

**CONFLICTS OF INTEREST IN SELF-REGULATION:
CAN DEMUTUALIZED EXCHANGES
SUCCESSFULLY MANAGE THEM?**

John W. Carson
Consultant for the World Bank

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ABSTRACT

This paper examines the implications of demutualization of financial exchanges for their roles as self-regulatory organizations. Many regulators and exchanges believe that conflicts of interest increase when exchanges convert to for-profit businesses. Demutualization also changes the nature of an exchange's regulatory role as broker-dealers' ownership interests are reduced. These factors are leading to reduced regulatory roles for exchanges in many jurisdictions.

The resulting changes have significant implications for regulation of financial markets, especially as exchanges are the only SROs in most countries. Major changes in the role of exchanges require a rethinking of the allocation of regulatory functions and the role of self-regulation, as well as stronger mechanisms to mitigate conflicts of interest.

The paper looks at the views of both exchanges and regulators on these issues in Asian, European and North American jurisdictions where major exchanges have converted to for-profit businesses. We found that views on the conflicts of interest faced by demutualized exchanges vary widely. In addition, the tools and processes used by exchanges and regulators to manage conflicts also differ significantly across jurisdictions. The paper concludes that new and greater conflicts result from demutualization, and canvasses the regulatory responses in the jurisdictions examined.

INTRODUCTION

The World Bank is frequently asked to advise policymakers, regulators and counterparts in emerging markets around the world on how to ensure sound regulation and supervision of markets, since developing market integrity and investor confidence forms part of the foundation for successful financial markets. Given its advisory role, the Bank believes it is important to understand and be in a position to advise its clients on the implications of demutualization of financial exchanges and possible responses to the public policy issues that arise.

This study was commissioned to examine the implications of demutualization for the regulatory roles of financial exchanges. Demutualization changes the nature of an exchange's regulatory role. As broker-dealer ownership of an exchange declines, the exchange ceases to be a self-regulatory body as traditionally defined. Exchanges are increasingly described as front-line regulators for this reason.¹ This change is causing exchanges to narrow their focus to regulation of their own markets. Our research produced a wide range of views on exchanges' regulatory roles and the degree of conflict of interest that arises in converting to a for-profit model. Views range across the spectrum, from "it is business as usual" to "everything has changed".

This paper addresses the following issues:

- What conflicts of interest do for-profit exchanges face?
- How do these conflicts of interest differ from those faced by traditional broker owned and operated exchanges?
- How are potential conflicts of interest faced by demutualized exchanges actually being managed?
- What conclusions can be reached from the experience gained to date in managing these potential conflicts of interest?

It is broadly accepted that market integrity is a cornerstone of vibrant capital markets. Investor confidence in the fairness of markets is a prerequisite to broad-based participation in markets. If exchanges reduce their regulatory roles, or relinquish them entirely, there are significant implications for regulatory structures in financial markets, especially as exchanges are the only SROs in the great majority of jurisdictions. Major changes in the role of exchanges may require a rethinking of the allocation of functions between self-regulators and statutory regulators and changes in the organizational structure of SROs.

Although securities exchanges are only one of the institutions that comprise the infrastructure of a capital market, their role is fundamental because exchanges are producers of public goods that traditionally have been necessary for liquid secondary markets to develop. Liquid markets are in turn a basic prerequisite to effective primary

¹ The terms self-regulation and SRO are still used in this paper for consistency.

markets. As such, exchanges' roles lie at the heart of the capital formation process and economic development.

Exchanges' regulatory roles have also historically been an important part of their value. As SROs, exchanges not only operate markets that bring buyers and sellers of capital together, they are also important sources of standards and safeguards that are designed to facilitate efficient markets and promote market integrity. Exchanges' regulatory roles are a significant contributor to securities markets' credibility.

While approaches vary widely, our research into the evolving role of exchanges confirms that several general trends are developing, and there is an increasing consensus on the major factors that determine an exchange's approach to regulation in the new environment. These factors are:

- Demutualization triggers changes in exchanges' strategies and priorities that inevitably impact an exchange's regulatory roles.
- Exchanges are increasingly concentrating on core regulatory roles that are directly tied to business operations, such as market surveillance.
- Most exchanges are reluctant to outsource regulatory functions generally, and especially market surveillance, because they feel it is important to be close to the market.
- Certain regulatory functions and powers are migrating from exchanges to securities commissions or independent SROs in many countries.

The core regulatory issue raised by demutualization is whether the conflicts of interest between business and regulatory mandates are manageable. This issue must be examined from both a business and a regulatory standpoint. It is possible for regulators and exchanges to conclude that the conflicts can be managed from a regulatory point of view, but for some exchanges to conclude that they are not manageable from a business point of view.

A lot of the debate about conflicts seems to be about where to draw the line on regulatory roles. While there is no international consensus on this point, if there is any convergence of views, it appears to be that exchanges' roles should focus on functions that are directly tied to their business activities. In general, exchanges exhibit a high comfort level with their current regulatory roles, regardless of whether they are narrow or broad. Exchanges also tend to believe they can perform their traditional regulatory functions better than anyone else – that services must be performed in-house and cannot be contracted out or transferred to public authorities.

Regulators are attentive to potential conflicts and have addressed the issues, but do not want to mandate significant changes in the absence of evidence that conflicts have become a real and bigger problem. A majority of regulators believe conflicts are likely to be exacerbated in for-profit exchanges, but feel the conflicts are manageable. Regulators are aware that exchanges are increasingly focused on competition, and that conflicts are likely to become a bigger issue as a result. If exchanges start to lose market share, pressures to level the playing field will intensify quickly, especially if they are competing

with markets that have minimal regulatory obligations or that free ride on others' regulatory investments.

Exchanges and regulators have employed a range of responses in order to manage conflicts of interest. While the specific mechanisms vary widely, responses fall into the following general categories:

- Enhance corporate governance requirements
- Impose ownership restrictions
- Reinforce exchange's public interest mandate
- Upgrade supervision by regulator
- Strengthen exchange internal controls and management processes
- Transfer regulatory functions to an independent SRO
- Transfer regulatory functions to the Public Regulator.

While the scope and importance of self-regulation in a particular jurisdiction reflect broad historical factors and public policy decisions, the reasons given by exchanges and regulators for either maintaining or reducing exchanges' regulatory roles after demutualization occurs are quite different. Exchanges cite business reasons in support of their regulatory roles whereas regulators focus on the public interest. Demutualization may also be seen as an opportunity to redefine exchanges' responsibilities in order to improve the quality and efficiency of market regulation.

While market integrity and confidence are vital attributes for any market, emerging markets face particular challenges. As noted by FEAS,² major obstacles exist in many emerging markets that make development of the necessary infrastructure and investor confidence difficult. Consequently, regulatory roles of exchanges in emerging markets are more sensitive than in developed countries, where reasonable levels of market integrity, regulatory compliance and investor confidence have already been established.³

Emerging markets may also be less able to sustain the injury caused by regulatory problems and scandals because the basic conditions required to establish market integrity, such as effective legal and regulatory systems, effective institutions, sound corporate governance and disclosure may not be in place. The exchanges' roles are crucial to building institutional capacity and effective systems.

² Working Group on Capital Markets Development of the Federation of Euro-Asian Stock Exchanges (2001). The report notes a host of problems, including abuses in privatization programs in transition economies, lack of investor protection standards (especially minority shareholder rights), inadequate disclosure standards, and entrenched cultures of self-dealing, that contribute to the obstacles. Even where adequate rules and regulations exist, lack of effective enforcement is often a major problem, for a range of reasons.

³ The recent market scandals in the U.S. and other developed markets illustrate that no market is immune to abuses and dishonest practices that threaten market integrity and investor confidence. While developed markets are currently suffering a decline in investor confidence, arguably the foundations of the system remain intact.

