Demutualization of Stock Exchanges in Pakistan and its Comparison with International Scenario

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Chapter 1: Background of the subject/topic & statement of the problem:

1.1. INTRODUCTION:

1.1.1. Introduction of the topic:

Capital market plays a vital role in channeling savings of an economy into investments and lead to increased income, employment and output for the country. In a developing country like Pakistan, the importance of capital market cannot be over emphasized.

Pakistan needs a security exchange that facilitates capital formation by bringing together issuers and investors. This exchange should enjoy the confidence of all participants who should regard is as fair, efficient and transparent. This exchange functions in line with international best practices and be internationally competitive so that it can also attract listing and capital from abroad.

Pakistan's economy is growing and economic factors are improving. The primary market is showing signs of recovery after many years of inactivity. The Government of Pakistan has embarked on a privatization program, which is successfully using the capital market. Economic growth offers opportunities for Pakistan's stock exchanges. These are opportunities that the country cannot afford to lose. To capitalize on these opportunities, the problems facing the exchanges have to be effectively addressed. So the issue was raised for demutualization of stock exchanges in Pakistan, which will be compared with international scenario in this research.

1.1.2 Evolution:

Globally, stock exchanges have undergone radical changes over the last twenty years. Technological developments have made it possible for a single exchange to provide geographically neutral trading, custody and settlement services throughout a country regardless of its geographical spread. This has resulted in a string of integration and alliances of exchanges in many parts of the world. Technological developments have also enable successful operation of alternative trading systems ECN's (Electronic Communication Network) that have the potential of replacing the traditional exchanges.

Due to technological advancements and globalization, investors and issuers have greater freedom to move to markets that are more competitive. To be able to compete with other exchanges alternative trading systems and ECN's in terms of efficiency and fairness, stock exchanges need access to economic capital as well as an efficient decision making structure. At the same time, there have been increasing demands from regulators and the public that stock exchanges raise their standard of governance and provide equitable representation to all stakeholders in ownership and management.

1.1.3 International scenario[1]:

Starting in the early 1990s, stock exchanges around the world have been undergoing major organizational and operational changes. One of the most visible changes has been the trend toward demutualization—the process of converting exchanges from non-profit, member owned organizations to for-profit, investor-owned corporations. In 1993, the Stockholm Stock Exchange became the first exchange to demutualize. Several others, including the Helsinki Stock Exchange in 1995, the Copenhagen Exchange in 1996, the Amsterdam Exchange in 1997, the Australian Exchange in 1998, and the Toronto, Hong Kong, and London Stock Exchanges followed it in 2000.

In some cases, the demutualized exchanges have taken the further step of becoming publicly traded companies. For example, following a demutualization process that began in 1996, the Australian Stock Exchange issued shares to the public and began listing on its own exchange in 1998. And shares of the London Stock Exchange, which converted

[1] *Demutualization and Corporate Governance of Stock Exchanges*

into a for-profit corporation in June of 2000, became fully listed in July of the following year.

TABLE 1

Demutualized Exchanges	
Stockholm Stock Exchange	1993
Helsinki Stock Exchange	1995
Copenhagen Stock Exchange	1996
Amsterdam Stock Exchange	1997
Borsa Italiana	1997
Australian Stock Exchange	1998
Iceland Stock Exchange	1999
Simex	1999
Athens Stock Exchange	1999
Stock Exchange of Singapore	2000
Hong Kong Stock Exchange	2000
Toronto Stock Exchange	2000
London Stock Exchange	2000
Deutsche Börse	2000
Euronext	2000
London Stock Exchange	2000
The Nasdaq Stock Market	2000
Chicago Mercantile Exchange	2002

