Listing of Stock Exchanges – Challenges and Prospects

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The stock exchange provides price discovery and liquidity to the securities listed on it. Historically the stock exchanges almost all over the world evolved were mutually governed and self regulated structure. However in the past few years there has been a fundamental change in the functioning of most of the stock exchanges and their governance structure.

Firstly there has been a transition in the trading mechanism. Electronic screen based trading has replaced the traditional floor based trading. Electronic trading has not only broken the spatial constraints of floor based trading thereby extending the reach of the stock exchanges, but also made trading a more systematic process through a predefined order matching logic.

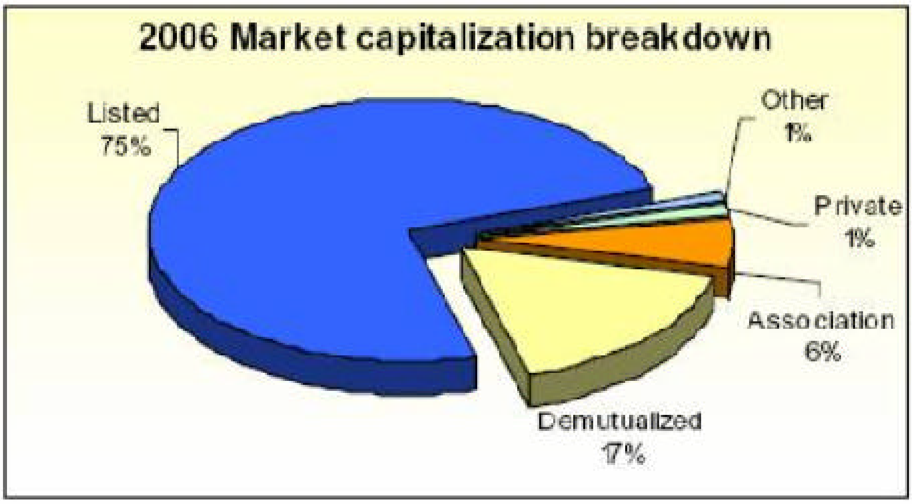
Secondly, there has been a transition in the governance structure of stock exchanges. Changing to a demutualized structure would mean a radical shift in the objective of the stock exchanges.

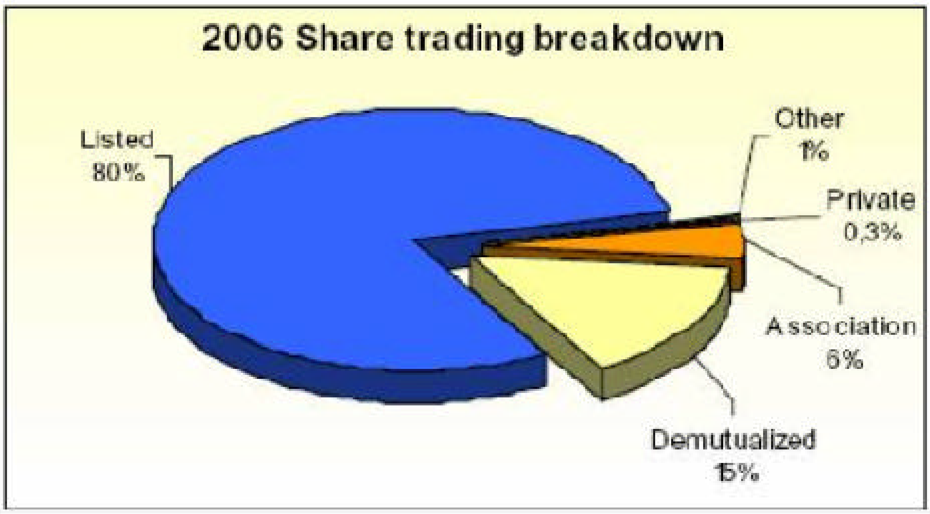
Earlier the exchanges functioned as mutual cooperative organization and profit was not at least the foremost objective of the exchange but in a demutualized corporate governance structure profit is one of the basic objective as in case of any corporate entity.

According to WFE cost and Revenue survey 2006, although listing confirms the trend observed in the industry for several years, the increase in listed members is spectacular. As most newly listed members used to be demutualized (except for NYSE, which belonged to the private category), this legal structure now only represent 23% of members, compared to almost 30% in 2005. Altogether, the 30 listed and demutualized exchanges represent more than 60% of total membership. The other categories are stable.