We acknowledge at the outset that there are no clear right or wrong answers to the issues addressed in this paper. For-profit markets are a recent phenomenon, and both exchanges and regulators are working through the issues as they unfold. Responses to conflicts and other issues are still being tested. Many exchanges remain in the process of demutualization, or are planning for it. Even those exchanges that have completed the formal process are still in the midst of transformation to a business culture and commercial orientation.

The paper's findings should be seen in the context of broader issues relevant to the development of capital markets, such as whether demutualization is a beneficial form of organization for financial exchanges and whether self-regulation is effective. However, analyzing the business implications of demutualization are beyond the scope of this paper.

The paper is organized as follows. Part 2 provides a global overview of exchanges' corporate and regulatory status as of September 30, 2002. Part 3 comments on the implications of demutualization for exchanges' regulatory roles and analyzes the types of conflicts of interest exchanges face. Part 4 surveys responses that exchanges and regulators have put in place to manage potential conflicts of interest. Part 5 sets out the conclusions reached from our analysis of the findings and points to the future of exchanges' conflicts management.

GLOBAL OVERVIEW

The global trend to demutualization of financial exchanges and the entry of new for-profit market operators⁴ has raised a host of issues about the business viability of exchanges, their role in the regulation of markets, and their public interest roles or mandates. Most financial exchanges are also self-regulatory organizations. Demutualization is perceived to create new conflicts of interest between the business operations of an exchange and its regulatory role. It raises significant questions about the extent to which exchanges should continue to act as self-regulatory organizations.

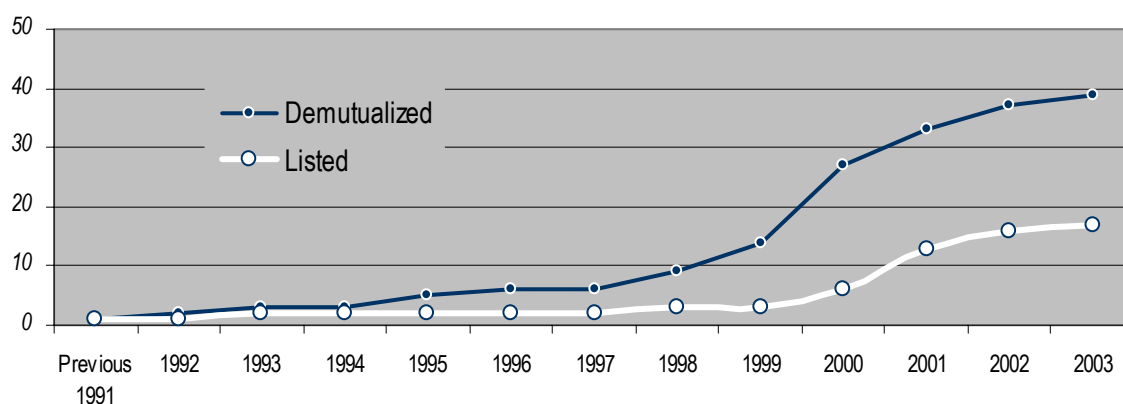
Demutualization generally refers to the process of converting from a non-profit, mutually owned broker-dealer membership organization to a shareholder-owned, for-profit corporation. Members of a mutual exchange are both owners with voting rights and users with trading privileges. In a fully demutualized exchange, shareholders are investors in the business of the exchange. Trading rights of participants in the market run by the exchange are created by separate contracts between the participant and the exchange. The board of directors and corporate governance structure of the exchange reflects the broader share ownership.

The table below summarizes the corporate status of members and affiliates of the World Federation of Exchanges as of March 2003.

⁴ Including electronic communications networks (ECNs), alternative trading systems (ATSs) and exchanges that started operations as for-profit companies.

	North America	Central and South America	Europe	Asia and Oceania	Africa and Middle East	Total
Demutualized	8	5	19	10	0	42
Listed	3	1	10	4	0	18
In process of demutualization	2	3	3	7	1	16
Not considering demutualization	2	3	9	6	7	27
Total	12	11	31	23	8	85

Figure 1: Global Trends in Demutualization and Listing of Stock Exchanges



The decision to demutualize an exchange is made for commercial and, in some cases, public policy reasons. In both cases, it is the commercial objective of making the exchange more competitive and efficient that drives the process. Technological advances and globalization have both broken down barriers in the investment markets, forcing financial exchanges to redefine their role and structure in order to survive. In emerging markets, another important goal is to reform ownership and governance to reduce the influence of brokers or government.

Government policy has been the driving force behind demutualizations in many emerging markets. For instance, in Hong Kong, Singapore, the Philippines and Malaysia, the consolidation and demutualization of exchanges has been one part of broader plans to bolster the competitiveness, efficiency and fairness of the capital markets sector of the economy. Countries such as Thailand and India are looking at following a similar path.

Demutualization fundamentally changes the orientation and mandate of an exchange from a cooperative to a business. This in turn necessitates a number of other changes, both internal and external, in order to transform the organization into one whose benchmarks are based on financial performance. Demutualization triggers dramatic changes in exchanges' governance structures, managements, organizations and internal processes and procedures. These changes are imperative if a successful transition to commercial status is to be achieved.

Box 1 describes self-regulatory functions frequently performed by financial exchanges around the world. Our study found that demutualization triggers changes in exchanges' strategies and priorities that inevitably impact an exchange's regulatory roles.

Box 1: Self-regulatory functions performed by exchanges

SRO functions that are frequently performed by securities exchanges around the world are listed below. The scope and tradition of self-regulation varies widely, and most exchanges only perform a subset of these.

1. Broker-Dealer Regulation

- 1.1 Member or Participant qualifications for registration
- 1.2 Capital adequacy regulations (net capital and margin requirements)
- 1.3 Financial examinations
- 1.4 Custody and account segregation
- 1.5 Books and records requirements
- 1.6 Business conduct and sales compliance rules
- 1.7 Compliance examinations

2. Market Regulation

- 2.1 Qualifications for access to trading by firms and traders
- 2.2 Market conduct rules (market integrity and ethical standards)
- 2.3 Trading rules (operational and trading system "business rules")
- 2.4 Market quality rules (e.g. market maker obligations)
- 2.5 Market surveillance and supervision of trading
- 2.6 Examinations of member trading operations
- 2.7 Market investigations

3. Clearing and Depository

- 3.1 Clearing rules and procedures
- 3.2 Settlement rules
- 3.3 Depository rules and procedures

4. Listings and Product Standards

- 4.1 New listings standards
- 4.2 Continued listings standards
- 4.3 Contract specifications
- 4.4 Corporate conduct rules (disclosure requirements, corporate governance standards)
- 4.5 Shareholder protection rules (approval of transactions that affect public or minority shareholders)
- 4.6 Filing requirements

5. Enforcement

- 5.1 Formal investigations
- 5.2 Discipline

CONFLICTS OF INTEREST

Many observers believe for-profit exchanges exacerbate the conflicts of interests between the business of operating a market and the responsibilities of acting as a front-line regulator and that the core regulatory issue that demutualization raises is whether for-

profit exchanges will continue to effectively perform their regulatory and public interest responsibilities.

Concerns about conflicts of interest are generally lower in futures markets because the markets are not as regulated as securities markets. Futures markets participants are mainly professionals and made up of sophisticated players. Retail investor participation is small.⁵ Also, the regulatory framework is different because futures exchanges have no capital formation role, and the contracts are a product created by the exchanges. The difference in approach is more evident in the U.S. where futures exchanges are governed by a separate regulatory regime. Elsewhere one regulator prevails, and securities and futures exchanges are merging, leading to a harmonized approach to the two market segments.

