of the capital market under the direction and guidance of the SEC.

---

1 Assistant Vice-President, Strategy Department, the Stock Exchange of Thailand.
22.1.2 The Securities and Exchange Commission

The SEC is comprised of:

- Minister of Finance as the ex-officio Chairman;
- Governor of the Bank of Thailand;
- Permanent-Secretary of the Ministry of Finance;
- Permanent-Secretary of the Ministry of Commerce;
- four to six well-qualified persons, appointed by the Cabinet upon the recommendation of the Minister of Finance, that must include experts from the fields of law, accounting, and finance; and
- Secretary-General of the Office of the SEC.

22.1.3 Statutory Regulatory Roles of the Securities and Exchange Commission

Public issuing and offering of securities. The SEC Act allows business sector to issue and offer for sale various kinds of securities, namely equities, debt instruments or hybrid instruments to mobilize funds from the public. Any issuer who wants to make a public offering of securities must first obtain approval from the Office of the SEC. The issuer must file the registration statement and draft prospectus that discloses accurate, reliable, and sufficient information necessary for investors to make investment decisions. Furthermore, an issuer must report updated information for public disclosure.

Securities businesses. Under the SEC Act, securities businesses mean securities brokerage; securities dealing; securities underwriting; investment advisory service; mutual fund management; and private fund management. The private sector is allowed to take part in securities businesses by applying for licenses from the Minister of Finance upon the recommendation of the SEC. Prior to the launch of each mutual fund, a mutual fund management company must obtain approval from the Office of the SEC.

The securities exchange. The SEC Act empowers the SEC to supervise securities exchanges such as the Stock Exchange of Thailand (SET) and the Thai Bond Dealing Center (TBDC). In terms of the relationship between the SEC and the SET’s Board of Governors, the SEC plays an
important role in setting out policies and approving main regulations for SET, for example, listing and delisting rules and commission fee structure. As for the day-to-day operation of the Stock Exchange of Thailand, SET is empowered by SEC to work independently in supervising the related personnel and institutions.

**Acquisition of Securities for Business Take-Over.** The SEC Act protects the interests of shareholders of listed companies on the stock exchange regarding the acquisition of securities for business take-over as follows:

(i) *Disclosure of information.* A person acquiring or disposing of such securities must file an acquisition or disposition report to the Office of the SEC within the next business day when such action causes the aggregate holding of the same type of securities to reach or pass a multiple of 5% of the total number of the securities of a business sold.

(ii) *Tender offer.* A person who acquires or holds securities of a business greater than or equal to 25%, greater than or equal to 50%, or greater than or equal to 75%, or greater than 5% while holding between 25-50% must make a tender offer to provide all securities holders with an equal opportunity to sell their securities to the offeror at the same price that must not be less than the highest price at which the acquirers had acquired such securities within 90 days prior to the tender offer.

(iii) *Unfair securities trading practices.* The SEC Act states that unfair securities trading practices include dissemination of misleading information and any false news that become rumor, insider trading, and price manipulation. Unfair securities trading practices are criminal offenses with severe penalties under the SEC Act. The securities exchange is primarily responsible to monitor securities trading prior to submitting the cases to the Office of the SEC. The Office is empowered to examine the report and gather all related evidences prior to take further legal proceeding.
22.2 The Stock Exchange of Thailand

22.2.1 Establishment of the Stock Exchange of Thailand (SET)

The SET was first established under the Securities Exchange of Thailand Act, BE 2517 (1974), or the SET Act, enacted on May 20, 1974. The exchange began its first trading day on 30 April 1975. On 1 January 1991 the Securities Exchange of Thailand officially changed its name to the Stock Exchange of Thailand (SET).

In 1992, the replacement of the SET Act, B.E. 2517 (1974), by the Securities and Exchange Act, BE 2535 (1992), or the SEA, became the next step towards the development of the modern Thai capital market, with regard to the creation of a concrete legal framework, progressive secondary markets and the improvement of securities business regulations. As defined in the SEA (1992), the SET’s primary roles are,

- to serve as a center for the trading of listed securities, and to provide the essential systems needed to facilitate securities trading;
- to undertake any business relating to the Securities Exchange, such as a clearinghouse, securities depository center, securities registrar, or similar activities; and
- to undertake any other business approved by the SEC.

22.2.2 Ownership Structure and Corporate Governance

The SET is a juristic, non-profit organization without ownership structure. The SET Board of Governors is comprised of a maximum of eleven people, five of whom are appointed by the SEC, and five who are elected by SET members (brokerage companies). The SET President, appointed by the board, is an ex-officio member of the board. The persons appointed by the SEC shall have an excellent knowledge of, and experience in, the operations of the securities exchange, securities or financial businesses and at least one person shall be a senior executive of a company whose securities are listed in the securities exchange. The board of directors of the securities exchange shall elect a director, who is not the manager of the securities exchange, to be the chairman and may also elect another director of the securities exchange to be the vice-chairman. The board is also responsible for formulating SET policies.
and supervising exchange operations; however, certain rules and regulations prescribed by the board must also be approved by the SEC.

