

**The 5th OECD Round Table on Capital Market Reform in Asia  
in Tokyo, Japan**

**Future Regulatory Role of Exchanges:  
Will exchanges continue to be regulators in the future?**

**Comments on Dr. Ruben Lee's Presentation**

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**Our experience in assisting developing countries in developing their capital markets is generally in line with Dr. Ruben Lee's position.** Demutualization is not necessarily a panacea for problems regarding securities exchanges in developing countries. A for-profit structure of securities exchanges may create more problems in developing country environments.

**The question of balancing the profit maximization and regulatory duties in securities exchanges is irrelevant to many developing countries.** The organizer of this conference has posed the following question for this session: "Some observers are questioning how to reconcile the role of "front-line" regulators of the market with the goal of maximising commercial returns. How should regulators respond? This question is not applicable to many developing countries, because a for-profit structure of securities exchange could be an unrealistic policy choice in their economic environments. The question is based on the assumption that a securities exchange could be profitably run as a private enterprise, setting aside an anti-competition issue. It is also assumed that a securities exchange has the capacity to regulate its market. By contrast, many exchanges in developing countries are not profitable enough for a conflict between profit maximization and regulatory duties to be an issue. Some exchanges operate trading systems well, but are not capable of adequately regulating the market activity

**Securities exchange operations in many developing countries do not appear commercially viable on a stand-alone basis.** They are likely to remain so at least for the time being, especially when regulatory costs are taken into account. They may be

profitable in some boom years, which tend to be followed by years of depressed, low-volume, and loss-making operations.

**Some securities exchanges in developing countries are statutory agencies of the government, but are not mutual organizations of intermediaries.** In extreme cases, they do not have their own regulators; they report to a minister, operate their marketplaces, and regulate intermediaries.

**Market efficiency or lower trading costs may be achieved through a transparent governance structure rather than by a for-profit structure in some developing countries.** Should a securities exchange be a mutual organization of intermediaries, which would be a major cause of high trading costs (probably due to its monopolistic status in the country), demutualization alone would hardly ensure lower trading costs to investors, let alone a combination of lower trading costs and better regulation. National markets are often too small to have competition without material market fragmentation. Market fragmentation should be avoided in such a relatively small market in the first place for the sake of liquidity. In addition, importing liquidity through foreign portfolio investment is unrealistic or unreliable at best. Trading domestic securities on a larger foreign market is also impractical as long as a “home country bias” persists.

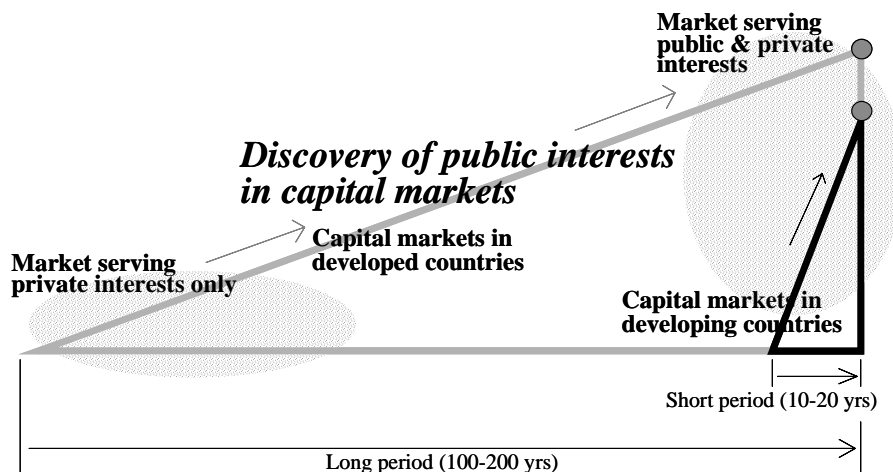
**Therefore, government intervention to support operations of the stock exchange and lower its operation costs may be inevitable in the medium term, if not in the long term, in certain developing country environments.** In such circumstances, a stock exchange makes a better sense as a public good than as a for-profit enterprise. Government support may be justified by a market failure in developing and maintaining a capital market. Regulated transparency requirements and an equitable governance structure would markedly discipline the management of a securities exchange to achieve the efficiency of operations.

**Modern securities markets may be more prone to market failures than a century ago, due to higher regulatory costs to protect public interests.** Today, it is widely recognized that the capital market serves public interests as much as it does private-interests. Capital markets in developing countries have been hastily established for public

interests. The public outside the marketplace benefits in many ways from information flows that the market constantly generates. However, the market players can hardly charge the public outside the market for most of the benefits. The public is not ready to pay the “true price”. This is a market failure. The market failure of capital market services unavoidably imposes unproportionately heavy economic burdens on the marketplace. Heavier burdens would be translated into high trading costs if the direct participants in the market alone have to bear all the costs of the market.

**A market failure is more serious in developing countries, though it is not necessarily unique to emerging markets.** The reason for a market failure in developing countries is presumably that developing countries are engaged in building up the capital market in a much smaller economy in a much shorter period under much higher and tighter specifications than many developed countries had in the past. In addition, the expectation for capital markets to serve public interests is much higher than before. The costs of capital market development per time unit (*e.g.* a year) in developing countries today must be higher than what it was in developed countries in the past as shown in the figure below, resulting in a higher cost of capital market development per trade.

**Costs per Time Unit of Market Development  
Who has financed reaching these points?**



The slopes of the two triangles diagrammatically represent the costs of market development per time unit (*e.g.* a year) in developed and developing countries. They can be translated to per trade costs of capital market development. The per unit costs must be higher in a developing country today than in a developed country in the past.

**Conversely, it is normally easier for capital markets in developed countries to make a profit than those in developing countries.** The former have a smaller cost base, thanks to a full or substantial depreciation of tangible as well as intangible assets over 100-200 years and a larger trading volume, than the latter. That is why a conflict between profit maximization and regulatory duties in their exchanges can be an issue.

**A market failure will result in high trading costs to investors if only direct participants in the trading, e.g. intermediaries and issuers, are unrealistically required to bear the most costs, if not all the costs, of the securities exchange in a developing country.** Such high trading costs, along with supply- and demand-side problems, would leave capital markets in many developing countries illiquid. The West African Regional Stock Exchange (La Bourse Régionale des Valeurs Mobilières) started as a demutualized private sector exchange, and practically failed.

**Therefore, market infrastructures in developing markets should be financed more by the government budget and/or socially broader-based resources than merely by market players.** For this, public awareness of common interests in the capital market should be promoted, and public consensus on a more aggressive budgetary support to the market infrastructure should be formed.

**The limited capacity of some securities exchanges in relatively small economies does not allow them to play a self-regulatory role in a significant way.** The reality is that some countries do not have so many competent and well-trained personnel for securities regulation in order to staff both their exchanges and regulators. In such a case, it may be more practical to have governmental regulators directly assume most regulatory responsibilities.