An emerging high-level consensus of views between regulators and exchanges

The primary reasons cited by exchanges for retaining regulatory functions are that they support the exchange's reputation and "brand name"; improve market integrity and quality which are central to the product; enable the exchange to control the features and standards of its products and services through its rules and policies; give the exchange the ability to significantly influence the substance, quality and cost of regulation; and ensure self-regulation is maintained.

The majority of exchanges tended to dismiss the conflict debate, partly because they know conflicts have always been present. They view the conflict issue in relative terms, and feel the concern is overblown because it is not new. In fact, the prevalence of this comment suggests that exchanges may have been subject to greater pressure from members on regulatory issues and resources than many realize. Exchange executives on the front line of regulatory programs often said that the conflict is probably greater in a membership organization. The view that accountability to a board of directors in a corporate model is preferable to the governance and management pressures in a mutual was widespread.

Exchanges are asking several significant questions:

- What functions are core to the business and directly add value to the exchange's products and services?
- Where does the exchange have a comparative advantage in terms of knowledge, skills and expertise over alternative regulators?
- Does the exchange have the necessary jurisdiction and powers to carry out the function?
- Do the exchange's functions overlap with activities of other regulators?

When exchanges drill down in their analysis of their regulatory activities, some are concluding that functions such as broker-dealer regulation and listing rules that govern corporate conduct (as opposed to standards for admission to the official list of the

⁵ Of course, this may vary based on the specific product involved and by jurisdiction.

exchange) are really not strongly related to their product and service standards. From a business standpoint, these regulatory functions can also create unnecessary friction in customer relationships which can be avoided if the functions are transferred to another regulator. As a result, these types of functions are migrating from exchanges to government authorities in many countries. Exchanges are increasingly focusing on core regulatory roles that are directly tied to business operations, such as trading supervision.

In discussing the issue with exchanges, managements tend to prioritize business needs such as product development, IT needs and finance. Regulation is a secondary consideration, and is often somewhat of a protected area because of its historic place in the organization, its quasi-public character and the high degree of scrutiny from regulatory authorities.

In some respects, exchanges are coming full circle – they are retreating to regulation based on their commercial interests, which was the origin of their regulatory activities. Demutualization therefore raises legitimate questions about the degree of reliance regulators should place on exchanges' self-regulatory roles, especially functions that are quasi-public in nature, such as dealing with insider trading or corporate disclosure.

Regulators see many public policy reasons for reducing exchanges' regulatory responsibilities, including the need to minimize conflicts of interest; recognition that many areas of regulation are more effectively delivered by public regulators; the opportunity to promote market development by improving regulatory efficiency and reducing an exchange's costs; and removing obstacles to competition in securities trading. Also, where multiple SROs exist, opportunities to consolidate SROs, harmonize standards and increase efficiency may arise.

However, a significant factor for many regulators is that transferring, or requiring significant changes to, exchanges' regulatory roles is not an option, because the exchange's SRO role is enshrined in law. For instance, U.S. securities and futures exchanges have a legal obligation to regulate their markets under applicable legislation, and the SEC and CFTC are obligated to ensure the exchanges carry out their responsibilities diligently. In the case of the CFTC, the Commission concluded that the overall regulatory risk level was no higher post-demutualization, although the nature of certain risks changed and they adjusted their oversight accordingly. The SEC appears to have concluded that conflicts are greater, but has stepped back from demanding complete separation of SRO functions from the business.

Of course, exchanges' and regulators' responses must reflect local conditions and circumstances, which are important determinants of the scope of conflicts of interest. It is also possible for regulators and exchanges to conclude that the conflicts can be managed from a regulatory point of view, but for some exchanges to conclude that they are not manageable from a business point of view – that regulatory roles need to be reduced or transferred elsewhere to enable the exchange's board and management to devote their energy and resources to achieving commercial success.

One of the most interesting findings of our study is that exchanges' and regulators' responses to the issue of what regulatory roles are appropriate for

demutualized exchanges, and what safeguards should be put in place to deal with conflicts of interest, vary dramatically. The approach is not at all consistent across jurisdictions. In fact, many responses are unique, reflecting both local conditions and local ideas about conflicts and how they might be managed. We are too early in the demutualization trend for countries' responses to have converged, notwithstanding the fact that both exchanges and regulators are following events in other jurisdictions.

From a public policy standpoint, the fact that exchanges are highly regulated entities is a significant source of protection in itself. The requirements and powers set out in the law and regulations can be deployed to address conflict of interest issues. Regulators have extensive tools to deal with any concerns raised by demutualization. In this regard, both regulators and exchanges recognize ongoing oversight of exchanges as an important safeguard, because it is a continuous and responsive process. Exchanges cannot simply obtain approval for demutualization, and close the book on the question. In most jurisdictions, close contact between the regulators and exchanges, especially the SRO section, is a feature of the system. An additional layer of scrutiny by the government is also present in many jurisdictions.

Types of conflicts of interest

Observers categorize conflicts of interest in different ways. We have identified the following sources of conflict of interest between the business operations and SRO responsibilities of an exchange. Some are “old conflicts” that have always existed (but may be exacerbated or reduced by demutualization); others are “new conflicts” that arise with demutualization of exchanges.

Box 2. Summary of Types of Conflict of Interest

1. Conflict between Business and Regulation Mandates

- 1.1 Acting in shareholders' interest by maximizing value vs. acting in the public interest as an SRO.

2. Conflict in Funding Regulation

3. Conflict in administration

- 3.1 Maintaining high regulatory standards and rules
- 3.2 Thoroughness of regulatory programs
- 3.3 Independent administration of rules and requirements
- 3.4 Independent decisions on investigations and enforcement
- 3.5 Regulation of owners and key customers who provide business and revenue
- 3.6 Regulation of membership association whose interests the exchange's rule is to promote and protect

4. Conflict in regulating competitors

- 4.1 Regulation of members of trading participants that compete with the exchange in providing liquidity of trading services
- 4.2 Regulation of listed companies that compete with the exchange in providing business services (or conversely, favouring business partners)
 - Rulemaking that favours the exchange's business or is biased against a competing business.
 - Using investigation and enforcement powers in a biased manner
 - Making administrative decisions affecting firms that compete with the exchange in a biased or unfair manner.
 - Predatory regulatory practices such as delays in responding to complaints or imposition of burdensome procedures.
 - Improper use of confidential information about regulated firms for business instead of regulatory purposes.

5. Self-listing conflict

- 5.1 Exchange assessing whether it meets its own listing requirements
- 5.2 Exchange monitoring trading in its own stock and making decisions on the need to review or investigated it.

6. Conflicts in specific regulatory functions

- 6.1 Listing rules:
 - Exchange competes with listed companies
 - Exchange has business relationship with listed companies
 - Customer relationship with major listings customers
 - Cross-subsidization of trading business
- 6.2 Market surveillance and regulation
 - Exchange competes with regulated broker-dealers
 - Customer relationship with major broker-dealer customers
- 6.3 Member regulation
 - Exchange competes with regulated broker-dealers
 - Customer relationship with major broker-dealer customers
- 6.4 Clearing and settlement
 - Competing markets must use Exchange's clearing services
 - Monopolistic pricing of utility services

Conflict between business and regulation mandates

Description: Conflicts can arise between an exchange's role as market operator with responsibilities for supervising trading and monitoring listed companies' disclosure on its markets and its role as a commercial entity.

Exchange view: While perspectives vary, most exchanges argue that reputation is their stock in trade, and that as commercial enterprises they can ill afford regulatory problems that would jeopardize confidence in their markets and threaten their brands. They argue that regulation is integral to their business, and they would continue to do the job even if they were not required to.