1.1.4 The Process:

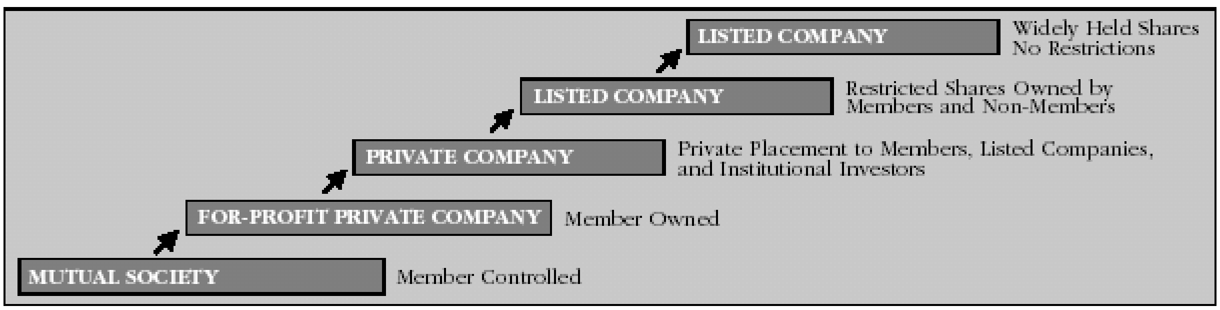
As stated earlier, demutualization is the process of converting a non-profit, mutually owned organization to a for-profit, investor-owned corporation. The members of mutually owned exchanges--that is, broker dealers with "seats" on the exchange--are also its owners, with all the voting rights conferred by ownership. [3] In contrast, a demutualized exchange is a limited liability company owned by its shareholders. Trading rights and ownership can be separated; shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange. And as discussed later, although demutualized exchanges will continue to provide many if not most of the same services, they will have different governance structures in which outside shareholders are represented by boards of directors.

As summarized in the Figure, the process of demutualization takes place in stages and can ultimately take several different forms. In the first phase, the members are typically given shares in and so become legal owners of the organization. Then or in some cases even as art of phase one, the organization raises capital through a private placement, typically from outside investors as well as members. Having thus become a privately owned corporation demutualized exchanges then has two basic options:

(1) The exchange can stay private
(2) The exchange can list and remove all restrictions on trading

FIGURE 1

FIGURE 1 ■ THE PROCESS OF EXCHANGE DEMUTUALIZATION



As of this writing, both the Toronto Stock Exchange and NASDAQ have demutualized but remain private companies. But for many exchanges, the private placement is clearly just an interim step. As mentioned earlier, in 1998 the Australian Stock Exchange became a publicly traded company with shares listed and traded on its own exchange. And the London Stock Exchange, after demutualizing in June 2000, completed the same transformation to public ownership (though during the interim period, trading in LSE shares was conducted through an off-market trading facility). Other exchanges that have become publicly traded companies include the Deustche Börse, Oslo, Hong Kong, and Singapore Stock Exchanges. Rather than become a standalone company, a demutualized exchange can also become a wholly owned *subsidiary* of a publicly traded company. For example, after demutualizing in 1993, the Swedish Stock Exchange became a subsidiary (called the OM Stockholmsbörsen AB) of the OM Group, a publicly traded and listed company. Many exchanges continue to have some ownership or voting restrictions after demutualization, Ownership or voting rights are typically limited to 5%.

1.1.5 Present status:

Presently Pakistan is having three stock exchanges in three different cities to make up the capital market of Pakistan.

1) KSE (Karachi Stock Exchange)
2) LSE (Lahore Stock Exchange)
3) ISE (Islamabad Stock Exchange)

KSE present status

TABLE 2

Listed Companies	659
Listed Capital Rs	438,489.99
Market Capitalization	2,068,187.15
New Companies Listed	9

LSE present status

TABLE 3

Market Capitalization	1.995 trillion
Number of listed companies	555

ISE present status

Number of listed companies range from 200 to 220.

PRESENT STATUS OF DEMUTUALIZATION:

Presently SECP is working with the members of stock exchange to negotiate with them. The main issue of treating the KSE members as per their worth is being recognized. Now

SECP has come up with a five year plan, in which they will first give Rs. 30 mn worth shares to each KSE members and after one year half of these shares i.e. Rs. 15 mn worth shares from each member will be sold out to the general public through listing the new stock exchange.

1.2. STATEMENT OF PROBLEM:

There are some problems related to the stock exchanges as three different identities.

1) Despite economic growth in the country, companies are not seeking listing at the exchanges and little capital formation is taking place through stock exchanges. Issuers do not appear to have confidence in stock exchanges and see minimal value addition in listing. There is limited free float I the market and it is coming under increasing pressure due to a disproportionately large growth in mutual fund.
2) Due to existence of three exchanges, liquidity and price discovery are fragmented and costs escalate for all stakeholders. There is virtually no competition among exchanges and KSE is the dominant exchange in all market segments.
3) The management of settlement risk is weak and needs improvement.
4) KSE the dominated market, has been unable to maintain the confidence of investors, it is because of lack of management system.