22.2.3 Business of the Exchange

In addition to the listing of entities, the stock exchange also provides:

- listed companies trading system;
- information dissemination;
- market surveillance, listed company and member company supervision;
- back-office services for clearing and settlement, shares depository and shares registrar by SETs wholly-owned subsidiary, Thailand Securities Depository Co., Ltd. (TSD);
- management of open-ended mutual fund and non-voting depository receipt (by SET wholly-owned subsidiaries, Thai Trust Fund Management Co., Ltd. and Thai NVDR Co., Ltd, respectively) to encourage foreign investment in the stock exchange;
- services to develop and lay down computer systems, information technology, and other communication network systems which relate to or connect with trading of securities, payment and delivery of security (by SETTRADE.COM Co., Ltd., joint venture between the SET and an IT company);
- investor education; and
- education and training programs for industry practitioners by Thailand Securities Institute (TSI) established by SET.

22.2.4 Listing Data

At day end 2 August 2001, there are 379 listed companies, and the market capitalization stood at THB1,466.31 billion (approximately US$ 32.23 billion).
22.2.5 Trading Rights

Only member companies of the SET are authorized to buy or sell securities on the exchange. Firms which have obtained a securities license from the Ministry of Finance (following recommendation by the SEC) to engage in the securities business as stockbrokers may apply for membership at SET. Membership status is obtained once approval is granted by the stock exchange’s Board of Governors. At present, the stock exchange has 28 member firms. Nonmember brokerage companies have to send their trading transactions via SETs members.

The board of governors has the authority to determine the number of members in the Exchange (currently unlimited) and admission fee—with the approval from the SEC. In general, a member must have the following qualifications:

(i) being a securities company which has been licensed to undertake securities business in the category of securities brokerage;

(ii) having sound financial status and operations according to the nature of its business;

(iii) having efficiency and readiness for business operation; and

(iv) having executives who are competent and experienced in the securities business with business integrity and ethics.

Admission fees that members paid varied considerably. The fee specified for the latest lot of admission back in 1996 was THB 300 million. Members can transfer trading/membership rights to another qualified securities company. The admitted transferee shall pay to the exchange the transfer fee of 10% of the value of the rights being transferred as agreed with the transferring member. The fee however must not be less than THB 10 million.

22.2.6 Risk Management

The stock exchange employs in-house self-regulatory functions through the Regulation and Risk Management Division. The division housed the following departments: Market Surveillance; Market Regulation; Risk Management; and Enforcement.
The Clearing and Depository Department of TSD, is responsible with the establishment and running of the schemes for risk management relating to clearing and settlement.

22.2.7 Memorandum of Understanding (MOU) Between the Stock Exchange of Thailand and Securities and Exchange Commission

In August 2000, the SET and the Office of SEC entered into an MOU between the two organizations to promote clarity and enhance roles of the Office as the regulator in formulating policies and supervising capital market participants. As a result, (i) information disclosure and good corporate governance of companies offering securities for sale to the public, (ii) information disclosure of listed companies, and (iii) supervision and examination of securities companies as well as registration of their marketing staff who provide services to clients and the public, would come under direct responsibility of the Office.

The MOU has the effect of reducing the burden of capital market participants and also enhancing comprehensibility and flexibility of law enforcement which is an integral factor in establishing standard of long-term capital market development in accordance with the rapidly changing capital market environment. Moreover, this would pave the way for the smooth transition in the role of SET from being a market regulator to a business-oriented and market-driven focus company. It represents an important step in support of the corporatization of the stock exchange and its transformation into a private company.

The significant result after entering into the MOU is that procedures will be shortened and are in line with international standards. Market participants will be positively affected as follows:

- Reduced burden on listed companies in submission of information disclosure. Beginning from the fiscal year of 2001, reporting of financial statements and annual registration statements are to be submitted to the Office only.

- Reduced burden of securities holding report: Beginning from January 1, 2001, management and auditors of listed companies are to submit securities holding report to the Office only.

- Consolidated the supervision and inspection of securities companies: Beginning January 1, 2001, the Office will be the sole agency to
supervise and conduct inspection of securities companies. Registration of marketing officer will be transferred from the stock exchange to the Office.

- *Reduced time for approving public offerings and listing on the SET:* The Office and SET agree to work together to reduce a maximum time frame that new public offerings of securities and listing on the stock exchange can be made.

Finally, the Office and the SET will closely coordinate to formulate a guideline and a definite time frame for the implementation of other measures whose principles are contained in the MOU.

### 22.2.8 Corporatization of the SET

In July 2000, the SET Board of Governors approved in principle a resolution supporting the transformation of SET from its current non-profit statutory structure towards corporatization.

Under this corporatization approach, the SET Board also agreed in principle to restructure SET current operations into two separate and independent entities: OpCo and Fund Entity. OpCo will be an incorporated public company that will act as the market operator. It will provide trading, clearing and settlement services on a commercial basis, develop a wide range of instruments and promote investment opportunities, transferring all the current staff, assets and operations of the stock exchange and its subsidiaries. OpCo’s board of directors will consist of representatives of Thai capital market stakeholders. Fund Entity, on the other hand, is a statutory non-profit body, established to invest funds exclusively for the development of Thai securities industry and Thai capital market.

The stock exchange has then conducted two hearing sessions with stakeholders in September 2000 and in July 2001 about the principles of and framework for SET corporatization. The Corporatization Working Committee has not finalized its report on the latest hearing results and its recommendation to the Board of Governors.

Full implementation of the SET’s corporatization requires legislative change. No time frame has been formally announced, but should corporatization be agreed upon and approved, the process could take at least three more years to complete.