Some listed exchanges believe the pressure to regulate well is much greater for a commercial entity than a club, because while brand damage and loss of business are threats to both, a public company is subject to greater scrutiny, is more sensitive to the threat of loss of business, and has greater incentives to practice sound risk management. Risk management is a corporate governance issue and the board is responsible to shareholders to ensure that risk management programs address the threat posed by inadequate regulation. The view is that regulatory risk will be reflected in the exchange's share price and cost of capital.

A minority of exchanges acknowledge that conflicts are significant and that a strong business orientation requires regulatory functions and powers to be minimized.

Regulator view: The majority of regulators believe conflicts are likely to be exacerbated in for-profit exchanges, but feel the conflicts are manageable. Generally regulators believe that better scrutiny and oversight is called for, at a minimum. At the other end of the spectrum, a few regulators saw conflicts as significant enough to reverse the demutualization trend. As the implications of commercial pressures for regulatory functions become evident, they believe exchanges will revert to non-profit utilities.

Responses: The overall conflict between the two mandates can only be addressed by broad safeguards that address an exchange's overall handling of its regulatory responsibilities, as opposed to measures intended to address specific types of conflict. Responses in this category include:

- Organizational separation of regulation functions from business operations, or transfer of functions to another regulator.
- Corporate governance mechanisms, such as composition of the board and board committees to oversee regulation.
- Regulatory oversight of board of directors' and management decisions on policy and programs.
- Regulatory oversight of performance of regulatory functions and public interest obligations.

Conclusion: Specific conflicts are frequently managed by escalating decisions or ensuring appropriate corporate governance stewardship or management supervision, but these responses only move management of the conflict to the highest level, where

arguably the conflict is greatest because it is the responsibility of the board and senior management to reconcile the two mandates. This kind of response places a high degree of reliance on the integrity of people and processes at the top, and on supervision of their management of conflicts by the regulator.

Box 3: Responses to potential conflicts of interest

The NASD and Nasdaq believe conflict of interest is the primary issue to be addressed and it is easier to manage conflicts and to focus business on customers when a separate and independent body carries out core regulatory functions. They decided that Nasdaq would be more successful as a business, and the NASD more successful as a SRO, if their roles were separated. Nasdaq obviously believes that quality regulation is important to its business, just as regulated exchanges do. The difference is it does not feel it is necessary to control the daily operations of the SRO in order to deliver quality regulation.

In Singapore authorities and industry leaders concluded that conflicts are not significantly greater notwithstanding the fact that the exchange performs broad regulatory roles similar to U.S. SROs. As part of Singapore's financial reforms, a high-powered committee (led by the chair of the Monetary Authority of Singapore) looked at the securities regulatory regime. While some major reforms were made, SGX's SRO role was left untouched. Conflict and public interest issues were considered, but were not viewed as major concerns. SGX considers its SRO functions to be an important asset for business development and does not see it as a conflict in the current business model because regulatory functions are embedded in the business. In future competitive pressures could give rise to concerns such as free riding or an uneven playing field.

Hong Kong is one of a very few jurisdictions to implement a comprehensive set of conflict management safeguards. HKEx felt major conflicts did not exist but it was prudent to implement safeguards to mitigate and manage any that might arise. The main focus was on Listings because it is a major source of revenue and HKEx has a major role in regulating listed companies. Also, its trading regulation is limited. The safeguards include:

1. The Exchange and its directors have a legal duty to act in the public interest, and to place the public interest first in the event of any conflict between it and the exchange's business interests;
2. The maximum shareholding is 5% unless exempted by SFC;
3. The Board of HKEx has public interest directors (appointed by Government);
4. SFC has a power of direction over the HKEx where conflict arises in regulation;
5. The Exchange maintains strict separation of its Regulation and Risk Management Dept. from business units;
6. The HKEx has established a Conflicts Committee to address conflicts that arise in relationships with listed companies;
7. The SFC can assume the Exchange's regulatory responsibilities in any case where it is not satisfied a conflict can be managed;
8. HKEx's self-listing process was administered by SFC;
9. HKEx's Chairman must be approved by the Chief Executive of Hong Kong and the SFC must approve HKEx's CEO and COO.

Conflict in funding regulation

Description: As exchanges concentrate on financial performance, questions about their willingness to adequately fund regulation functions arise. Regulation is a cost

center and functions that do not produce revenue are often subject to proportionately larger reductions when a corporation decides to reduce costs.

Exchange view: Exchanges say that this conflict has always existed – members were also interested in efficiency and keeping a lid on costs. In fact, several exchanges indicated there was a greater conflict when members controlled the exchange because they not only favoured lower costs, they also had an interest in limiting the scope of regulation. These exchanges argue that a corporation and its shareholders actually have a greater interest in maintaining sound regulation as a matter of risk management: any regulatory failure could severely damage the business.

Regulator view: According to the SEC, it is vital for an exchange to believe that its reputation, and consequently its investment in regulation, is crucial to its business and an essential component of its strategy, if this conflict is to be managed successfully. Overall, regulators are not highly concerned about this conflict because they have not seen evidence of a greater problem yet. If one arises, they believe their oversight powers are sufficient to deal with it.

Responses:

- Transfer and streamlining of regulatory functions
- Oversight of regulatory programs, budgets and resources
- Corporate governance mechanisms, such as public interest / independent directors or board committees to oversee regulation

Conclusion: The question is whether the conflict is increased in a for-profit environment. Business pressures intensify scrutiny of costs, and it is generally accepted that for-profit exchanges manage costs better and keep all forms of costs under the microscope.⁶ Business case analysis questions the rationale for any costs that do not produce business benefits. Mutual exchanges are not as disciplined in this regard because financial performance is not their central measure of success, it is merely one of a number of objectives and often the target is simply to cover costs.

Some exchanges admitted their commitment to regulatory funding could change based on the fortunes of the company and market – the real question is what happens when exchanges are under financial pressure and losing money. This has yet to be tested, although the current market environment is grim. Going forward we should expect exchanges to apply a more rigorous approach to measuring the performance of staff and use of resources. But the application of business disciplines is not necessarily a negative. It will improve efficiency and performance, and the allocation of regulatory resources.

Conflict in administration of operating rules

Description: Conflicts arise in the ongoing administration of rules and programs since exchanges have the authority to make administrative decisions that affect the

⁶ World Federation of Exchanges 2000 annual report

interests of customers in all areas of SRO operations. Even if business and regulatory goals are broadly aligned, they clearly can diverge in individual cases, for example when considering whether to investigate or discipline a major customer, or what sanction to apply.

Exchanges administer enforcement programs and have discretionary authority over investigations, case management and discipline. An exchange's handling of sensitive decisions and cases may call into question the thoroughness and integrity of its regulatory operations, or whether it is administering them in a neutral and unbiased fashion.

An issue that is often overlooked in assessing the incentives that influence regulatory decisions is whether regulatory staff will be compensated in part based on the exchange's profits or financial performance. Compensation is designed to influence behaviour. If regulatory staff receives bonuses and stock options based on the exchange's financial performance, it appears to be a clear conflict of interest because regulators' compensation is linked to customer interests. Exchanges are in a difficult spot because they do not want to drive a cultural wedge between business and regulatory staff. They argue that if business and regulatory goals are in alignment, conflict is not an issue.

Exchange view: Exchanges generally acknowledge this conflict. Some cite it as a major reason to reduce or transfer regulatory functions. Others suggest it can be managed with appropriate safeguards, including organizational separation of regulation departments.

Regulator view: Regulators see the potential for greater conflicts as exchanges are subject to greater commercial pressures, which requires stricter oversight. But few regulators commented on how conflicts might influence the exercise of regulatory discretion.