Given the magnitude of change in 2006, the comparisons based on legal structure between 2006 and 2005 are done on the same sample for the two years; it is the 2006 legal structure which constitutes the reference sample for comparing the two years.

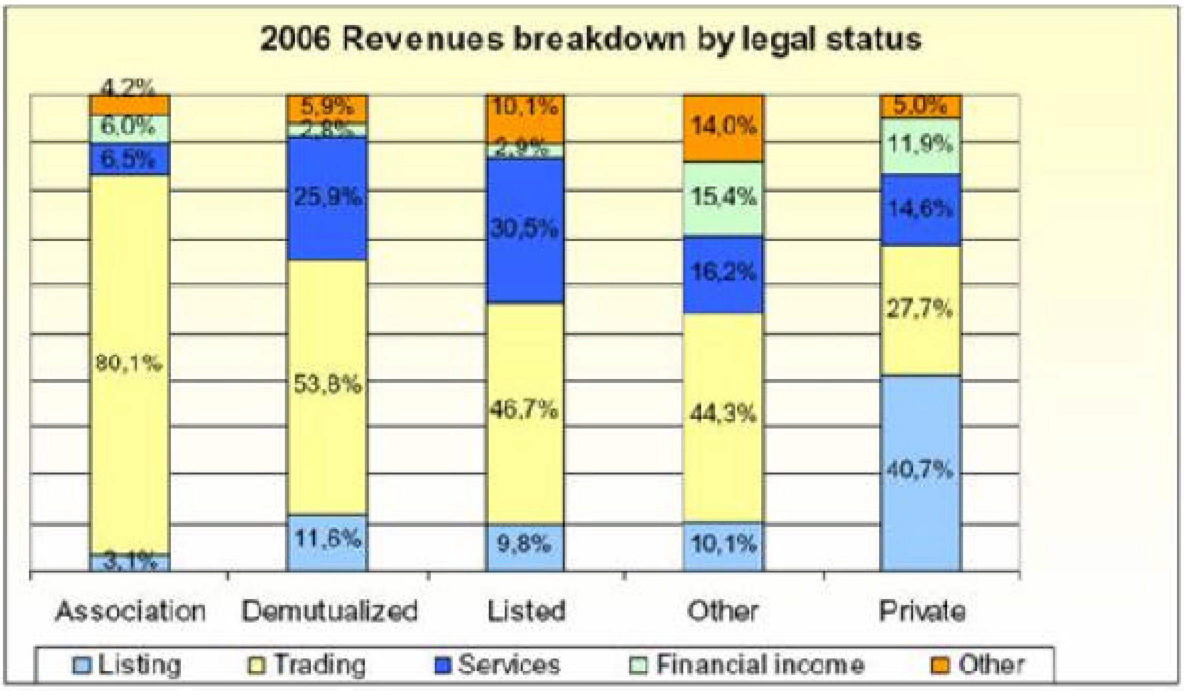
The weight of listed exchanges when looking at market capitalization and share trading value is now very dominant. The fact that NYSE, and to a lesser extent BME Spanish Exchanges, got listed, had a significant impact, as they both were in the top 10 in terms of market capitalization and share trading revenue.





Source – World Federation of Exchanges

'The stock exchange industry has experienced strong competition in recent years. The practicable veracity of the day have compelled some exchanges to change their ownership and governance structure from mutual to public ownership and have listed their shares on their own exchanges. A comparison of the operating performance of the listed exchanges to that of a control group of non-listed exchanges shows that the self-listed exchanges have performed better than their non-listed counterparts. The self-listed exchanges also outperformed the stock market indexes and a control group of non-exchange firms that went public in the same year as the listed exchanges.



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Trading revenues contribute an overwhelming 80% of the total revenues of association or mutual exchanges. This striking figure is due to the fact that these exchanges have a similar revenues breakdown where trading revenues are very dominant.

The demutualized and listed exchanges, which are the two main contributors to total revenues, logically have a breakdown in line with the industry average.

The "other" exchanges category has important relative revenues from financial income, mainly because of the weight of this line of revenues for the Stock Exchange of Thailand.

The surprising relative importance of listing revenues among private exchanges can be explained by the relative important weight of these revenues for the Irish and Luxembourg exchanges with their product range for bonds, public funds and certain other financial products.

