

Session 2 – Consolidation and Demutualisation. What Strategies should Exchanges adopt for future?

I understand that a source paper for this session will be “The Future of Securities Exchanges” by Ruben Lee.

This paper contains specific observations on predictions made in the paper, as well as some other comments about demutualisation and exchange structure.

The Future of Securities Exchanges

Prediction 1 does not hold to the extent that, as noted at pages 4 and 7 to 10, exchanges are able to hold on to their own liquidity.

In Asia, the experience is that the market for equities is highly dependent on local retail liquidity and this gives each exchange a natural monopoly in trading its own national stocks. HK, for example, retains the major share of trading of H-shares listed both in HK and NY, despite the fact that over 80% of the IPO goes to overseas investors.

Hong Kong has been unable to attract trading in other regional or international stocks (e.g. NASDAQ 7) or, despite being the most active trading centre for derivative warrants, much interest in warrants over foreign underlyings.

So long as an exchange is the dominant liquidity centre, it can charge a premium for being allowed to be “listed”, for being allowed to trade etc.

Predictions 2 - 4 inclusive. Agree. HK has not attempted to approach information ownership issues conceptually, due to overseas failures. Regulatory emphasis is on a reasonable balance between interests of Exchange and of information-users.

Prediction 5. Dominance by the few is probably true for integrated markets such as US and Europe but only for stocks with cross-border recognition with retail investors.

No MONSTER has made any impact in order-driven Asian-Pacific markets. MONSTERS need inefficiencies in existing exchanges as a precondition for success.

Prediction 7. Agree. The problem not so much anti-competitive behaviour but ability to extract monopoly rents, cross-subsidization and resistance to change due to vested interests in the continuation of rents from the existing system.

Predictions 8, 9 10. Agree. Demutualised listed companies have clear incentives to exploit their position to maximise shareholder value. Demutualization increases difficulties for regulators because it creates an interest group (shareholders of exchange) that may well have interests antithetical to objectives of regulator. Also, inhibits governments.

Other issues arising from demutualisation

- New conflicts replacing old conflicts. On the “business” side, the conflict between overriding public interest duties and profit. On the regulatory side, the conflict between profit and regulation.
 - (a) Is it valid to claim that neutral regulation and shareholder value coincide? If not, what mechanisms are appropriate to address perceived conflicts?
 - (b) What tangible problems do conflicts give rise to ?
 - maximisation of new listings/decline in quality
 - compromised gatekeeping/re reluctance to pursue expensive enforcement cases
 - compensation of a regulatory staff linked to Exchange financial performance
 - perception of conflict impacting on investor confidence?
- Reasons for demutualisation.

- (a) In HK - a listed entity with transparency and shareholder accountability to incentivise management to develop the exchange as a leading trading business.
 - (b) In New York – conflicts within a mutual organisation – whether an exchange controlled by intermediaries compromises governance.
- Side-effects of demutualisation.
- (a) The ability of former management of a mutual exchange to respond to governmental and market expectations following conversion into a public listed company.
 - (b) Distribution of regulatory functions between a statutory regulator and the exchange post-demutualisation/listing. Examples:
 - Broker supervision
 - Listing Rules:
 - regulations that concern exchange “branding” should remain with the exchange
 - regulations based on the market-wide public interest require statutory sanctions for breach and administration by a statutory regulator
 - (c) Exchanges should concentrate on regulatory roles tied to business operations which add value and impact on:
 - reputation and brand name
 - market integrity/quality essential to the Exchange product.

Intermediary regulation and listing rules governing corporate conduct/disclosure not strongly related to products/service standards.

Standards for admission to trading (track records etc) and trading supervision are more closely tied to business operations.

Management of Conflicts

- The more regulation that is left with a demutualised exchange the more regulatory oversight is required.
- Problems with oversight. Statutory “nuclear” options of limited value in practice. Limited ability to identify case specific conflicts.
- Overlapping regulatory roles/problems of accountability.
- Examples of controls:
 - Separate financial accounting for regulation to ensure regulatory costs are transparent/cost allocation is appropriate/cross subsidisation of business does not occur
 - Public interest directors
 - Shareholder representatives at board level
 - Public interest override.

Main Regulatory Challenge. Assuring that public interest obligations following demutualisation are defined in a manner consistent with business strategy.