Responses: Many regulators appeared to have limited means to identify case-specific conflicts. At a minimum, the threat of increased conflict in exercising regulatory authority demands that new safeguards be put in place to reduce the possibility of either the business units or customers attempting to influence regulatory decisions, to identify potential conflicts of interest in specific regulatory decisions, and to ensure they are handled appropriately. Responses include:

- Organizational separation of regulation and business functions
- Conflict committees and similar internal procedures at exchanges
- Internal policies on handling potential conflicts
- Regulatory oversight of handling of potential customer conflicts
- Transfer of case files to the regulator if necessary to address conflicts
- Outsourcing of regulatory functions.

Conclusion: Strong measures are required to ensure that the integrity of an exchange's regulatory program is maintained and that it handles regulatory issues and

decisions in a neutral and unbiased manner. This should be a priority for regulators in addressing demutualizations and oversight programs.

Conflict in regulating competitors

Description: There are two types of conflict:

1. The conflict arising between an exchange and a participating broker-dealer that provides competing trading services and is subject to the exchange's supervision. The primary example is an alternative trading system (ATS) that is a member or participant in an exchange. Large broker-dealers also compete with exchanges as liquidity providers, mainly by internalizing the matching of orders.
2. The conflict between an exchange and a listed company that provides any services in competition with the exchange. Conversely, an exchange may favour a company that it has a business relationship with. As exchanges broaden their businesses the number of these conflicts increases. The broader an exchange's listing rules and regulation program, the greater the conflict is.

These conflicts can in turn arise in several areas including:

- Rulemaking that favours the exchange's business or is biased against a competing business. Exchanges make policy and rules that can affect the interests of customers.
- Using investigation and enforcement powers in a biased manner.
- Making administrative decisions affecting firms that compete with the exchange in a biased or unfair manner.
- Predatory regulatory practices such as delays in responding to complaints or imposition of burdensome procedures.
- Improper use of confidential information about regulated firms for business instead of regulatory purposes.

Exchange view: Few exchanges outside the U.S. recognize conflict issues in regulating competing trading entities because ATSS are not a significant source of competition for order flow. Because of market structure and liquidity differences, internalization of order flow by ATSS and major dealers is not as big an issue in markets outside the U.S.

Australia has experienced broader potential for conflicts in this area because of the number of new business initiatives ASX has pursued, including share registry services, order routing and market data services, futures trading and clearing, a trading linkage with the Singapore exchange, and ASX World Link to provide access to US and other international markets.

Box 4: Regulating competitors

Exchanges are also listing on other exchanges that may be competitors, for example CME on NYSE. This raises a different sort of conflict that regulators must address.

The starkest example of the listings conflict is in Australia, where the SFE is a listed company on ASX and subject to its supervision, while ASX operates a competing futures market. However, under the law, ASIC may assume responsibility for handling initial and ongoing listing functions from ASX on application of a company that competes with ASX.

The issue of conflicts in regulating competing providers of market services arises primarily in the U.S. because of the number of ATs that are members of Nasdaq and regulated exchanges. The SEC rules governing ATs give operators a choice of regulatory status: become an exchange with SRO responsibilities, or become a member of an SRO, which has full regulatory oversight. ATs that join an SRO must comply with its rules. The SEC believes that its oversight of SROs is sufficient to address any conflicts of interest.

The UK government recognized the principle that public regulatory powers should not be delegated to an exchange that competes for listings with other markets in its decision to transfer the LSE's designation as the UK listing authority to the FSA.

Regulator view: Regulators' views are similar to the exchanges' in each jurisdiction, according to the likelihood or experience of each type of competitive conflict. Some regulators that are particularly concerned with competition policy feel they must address the impact of conflicts on the behaviour of exchanges, especially where the exchange has monopoly power. In other jurisdictions the issue is primarily within the purview of competition regulators. Competition issues tend to be a lower priority in emerging markets.

Responses:

- Conflicts Committees at exchanges to review handling of potential conflicts
- Regulator review of handling of sensitive cases
- Transfer handling of specific files to the regulator
- Reduce scope of Exchange's Listing rules and authority
- Separation or outsourcing of market regulation functions from exchange.

Conclusion: This seems to be one of the most serious areas of conflict faced by for-profit entities, because business diversification can create unforeseen new conflicts. Furthermore, competition in core exchange services is expected to grow. Conflicts that arise in specific cases are often difficult to both identify and manage appropriately.

Self-listing conflict

Definition: Two areas of conflict arise:

1. The conflict involved in an exchange assessing whether it meets its own listing requirements.
2. The conflict arising when an exchange monitors trading in its own stock and makes decisions on whether to review or investigate trading for any reason.

Exchange and Regulator view: Exchanges and regulators universally recognize the conflicts that arise when an exchange lists its securities on its own market.

Responses: Virtually all jurisdictions with listed exchanges have taken steps to address these conflicts. Approval of the listing pursuant to the listing rules has been the responsibility of the regulator. Administration of the listing rules in respect of the exchange's listing has either been transferred to the regulator, or is subject to close oversight by the regulator. Similarly, surveillance of trading in the exchange's stock is either the regulator's direct responsibility or is closely supervised by it.

Conclusion: This conflict is fairly narrow in nature and easily defined. As such, the measures needed to manage it are clear. Our research did not identify any situations where this conflict became a practical problem.

MANAGING POTENTIAL CONFLICTS OF INTEREST

This section expands on the brief description of the types of responses that exchanges and regulators are implementing for the purpose of managing the conflicts of interest involved in a for-profit exchange carrying out regulatory responsibilities. Responses range from an exchange retaining its full self-regulatory responsibilities but completely separating these functions from its business activities to an exchange having supervision functions removed from it and their being undertaken by the government regulatory authority.

Enhancing exchange internal controls and management processes

Many exchanges have a history of clear separation of regulatory operations from business functions, especially exchanges in Anglo-American legal systems. Given the potential for greater conflicts of interest in for-profit exchanges, the view that segregation of functions should be required (if not in place before) or strengthened (if separated before) is widespread. Segregation takes the form of complete organizational separation of regulation units from business development and trading units. The approach varies, for instance on the level at which separation occurs. The best practice is for regulation to report separately to the CEO. Opinions differ on the definition of regulation functions. Many exchanges treat listings as a regulatory function while others do not.

Internal controls or processes are widely used as safeguards against conflicts influencing regulatory decisions. Examples include imposition of information firewalls, measures to safeguard confidential information and conflict management processes such as internal guidelines for handling potential conflicts, conflict committees and internal audit processes. Separate financial accounting for regulatory functions should be employed to ensure regulatory costs are transparent, cost allocation is appropriate and to show cross-subsidization of business operations does not occur.

5: Examples of corporate governance solutions

A unique approach is ASX's creation of an independent entity, ASX Supervisory Review, to supervise the delivery of its regulatory functions. ASX SR has its own board and acts as an independent auditor of ASX's handling of regulation and conflicts of interest. ASX created the entity in response to pressure to move regulation to a separate body, which ASX felt would compromise its business because regulation is part of the product. ASX SR's mandate is to report to the ASX Board on three areas:

- Review of listings decisions relating to companies that have a business relationship with ASX or are in competition with it, if the company elects to become a "review group entity" to ensure unbiased treatment;
- Review of funding for regulation functions;
- Review of supervision policies and procedures manuals for thoroughness and adequacy.

The creation of Conflicts Committees to address any conflicts between a listed exchange and listed companies that it regulates appears to be an emerging best practice. Such committees are in place in Hong Kong, Singapore and Toronto. The Committees generally review any dealings with companies that the exchange either competes with or has business dealings with to ensure that listings rules are administered in an unbiased manner, and report their assessment to the regulator. In Hong Kong, issues are referred to the SFC even a conflict could even be perceived – for example, a listing application from a company that provides back office services to HKEx. The make-up of such committees is also an issue. Most are comprised of exchange executives, but Toronto recently agreed to add independent members to its Conflicts Committee.