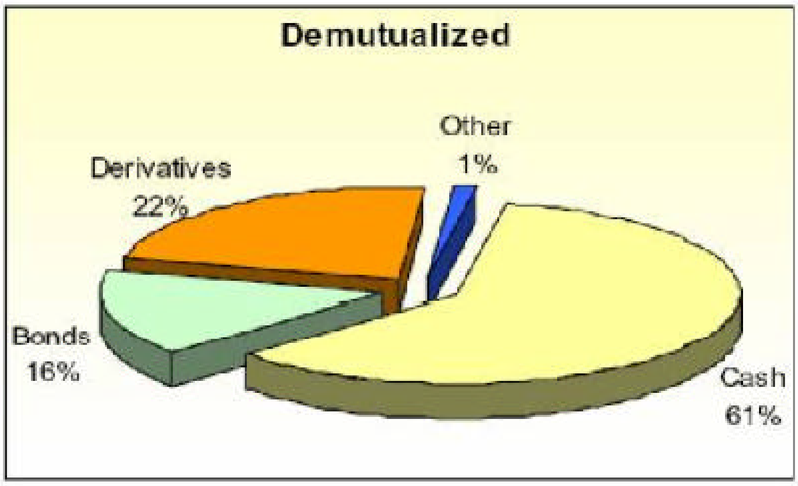
Having been through the process of change within the organisation, it is important to understand if the result of this complex multi-dimensional process, which involves huge costs in terms of both management resources and financial costs, was as expected. We asked participants in the survey to list some of the key benefits they expected to achieve by demutualising. The table below lists the main ones:

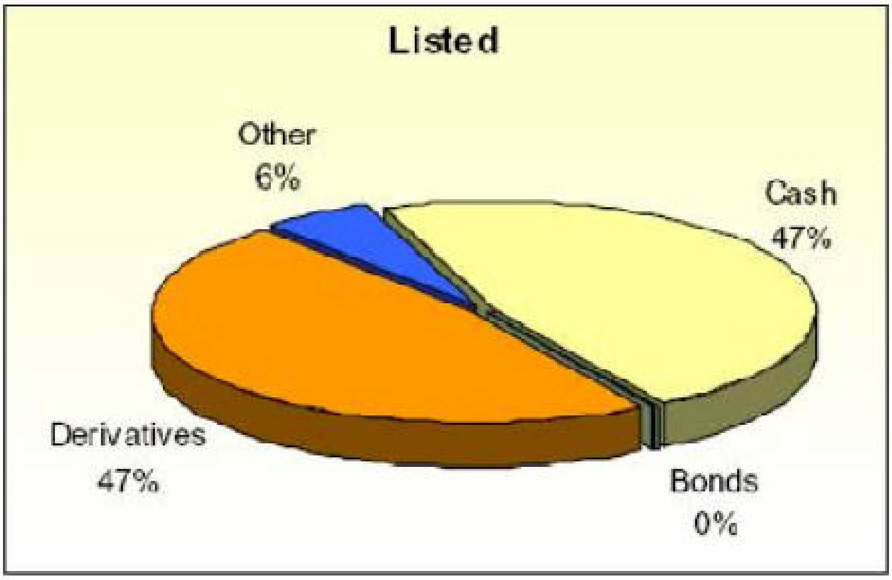
Key financial and non-financial benefits of self listing:

Expected financial benefits
Access to greater variety of capital sources
Wider customer base
Improve shareholder value - payment of dividends, better relationships
More profits driven
Better cost control
Share price improvement
Increased market capitalisation
Expected non-financial benefits
More focused management
Quicker decision making
Freedom to pursue business opportunities unconstrained by vested interest issues
Flexibility, efficiency and competitiveness
Ensuring own destiny and not reliant on members
Accurate means of measuring value creation by management
Greater respect for company
Better public relations - positive press coverage

The Australian stock exchange significantly outperformed the stock index and the control group on a market-adjusted return basis. The stock market performance is driven by strong operating performance. The profitability ratios of the ASX have significantly improved in the last five years following the demutualization and self-listing. The performance improvements remain significant even after controlling for growth in the Australian economy. The results show that stock exchange conversion from mutual to publicly traded exchange is not only value enhancing for the exchange and its shareholders, but it is also beneficial for the stock market as a whole.

<u>Trading revenues by legal status</u>





Listed exchanges showed more balance between cash and derivatives revenues, but the limitations explained above apply here as well, as within the demutualized sample one major cash exchange and one major derivatives exchange did not provide detailed figures. The cash revenues are most likely quite undervalued, as two major exchanges active in cash markets did not provide details on their trading revenues.

