

OECD, Tokyo Round Table, 11/2003

**Consolidation and Demutualization:
What Strategies Should Exchanges Adopt
in the Future?**

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Changing Market Structures & the Future of Trading

Overview

- 1) Threatening Factors
 - 2) Self-Sufficiency
 - 3) Linkages
 - 4) Mergers and Takeovers
 - 5) Demutualization
 - 6) Conclusions
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1) Threatening Factors

Threatening Factors

Main Trends

- Small Number of Liquid Stocks
 - International Listing & Trading of Domestic Stocks
 - Internalization
 - Regulatory Liberalization
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Threatening Factors

Reasons for Small Number of Liquid Stocks

- Not Many Companies
 - Privatization Stalled
 - Concentration of Shareholdings
 - Foreign/Private Purchases of Best Companies
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2) Self-Sufficiency

Self-Sufficiency

Factors Supporting Domestic Stock Exchanges

- Positive “Network Externality” with Liquidity
 - Competition Not Always Successful
 - Foreign Listing/Trading Complements Local Trading
 - Support of Domestic SMEs
 - Adaptability to Local Conditions
 - Declining IT Costs
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Self-Sufficiency

Current Major Revenue Sources

- Membership
 - Listing
 - Trading
 - Clearing
 - Settlement
 - Provision of Company News
 - Provision of Quote and Price Data
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Self-Sufficiency

Threats to Revenue Sources

- Membership - Demutualization
 - Listing – Decline in Value + Competition
 - Trading – Marginal Cost Pricing
 - Clearing – Expensive + Antitrust Scrutiny
 - Settlement – Antitrust Scrutiny
 - Provision of Company News – Competition
 - Provision of Quote and Price Data – Antitrust Scrutiny
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3) Linkages

Linkages

Potential Cost Savings

- Economies of Scale
 - Greater Access to Markets
 - Greater Liquidity by Pooling Order Flow
 - Lowering Member/User Costs – Technology, Standards
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Linkages

Potential Functions to be Provided

- Marketing
 - Listing
 - Order Routing
 - Information Dissemination
 - Matching
 - Order Execution
 - Clearing
 - Settlement
 - Administration
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Linkages

Different Contractual Procedures Possible

- Joint Venture
 - One Exchange Purchases from Other Exchange
 - Third-Party Provision
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Linkages

Reasons Why Almost All Have Failed

- Over-Optimistic IT Assumptions – Cost & Speed
 - Exchange Governance Implications
 - Lack of Credibility of Contractual Commitments
 - Still Relatively Small
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4) Mergers and Takeovers

Mergers & Takeovers

Difficulties of Agreement & Implementation

- Technological
 - Commercial
 - Legal
 - Regulatory
 - Political
 - Cultural
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Mergers & Takeovers

Advantages over Linkages

- Distribution of Gains not likely to Lead to Conflict
 - Credibility of Implicit Contract Commitments
 - Contracts do not have to be Comprehensive
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Mergers & Takeovers

Lessons

- Retention of National Identities Possible
 - Anticipated Technological Efficiencies take Time
 - Regulatory Efficiencies Very Difficult to Achieve
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5) Demutualization

Demutualization

Potential Benefits – May Allow Exchange to:

- Modernize Technology
 - Create Currency for Alliances/Mergers
 - Escape Conflict between Members in Control
 - Unlock Members' Equity
 - Allow Big Users some Control
 - Reward Users via Dividends
 - Obtain Capital
 - Facilitate Opening Access to Market
 - Improve Financial Decision-Making
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Demutualization

Unlock Member's Equity

- Different Types of Members
 - Small Members' Votes Normally Determinative
 - Cash – Now!
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Demutualization

Improve Financial Decision-Making

- Exchanges seek to Maximize Profits
 - Essentially Monopolies
 - Benefit of Mutual Structure
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Demutualization

General Comments

- Benefits may not Materialize
 - Benefits may Conflict with Each Other
 - Costs as well as Benefits
 - Benefits may be Obtainable in Mutual Structure
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6) Conclusions

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Conclusions

- Consider your Options
- Undertake Realistic Cost-Benefit Analyses
- Revenues: Assess Competition and Regulation
- Linkages: Assess Current and Future Incentives
- Linkages: Most Fail
- Mergers: Problems of Agreement & Implementation
- Demutualization: Costs as well as Benefits