In conjunction with a reorganization of regulatory responsibilities, Thailand's SET moved its regulation functions into a separate department reporting directly to president, and last year separated market surveillance from market operations. The separation of business and regulation functions has helped to clarify mandates and address perceptions of conflict, according to the exchange.

Other types of internal processes that we noted include improved governance processes for SRO functions, such as appointment of Board-level regulation or risk management committees and adoption of codes of ethics to reinforce the neutrality and fairness of SRO processes. Exchanges normally disclose and promote the internal processes they have adopted, which informs market participants about steps being taken to manage conflicts, or prevent them from arising. Several exchanges noted their status as SROs sets them apart from the standard corporate model, and requires that regulated firms be represented on the board as major stakeholders.

With demutualization, the composition of the board should generally reflect the shareholder base, but given the public interest and regulatory obligations of exchanges, many jurisdictions also insist that other stakeholders continue to be represented in order to provide checks and balances in the governance structure. A requirement for public

interest or independent directors is common. Some countries, including the U.S., insist on member or industry directors so securities firms are not disenfranchised as ownership moves to investors. Others, such as the UK and Australia, impose a fit and proper requirement for directors of a regulated exchange.

Box 6: Approaches to corporate governance

Hong Kong and Singapore have retained the category of public interest directors appointed by Government even after listing, in recognition of the exchanges' express public interest obligations. In addition, the top executives of both exchanges are subject to the approval of Government or the regulator.

The German model is unique in requiring separate legal entities and governance structures for the exchange as a public entity and the market operator. The Exchange Council governs the exchange and represents stakeholders in the market. State government closely supervises it, and may attend its meetings. The operator of the exchange may be a private or listed company (for example, Deutsche Borse) that is governed and run as a standard corporate entity.

The UK FSA has reinforced the responsibility of the board for regulation by requiring exchanges to give the executive in charge of regulation direct access to the chairman and the board if any regulatory concerns arise that the executive feels are not being addressed by management.

The presence of public interest or independent directors is considered to be an important safeguard against conflicts of interest. In many emerging markets the government retains a significant role in selection of these directors. Independent directors can be defined in two ways. The traditional meaning in corporate governance parlance is a director who is independent of the company and its management – a true outside director. In an exchange context, the term often refers to a director who is independent of the securities industry and brokerage firms that owned the exchange prior to demutualization (and which often retain a major stake even post demutualization).

Finally, some jurisdictions have imposed requirements on the executives who manage the exchange following demutualization. These range from general fit and proper tests imposed on all registrants to specific approval requirements for top appointments.

Imposing ownership restrictions

Many exchanges have set limits on the share ownership position of any one person or company. Ownership limits can serve several purposes, including:

- Preventing a take-over of an exchange by one user or control group
- Preventing a take-over of a SRO by a regulated firm
- Limiting potential conflicts between the interests of shareholders and the interests of user-stakeholders
- Managing potential conflicts between an exchange's public interest and regulatory obligations and the interests of shareholders.

In addition, an express or at least implicit reason for ownership limits is often to prevent a take-over of the local exchange by a foreign company. In most cases, the restrictions can be raised or lifted with the approval of the regulator or the government,

which enables them to review a proposed transaction that would give a party a significant stake in, or control, of the exchange.

Box 7: Examples of ownership restrictions

The Swedish government retains the power to prevent a change of control in OM Group, owner of the Stockholm Exchange, through a “golden share” that gives it the right to exercise voting control of the company.

Hong Kong and Singapore exchanges have ownership caps of 5% but the regulator or government has authority to raise the limits on application, for instance to accommodate a strategic investor or an alliance with other exchanges. National interest concerns about maintaining local control are more important factors than controlling ownership and governance conflicts in these jurisdictions.

In Australia, the Financial Services Reform Act 2001 imposes a 15% ownership restriction on operators of financial markets and clearing and settlement facilities which are of “national significance”. The Australian Government also has the power to decide on whether to approve any foreign acquisition of at least 15% control of ASX or SFE under the Foreign Takeovers Act.

TSX raised its limit from 5% to 10% in conjunction with its listing in fall 2002, by agreement with its supervising Commission.

Reinforcing the exchange’s public interest mandate

The authorities may reinforce the existing public interest mandates of exchanges in the course of approving demutualization as a means of addressing conflicts between those mandates and the business of the exchange. This has occurred in the U.S., Australia and Canada, and may take the form of changes to the law, conditions to approval of demutualization or conditions for licensing of the exchange.

Box 8: Examples of reinforcement of the public interest mandate

In Hong Kong and Singapore, the law expressly states that in the event of any conflict between the public interest and the exchange’s business interests, the public interest must prevail. In Hong Kong, directors and officers of HKEx have a legal duty to place the public interest first. Singapore’s MAS has the power to issue a directive to SGX if it considers public interest considerations require it. At the time of financial reform, SGX’s public interest role was the subject of significant debate. The public policy view is that SGX has public interest obligations and it cannot act strictly in accordance with its commercial interests.

Strengthening supervision by the regulator

If there is one area of commonality in regulators’ responses to demutualization, it is imposition of a heightened level of oversight of the exchange. Effective government oversight is viewed as a backstop by both exchanges and regulators. It is considered essential to ensuring conflict does not lead to lower standards. Some exchanges acknowledged that under competitive pressure, standards could slip without strong oversight.

Stronger oversight may take several forms, including:

- Increased scrutiny of governance and management, including board decisions and business initiatives in order to ensure compliance with public interest obligations;
- Strengthened examination of scope and content of regulatory programs and processes;
- Review of resources and budgets for SRO operations;
- Review of effectiveness of processes and procedures in place to manage conflicts of interest, including organizational structures and information firewalls;
- Specific review of handling of listings, surveillance and investigation files where conflicts may arise;
- Closer examination of proposed rule changes to ensure appropriate standards are maintained and no adverse impact on competition results;
- Monitoring of exchanges' financial strength and viability.

Of course the SRO functions are the most closely examined to ensure they are carried out effectively and any conflicts are dealt with appropriately. More stringent oversight of an exchange's disciplinary processes and management of enforcement cases should be imposed to ensure that they are not influenced by conflicts or business considerations and that appropriate standards of due process are met.

Box 9: Examples of stronger supervision

Some regulators have been granted explicit new powers to intervene where conflicts of interest or commercial pressures create concerns about how the exchange is carrying out SRO obligations or public interest mandate. Several forms of intervention powers exist:

- Power to issue a directive to the exchange (UK, Australia, Singapore)
- Power to make a decision for the exchange (or reverse a decision) (Canada)
- Power to directly assume an exchange function or handling of a file (Hong Kong, Australia on request of issuer)

Although organizational structures and internal processes are important, the SEC believes they cannot control the risks of conflicts of interest through direct regulation such as mandating processes. Continuous oversight is crucial. For instance, the SEC needs to push some exchanges to implement adequate surveillance programs for new products. Oversight must be tailored to the circumstances of each exchange. If sufficiently concerned about an SRO's management of its regulatory functions, the SEC said they could require an exchange to contract them out to another SRO. They could also address free rider problem by allowing one exchange to charge another for regulatory services.

The UK FSA does not treat for-profit exchanges much differently in supervising them. The FSA, the Department of the Treasury and the Bank of England were all involved in discussions on LSE's and LIFFE's demutualization. Conflicts of interest and governance were major issues, but significant changes in oversight or delivery of the exchanges' (narrow) regulatory functions were not considered necessary. FSA manages the conflict issue as part of its ongoing oversight, which includes open communications with exchanges that provide a kind of early warning system if any changes are contemplated. Each exchange has a designated supervisor. For instance, a proposal to reduce resources in regulation would raise issues for review. The FSA also has the power to direct an Exchange to change its regulatory program but haven't used the power of direction so far. The FSA is now developing a risk-based approach to supervision of Exchanges.