What Does the Future Hold?

All major exchanges are facing increasing global competition from other exchanges or alternative trading systems. The mutual organization structure is too restrictive and frequently leads to decision "gridlock" as competing interests attempt to influence the strategic direction of an exchange. Most exchanges have recognized this and have already transformed themselves into traditional joint-stock corporations. Nevertheless, a privately owned exchange poses its own set of problems. It may be hard to reconcile the interests of traders with the interests of an exchange that is trying to maximize profits for its owners. It is commonly argued that exchanges are "natural monopolies" in the sense that traders prefer to trade in the most liquid markets. To the extent there is a natural monopoly structure for exchanges, we might be concerned about their use of market power to increase prices and profits at the expense of customers. Our feeling, however, is that the market power of such super-exchanges will be kept in check by global competition, "internalizing" of trades by large institutions, and the threat of lower trading costs offered by Electronic Communication Network (ECNs) and crossing networks.

In May 2006, both Borsa Italiana and Bolsas y Mercardo Espanoles (BME) announced possible self-listings. SWX, the Swiss Exchange, has also not ruled out a possible reorganization. In the next five to ten years, we foresee a major consolidation of the financial exchanges industry. Already a number of small regional exchanges have merged into larger groups (e.g. Euronext). The next wave should see both geographical consolidation as well as mergers/ acquisitions across product lines (e.g. merger of leading equities and derivatives exchanges). After the initial phase of consolidation between exchanges in North America and Europe, we expect the focus to shift to other regions and smaller exchanges. Mergers among stock and derivatives exchanges are also quite likely. The consolidation process will be greatly facilitated by the new organizational form of joint-stock companies. As shareholder owned firms, exchanges face more pressing demands to deliver performance, which provides the spur to seek revenue and cost synergies through mergers. The publicly listed status makes the execution of such M&A strategies much easier. It is also worth noting the challenges that will mark this consolidation phase. Cross-border acquisitions are extremely difficult in any industry and are likely to create several obstacles for exchanges.

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. 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.

A demutualized, unlisted exchange may more closely resemble a mutual exchange because the brokers simply own shares rather than having a membership interest. Listing creates a conflict of interest because the exchange is, usually, the listing authority. However, it should not admit and supervise itself. 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 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.

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. 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.

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, 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.

Conflict of interest in Listing activity

Traditionally listing has been viewed as a "signaling" function, endorsing the quality of the security, indicating that the security is above a certain benchmark set by the exchange. Steil (2002), drawing analogy from bond rating agencies argues that just like bond rating agencies have a strong incentive to rate the bond correctly, the exchange too will have a strong incentive to set optimum listing criterion for trading on its platform. He argued that if the exchanges set the listing criterion too high then many firms who cannot meet the listing criterion would not be able to list their securities on the exchange platform and the exchange will loose its revenue from listing fees while on the other hand if the listing criterion is set too low then poor quality securities will be eligible to be traded on the exchange platform which will lead to a deterioration of investors profitability resulting in an adverse effect on the reputation as a fair and efficient exchange and finally the order flows. Thus equilibrium is struck where both the interests of the exchange are balanced. This equilibrium is very critical for entrusting the responsibility of listing on the exchange. This equilibrium was intact as long as listing and trading was limited to a single exchange. Macey and O' Hara(1999) has shown that it is not necessary that the security is traded on the same venue where it is listed as a particular security may be listed on one exchange and permitted to be traded on the other exchange. In such a situation it is not necessary that the listing exchange will face the brunt of the investors in the form of reduced order flows. Thus the detachment of listing and trading activity disturbs the equilibrium discussed above. Since listing fees forms a major source of revenue it makes sense to list as many firms as possible. It can be argued that the motivation to earn listing fees by setting aside the regulatory responsibility is higher in case of demutualized exchange with outside ownership than that member owned mutuals. This is because the cost of listing a substandard security is paid by the members through loss of order flow and not by the outside owners. Such concerns were raised in case of Hong Kong Stock Exchange (HKEx) where a government appointed commission found that HKEx had clear interest in listing as many firms as possible as the listing fees constituted 18% of its sources of revenue. It would be unnatural to expect the exchange to shun away companies for listing purposes especially when it is functioning in a competitive environment. The Cost and Revenue survey 2003 reported that there has been a 12% increase in the revenue from listing fee in case of listed demutualized exchanges while there has been a 10% increase in the revenue from listing fee in case of member owned exchanges.