1.3. SIGNIFICANCE OF STUDY:

This study will bring into account the international scenario of demutualization of stock exchanges and it will help SECP, the management of three stock exchanges of Pakistan and the Investors.

1.4. SCOPE:

The research will consider the data up to 30 June 2005. The changes in regulation after this date will be ignored.

1.5. DELIMITATIONS:

Any changes in the regulation regarding the demutualization of stock exchanges after 30 June 2005 will not be considered in this report.

1.6. DEFINITION OF TERMS:

CDC Central Depository Company of Pakistan

CDS Central Depository System

NE National Exchange

ECN Electronic Communication Network

SECP Securities & Exchange Commission of Pakistan

NCEL National Commodity Exchange Limited

ASIC Australian Securities and Investment Commission

FIDE Fully Integrated Demutualized Exchange

DEMUTUALIZATION is a process that converts a not-for-profit company, often limited by guarantee, into a for-profit company limited by share, thus separating the trading rights from ownership rights.

Chapter2: Research – Methodology & Procedures:

2.1. RESEARCH DESIGN:

The research paper is mainly based on the secondary data. The requirement of the data for this research will be gathered from different sources. This is an exploratory research, as in this the problems regarding the demutualization of stock exchanges of Pakistan are highlighted.

2.2. RESPONDENTS OF THE STUDY:

This research is directly related to the three stock exchanges of Pakistan i.e. KSE, LSE and ISE. SECP being the regulator is the main concern with this study. Broker community is the mainly effected party of this issue and the study can bring awareness among the respondents with the help of international scenario analysis.

2.3. RESEARCH INSTRUMENTS:

The research instruments that will be helpful in extraction of data are Internet, books, newspaper and magazines. Interviews will be conducted with the broker community, which can help me derive the conclusion.

2.4. TREATMENT OF DATA:

The gathered data for the Pakistan will be comparatively analyzed with the internationally demutualization process. The demutualization is becoming very popular these days because of two reasons, which are Technology and Globalization. So, these upcoming trends will help me doing the comparative analysis.

2.5. PRESENTATION ANALYSIS:

The presentation of the research analysis will be in the form of graphical representation. This graphical presentation will be helpful in comparative analysis.

Chapter 3: REVIEW OF THE LITERATURE & STUDIES:

3.1 RELATED LITERATURE:

3.1.1 LOCAL LITERATURE:

3.1.1.1 PROBLEMS OF STOCK EXCHNAGES IN PAKISTAN[2]:

Pakistan's capital market has undergone some developments but it continues to reflect some serious weaknesses and problems, which needed to be addressed to achieve materialization of the full potential of the market and to ensure that the market plays its economic role effectively. Where we discuss some of these problems:

- ***INSUFFICIENT GROWTH IN MARKET CAPITALIZATION:***

Stock exchanges have not been able to ply their due role in capital formation.

Market capitalization is below International Benchmark, which is 100% of the Gross Domestic Product.

Too few listing, the number of new listed from Jan 1999 to May 2004 was only 17 along with 36 companies got delisted.

Low quality of many listed companies they are low in terms of governance and financial performance.

[2] *Demutualization and Integration/Transformation of Stock Exchanges*

Limited free float and supply-demand imbalance as most pf the listed companies are tightly held.

- ***NARROW BASE OF INVESTORS:***

Investors are the most important stakeholders in any stock exchange, but in our countries it is very narrow.

Minimal share ownership, as the number of shareholders in the country is less than 1% of population and out of them very few are active.

Stagnation in number of shareholders, the number of share holders is stagnant as there is very minimal growth in it.

Small number of unit holders in mutual funds, in some past years there is increase in number of mutual funds but even this can't help improve the investor base.

Lack of the market awareness, most of the Pakistanis is unaware of the capital market and there are no measures to educate investors.

Public offers essential to broad investor base, initial public offering for the privatisation of companies can be helpful in broadening the investor base.

- ***LACK OF BALANCE IN GOVERNANCE STRUCTURES:***

Weak professional management, professional management at the exchanges has not been encouraged by the members.

Ineffective regulation of members, members are unwilling to take any disciplinary action against other members.

Ineffective regulation of listed companies, due to governance problems and poor perception, listed companies are unwilling to accept stock exchange as front line regulators.

