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Capital Market Reform in Asia**

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**SESSION 5: GOVERNANCE ISSUES RELATED TO
SECURITIES MARKETS**

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Governance of Market Infrastructure Institutions

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Governance of Market Infrastructure Institutions

Overview

- 1) Introduction
 - 2) Conceptual Models
 - 3) Demutualization
 - 4) Industry Structure
 - 5) Complexities
 - 6) Allocation of Regulatory Responsibilities
 - 7) Conclusions
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Governance of Market Infrastructure Institutions

1) Introduction

Introduction

Governance is about Power

- Who Has It?
 - How and Why do they Obtain It?
 - **How and Why do they Use It?**
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Introduction

Reasons for Controversy

- Debate about Effectiveness of Different Structures
 - Confusion about Governance in Practice
 - Conflicts of Interest
 - Legislative and Regulatory Developments
 - Difficulties at Various Institutions
 - Focus on Corporate Governance
 - **Concern about Consolidation and Market Power**
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Introduction

Objectives for a Market Infrastructure Institution

- Investor Protection
 - Fair, Efficient & Transparent
 - Financial Stability
 - Privatisation Vehicle
 - Central Element of a Financial Centre
 - Economic Development
 - **National Development**
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Governance of Market Infrastructure Institutions

2) Conceptual Models

Conceptual Models

Non-Profit

- No Distribution of Profits
 - Reasonable Compensation to Management
 - Only Shareholders can Vote
 - “Commercial” “Mutual”
 - **Maximisation of Consumer Surplus**
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Conceptual Models

Co-operative

- Services for Members Only
 - Only Consumers can be Members
 - Only Members can Vote
 - **Maximisation of Consumer plus Producer Surplus**
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Conceptual Models

For-Profit

- Profits can be Distributed
 - Non-Members can have Voting Rights
 - Non-Members can Consume Goods
 - **Maximisation of Producer Surplus**
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3) Demutualization

Demutualization

Merits I

- More Responsive to Customers
 - Modernize Technology
 - More Flexible Governance Structure
 - Currency for Mergers and Acquisitions
 - **Unlock Members' Equity, and Buy them Out**
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Demutualization

Merits II

- Avoid Concentration of Ownership
 - Reward Market Participants with Equity
 - Catalyst for New Business Opportunities
 - Access to Capital
 - **Improve Financial Decision-Making**
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Demutualization

One Potential Cost of Demutualization - Monopoly

- Owners want Profits
 - Exploitation of Monopoly where Possible
 - Standard Corporate Governance will not Stop this
 - **Merits of the Mutual Structure**
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4) Industry Structure

Industry Structure

Sources of Market Power at Exchanges, CCPs and CSDs

- Liquidity Externality: Order flow attracts Order flow
 - Switching Costs
 - Netting Benefits
 - Collateral Management
 - **Economies of Scale**
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Industry Structure

Changing Structures: A Short European History

- Single Municipal Exchange
 - Multiple Competing Municipal Exchanges
 - Single National Exchange
 - Multiple Competing National Exchanges
 - Multiple Competing MONSTERS
 - **Single Pan-European Exchange**
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Industry Structure

Vertical Integration: Benefits

- Straight Through Processing
 - Non-Correlated Sources of Revenue
 - Economies of Scope
 - **Competition between Full Service Exchanges**
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Industry Structure

Potentially Anti-Competitive Behaviour

- Restrictions on Access
 - Price Discrimination
 - Predatory Pricing
 - Monopolistic Pricing
 - **Bundling**
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5) Complexities

Complexities

Business in the Real World

- Buy Me Out, Please
 - Effects on Linkages
 - Simultaneous Utility and Commercial Activity
 - "Successes"
 - **The Rise of Shareholder Power**
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Complexities

Politics

- Concentration of Power
 - Business is Borderless, Regulation is Not
 - **Of Flags, Airlines & Stock Exchanges**
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6) Allocation of Regulatory Responsibilities

Allocation of Regulatory Responsibilities

Self Regulation: Benefits

- Good Monitoring beyond Reach of Law
 - Practitioners' Knowledge and Experience
 - Self-regulation brings Legitimacy
 - Policies less Susceptible to Political Whim
 - Alternatives Not Cost Effective
 - **More Flexible and Informal**
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Allocation of Regulatory Responsibilities

Self Regulation: Issues

- SRO may further Members', and not Public, Interest
 - Fraud
 - Monopoly
 - SRO may supervise Competitors
 - Unfairness
 - **Multiple SROs brings Gaps/Antagonism**
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Allocation of Regulatory Responsibilities

Self Regulation: Governance Mitigating Policies

- Transparency
 - Due Process
 - Diversity of Representation
 - Regulatory Oversight
 - **Conflict of Interest Management**
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Allocation of Regulatory Responsibilities

Reasons why Demutualisation is Consistent with Self-Regulation

- Coincidence of Market Integrity & Commercial Goals
 - Reality of Alternative Governance Models
 - **Incentive Structures of Institutional Alternatives**
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7) Conclusions

Governance of Market Infrastructure Institutions

Conclusions

- Large Diversity in Governance Structures
- Demutualization brings its Own Problems
- Commercial and Regulatory are Tightly Linked
- Elimination of Conflicts of Interest has Problems
- **Ignorance and Uncertainty about Optimal Solutions**