Improved oversight may also involve requiring exchanges to increase the transparency of their regulatory processes, for instance by notice and comment process for rule changes. This enables interested parties, including regulated firms and competitors, to comment on proposed new rules. These processes strengthen the regulator's ability to identify and address concerns with proposed exchange rules (including conflicts issues) and respond to them.

Introducing special procedures for self-listing

In cases where exchanges are self-listing on their own boards, regulators are universally taking a more direct role in both approving the listing under the exchange's requirements and handling surveillance of trading in the exchange's stock. In some cases, the regulator assumes direct responsibility for administering the listing rules as they apply to the exchange's listing. In others, the regulator imposes stronger reporting requirements and heightened supervision on the exchange in handling the listing. Similarly, some regulators assume responsibility for monitoring trading in the exchange's stock, while in others the exchange continues to monitor trading under special supervision of the regulator.

Outsourcing regulatory functions

Despite widespread concerns about conflicts, very few exchanges have gone so far as to spin off regulatory functions to independent entities. Two markets that have are Nasdaq and Toronto.

Box 10: Examples of outsourcing

Many international observers believe the Nasdaq model is one of complete separation of the market and regulation, but that is far from the case:

- Nasdaq remains responsible for its SRO responsibilities but it has contracted the day-to-day administration and decisions involved in market regulation by contracting services to NASDR.
- Nasdaq continues to perform several regulatory functions directly, including listings regulation and the stock watch function of market surveillance.
- Since the outsourced functions are carried out on its behalf by NASDR under contract, Nasdaq continues to have significant control over the quality and costs of regulation, and it is involved in decisions on policy and approach.
- Nasdaq continues to set its own rules and must administer and enforce them.

Toronto has transferred market regulation, including surveillance and investigations, to a new SRO that it owns a 50% stake in, but which has independent governance. TSX continues to perform all listings functions and to administer its business trading rules. The SRO, Market Regulation Services, focuses on what have been labeled the market integrity rules -- basically trading ethics and anti-manipulation rules.

Even if an exchange spins off or outsources regulation to avoid conflicts, competitive and financial pressures still create pressure to cut regulatory costs, unless the costs are funded independently from the exchange.

Transferring regulatory functions to government regulators

A number of jurisdictions have transferred regulatory responsibilities from the exchanges to government regulators, and reduced the scope of self-regulation accordingly. Examples include the UK, France, Mexico and Hong Kong. Where this has occurred, several factors are behind the changes, with demutualization or commercialization of exchanges being just one. Others include elimination of duplication and placing responsibility with a commission or similar body that has the legal power and jurisdiction to more effectively enforce rules.

While government or regulatory policy initiates regulatory transfers, we found that exchanges usually favour the changes because it enables them to focus their efforts on areas that are most relevant to them and where their capabilities are strong, while also reducing costs. Exchanges are generally comfortable in the regulatory roles assigned to them, even if they are quite narrow, as is the case in the UK and much of Europe. The only example of exchanges opposing loss of regulatory authority is in the EU, where some (but not all) exchanges are resisting the centralization of all regulatory functions in one competent authority in each country, because it could lead to the virtual elimination of any regulatory role for the exchanges.

There appears to be a trend toward exchanges passing on investigative files to regulators at an earlier stage, leaving most of the investigative work to the regulator, based on the view that exchanges should not be doing work that involves enforcement of public laws, especially criminal law.

Box 11: Examples of transferred regulation

In Hong Kong, the SFC assumed responsibility for broker or member regulation as part of the demutualization process. The Exchange only does market regulation to the extent of exchange trading rules, which are mostly “business rules”; all breaches of law, including manipulation and insider trading, are the responsibility of SFC, including surveillance and monitoring. The SFC now proposes to take on more authority over listings, particularly the continued listing rules which contain many provisions governing corporate conduct that, as exchange rules, lack statutory backing and which are usually found in companies law elsewhere.

In Thailand, functions such as broker oversight and supervision of issuers’ financials moved to the SEC from the exchange as a result of a joint SEC / SET review process initiated early in 2001. This reflected several objectives, including the exchange’s objective to emphasize business development and focus on regulatory functions directly tied to trading, to streamline services and eliminate overlap in member regulation. This also occurred in the context of ongoing discussions on demutualization.

In Germany, the public and operational functions of exchanges are separated by law. Regulatory functions are public in nature and are governed by the Exchange Council, which represents stakeholders in the markets. Each exchange is required to establish regulatory and control bodies, including Trading Surveillance Unit, Listing Admission Board, and Disciplinary Committee. Each exchange must have an operator, which are increasingly commercial entities such as Deutsche Borse. In practice the system is a compromise between separating regulatory functions from the exchange and managing them separately within the exchange.

CONCLUSIONS

Demutualization of exchanges raises new conflicts of interest in carrying out front-line regulatory roles. These conflicts are usually greater than those that existed previously, even though certain conflicts they faced as a mutual may be reduced.

The degree of conflict of interest involved in carrying out regulatory roles depends on:

- The scope and intensity of the exchange's regulatory roles
- Effectiveness of safeguards put in place to manage conflicts
- The model of demutualization in place
- Intensity of competitive pressures
- The exchange's regulatory culture and tradition.

Changing an exchange's SRO responsibilities, or even restructuring the SRO system entirely, is an approach that can significantly reduce or eliminate conflicts of interest, but it involves radical change for an exchange and the regulatory system as a whole. In identifying alternative structures for self-regulatory functions which have been adopted in various countries, we are not advocating that a new market structure should be implemented when an exchange demutualizes, rather that exploring the application of practical models to local conditions helps to define the issues and explore possible solutions to conflict of interest issues that are raised by demutualization.

Regulatory models for managing potential conflicts

The essential benefits of each model in terms of managing conflicts of interest are set out below. Five basic approaches to devising a self-regulatory system are possible, including the possibility of eliminating self-regulation.

1. Retain the exchange as primary SRO

In most jurisdictions, one exchange is the sole (or primary) SRO for all self-regulatory responsibilities. While this requires the exchange to manage a range of conflicts, it minimizes the scope of institutional change and ensures that regulatory staff stays close to the market. But conflicts of interest will be difficult to manage if the exchange is not committed to the full range of regulatory functions. Also, SRO obligations may divert focus from building competitive markets.

Singapore and Australia both left the full range of self-regulatory functions to the exchange in large part because there was no alternative home for them. Both SGX and ASX consider their regulatory functions to be major assets from a business perspective.

2. Exchange retains market regulation only

Under this approach, exchanges restrict their role to core market regulation functions. Any member regulation functions are transferred to another SRO or the statutory regulator. This reduces conflicts of interest but allows an exchange to retain basic market regulation, which most see as an integral feature of the market and central to their reputation and “brand”. Arguably an exchange has the biggest incentive to ensure market quality and provide efficient, responsive regulation, which significantly mitigates conflicts. Regulatory staff remains close to the market, retaining the expertise arising from both running and regulating a market.

Exchanges responsible only for fairly narrow market regulation functions include LSE, Euronext, Stockholm, Mexico and Hong Kong. They concentrate on monitoring the market for compliance with the exchange’s trading rules only.

3. Exchange creates separate entity to carry out SRO functions

If an exchange retains self-regulatory responsibilities, it must establish a separate corporate entity with independent governance to administer them. This approach could apply to any set of regulatory responsibilities. It could also enable several exchanges to consolidate their regulatory functions in one jointly owned entity. The model minimizes conflicts by creating a separate governance structure for SRO functions that focuses the board and management on their regulatory mandate without pressures from commercial objectives. Similarly, the exchange’s board does not need to reconcile potentially conflicting mandates.

The NASD implemented this approach before spinning off Nasdaq. It created separate subsidiaries to run Nasdaq and NASD Regulation. As another example, Toronto spun off its market regulation functions to Market Regulation Services, a separate company 50% owned by TSX. In both cases, the market operator remains responsible for performance of SRO functions, and has contracted the activities to the SRO. The Bombay Stock Exchange proposes to employ this approach as part of its demutualization plan.

4. Create a single independent SRO

All self-regulatory responsibilities are centralized in one member owned SRO for the securities industry that is independent from the exchanges. This approach obviously minimizes conflicts of interest because it requires exchanges to transfer the functions. It enables an exchange to focus its governance and management resources on the business, while the SRO’s mandate is simply to deliver effective regulation. The SRO’s independence and neutrality promotes competition, a level playing field and the maintenance of uniform market-wide rules and regulatory standards.

On the other hand, it forces exchanges to offload services they may view as central to their business model and “brand”. Regulatory staff is not as close to the market, and synergies between market operations and regulation will be lost. Regulatory services could become less responsive and more bureaucratic – the SRO could effectively become an arm of government instead of a self-regulator. Perhaps the biggest

obstacle to using independent SROs is the challenge of building a new regulatory agency from scratch, including deciding on ownership, governance, funding and jurisdiction.

Three examples of independent SROs are the NASD and the National Futures Association in the U.S. and the Investment Dealers Association in Canada. When the U.S. Securities Industry Association released its paper on self-regulation and conflicts in 2000, a majority of SIA members favoured a “hybrid model” – leave market regulation to exchanges but centralize member regulation in one SRO in order to reduce inefficiencies and conflicts. The NYSE was opposed because it believes the synergies of integrated regulation are of significant value. The SIA did not endorse the unified SRO model partly because of the risk that self-regulation would become too far removed from market operations.⁷

5. Consolidate regulation in statutory regulator

Eliminating self-regulation by transferring all responsibilities to a statutory regulator clearly eliminates any perception of conflict, at the expense of the benefits of self-regulation. It could also compromise the strategic and competitive position of an exchange.

The UK took this approach with the advent of the FSA. While the exchanges remain responsible for basic market supervision, the universal statutory regulator has effectively supplanted self-regulation in financial services. In addition, the LSE was required to relinquish its role as the “competent authority for listing” to the FSA.

Lessons learned in looking to the future

In an increasingly competitive environment, demutualization is an approach to the corporate structure of exchanges that is relevant to both small and emerging markets. The more exposed an exchange is to competition, the greater the need to realize the benefits of a commercial orientation and focus. Even if competition is limited, benefits may be realized from a commercial governance and business model, including clearer measures of performance, increased efficiency, and improved innovation and business development. Since the trend towards commercialization of exchanges may be expected to continue in all types of markets, the issues examined in this study are relevant for all markets. The study’s primary findings are summarized below.

International practices in responses to conflicts can be identified in general terms, but no single best approach has emerged. Many approaches are still being tested. The primary responses include:

- separation and independent management of SRO functions from business units
- strong oversight by public authorities, including processes to identify and address conflicts
- internal controls and processes at exchanges to identify and manage conflicts

⁷ GAO p. 28

- corporate governance processes to oversee the management of conflicts and protect the public interest
- management of self-listings by the supervising regulator
- specific conflict management processes tailored to the needs of each regulatory function performed.

The type and the scope of safeguards must be proportionate to the degree of potential conflict and the experience of actual conflict, and must be appropriate given the scope and nature of the exchange's regulatory functions.

Responsibility for regulatory roles may be consistent with a demutualized exchange's business strategy if it views effective regulation as a core asset. Regulatory functions should directly support and add value to the business. If regulation is not integral to an exchange's strategy, it should minimize regulation functions to activities that it would carry out as a business even in the absence of any SRO obligations or oversight. Some exchanges believe regulation is integral to their product and some do not. If regulation is not integral to an exchange's business model, it should not be responsible for broad regulatory functions, because the conflicts will become unmanageable. An exchange is unlikely to do an effective regulatory job if it does not have strong incentives to do it well. This is not a strict either / or proposition – it is a question of degree. For instance, basic market surveillance may be a core function and everything else tangential, depending on the circumstances.

Demutualization may require reallocation of certain regulatory functions from an exchange to public authorities or another SRO. Regulators should not require exchanges to perform expansive self-regulatory functions simply because there are no other SROs to perform them. An exchange should continue to perform a full range of self-regulatory functions only if responsibility for those functions is consistent with its business strategy. Logically, an exchange organized as a business should have the flexibility to choose the strategy that is appropriate to its circumstances. This implies that an exchange should only perform regulatory functions that it considers to be relevant to its business.⁸

If regulatory responsibilities need to be reallocated, difficult questions arise about who is going to assume the functions involved, and how to pay for them. The difficulties involved in finding solutions to these problems, as well as legal impediments to transferring responsibilities, explain much of the reluctance to changing the status quo in many jurisdictions.

In an emerging market, government and regulators may require an exchange to perform a broader range of self-regulatory functions because they have concluded that the exchange can most effectively perform the relevant functions. However, this approach should only be taken if all parties, including the owners of the exchange, are clear on the implications for the exchange's objectives. It may imply a demutualization model that is not strictly commercial but rather combines business and public interest objectives.

Imposing certain public interest obligations on an exchange is not inconsistent with demutualization, provided that they are defined in a manner that is consistent with

⁸ It is recognized that many developed markets currently impose a broad range of self-regulatory functions on exchanges by law, including the United States.

the exchange's business strategy. The public interest mandate cannot be so broadly defined as to undermine the basic objectives of demutualization. The wider an exchange's public interest role, the more it retains quasi-public utility status, even if demutualized. Imposing broad public interest obligations on an exchange is difficult to reconcile with its business mandate and objectives.

An emerging market may be at a stage of development that requires a different policy response on public interest obligations. If non-commercial objectives are a priority the stakeholder model of demutualization is a useful model, provided that the owners accept the tradeoffs implied for profitability. In this model, the profit objective is balanced with public interest and stakeholder objectives, such as long-term market development initiatives. The relative priority of objectives should be clearly defined, including the implications for rate of return.

Similarly, government and regulators in an emerging market may require an exchange to perform a broader range of self-regulatory functions because they have concluded that the exchange can most effectively perform the relevant functions. This approach should only be taken if all parties, including the owners of the exchange, are clear on the implications for the exchange's objectives.

Emerging markets regulators and exchanges should strive to achieve a mutually-reinforcing set of conditions in order to support effective self-regulation by a demutualized exchange:

- Strong and effective oversight by the statutory regulator
- Tradition and culture of effective self-regulation
- Legal and regulatory framework that clearly sets out an exchange's self-regulatory responsibilities and public interest obligations
- Selection of a demutualization model that is compatible with the self-regulatory framework and the business strategy established for the exchange
- Implementation of effective measures to identify and manage conflicts of interest on an ongoing basis
- Appropriate corporate governance of an exchange's regulatory responsibilities
- Independent management and administration of regulatory functions and enforcement of rules, including organizational separation of SRO functions from business units
- Regulatory leadership and staff with demonstrable experience, expertise and integrity
- Allocation of sufficient resources to SRO functions
- If competition exists, consistent standards of regulation and a level playing field among market centres.

In conclusion, a new paradigm is developing among exchanges world-wide. The former prevailing model of mutual exchange-SROs is being supplanted by the for-profit business model. This change is evolutionary, and is progressing at different paces in each jurisdiction, depending on a host of local factors. But the trend is undeniably global. Both regulators and exchanges are increasingly recognizing that the kinds of regulatory functions that were appropriate for the old model are not all appropriate for a business-

driven exchange. The change also demands new governance, management and organizational structures designed to protect the integrity of regulatory services. As this trend matures, we will likely see increasing international convergence in the mechanisms used to manage conflicts of interest by regulators and exchanges.