Unequal access to corporate announcements, all the investors are not able to get equal access to the announcements.

Mixed performance of nonmember directors, as nonmembers performance is not up to the mark.

- ***FRAGMENTATION OF MARKET:***

Division of liquidity and distortion of price discovery, as it has fragmented the liquidity pool.

Cost inefficiency for all stakeholders, three stock exchange existence increase the cost of operation for each of them.

Complexity in operations, difference in regulations and operations bring complexity .

Inadequate investor protection, investors are not satisfied with the degree of protection received from the stock exchanges.

- ***WEAK MANAGEMENT OF SYSTEMIC RISK:***

Management of systemic at the exchanges remains weak. Despite use of a set of a variety of risk management measures, none of the three exchanges provides full notation.

The design and enforcement of risk management measures can be improved. Margins are not based on volatility and liquidity of outstanding positions. The clearinghouse protection fund and investor protection fund are not fully funded.

- ***INSUFFICIENT ECONOMIC CAPITAL:***

Limited revenues, the financial statements of the exchanges show that all three exchanges are in weak financial health.

Inequitable burden sharing, internationally exchanges derive most of their income from trading related service charges and listing revenues are a relatively small part of their total income, while in Pakistan exchanges are having most of its revenues based on listing revenues.

Low level of capital expenditure, due to lack of efficient income and reserves, exchange are short of funds to meet their capital expenditure needs.

No financial guarantee, the liability of members, in case of winding up of each exchange is limited to Rs. 1000, which is often misinterpreted by the word "Guarantee".

- ***INSUFFICIENT HUMAN CAPITAL:***

The exchanges in Pakistan do not have sufficient human capital.

Few professionals, perception of weak governance and inadequate managerial compensation are keeping good professionals away from stock exchanges.

Inability to develop new products and services, due to insufficient human capital the exchanges have not been able to develop new products.

- ***HIGH DEGREE OF SPECULATION AND CONCENTRATION***

Low level of actual settlement, the settlement by delivery is estimated to be less than 10%.

Concentration of liquidity and market capitalization, top 10 companies at KSE account for 49% of the market capitalization.

Dominance of the financing, the amount of CFS is fully utilized of the last 5 months which is Rs. 25 billion.

Excess volatility, narrowness of market, manipulation, liquidity concentration and Financing has added excess volatility to the market.

- ***LARGE NUMBER AND LOW QUALITY OF INTERMEDIARIES:***

Weak criteria to become a member, by laws of KSE only mention a set of negative grounds of ineligibility and no certification requirements have been prescribed.

Weak criteria to become an agent or trader, no requirement of certification for the agents and also there is no requirement of registration of traders with the Commission.

Barrier to entry to new intermediaries, heavy investment creates the barrier for the entry into the exchanges.

Membership card treated as real estate, the percentage of inactive members is KSE 21%, LSE 44% and ISE 66% which shows that the card is treated as source of capital gain.

Low capitalization of brokers, every member has to have a specified minimum net capital balance according to the securities and exchange rules.

Single classes of brokers, all brokers are clearing brokers regardless of their capital balance, which is in contrast with the international markets.

3.1.1.2 DEMUTUALIZATION:

Demutualization is usually defined as a process that converts a not-for-profit company, often limited by guarantee, into a for-profit company limited by share, thus separating the trading rights from ownership rights. This, however, is only a technical definition because if shares of a demutualized exchange are only held by brokers, then for all practical purposes it would remain a mutual body.

Demutualization is better thought of as a process that brings about balance among interest of different stakeholders in the corporate and governance structure of a stock exchange. It provides the exchange with a for-profit motive and access to economic and human capital to develop business.

- ***CONCEPT:***

The concept of demutualization has already been introduced in Pakistan. The NCEL, incorporated in 2002, was set up as a company limited by shares in which trading rights and ownership rights are not linked. KSE, LSE, and ISE own 40%, 10%, and 10% of shares in the NCEL. The structure reflects recognition of the fact that from the governance point of view, demutualized structure is preferable.

Two other companies, related to stock exchanges, the CDC and the NCC, are also companies limited by shares and KSE, LSE, and ISE own more than 50% of shares in these two companies.

- ***ADVANTAGES OF DEMUTUALIZATION:***

Advantages of demutualization in the context of our exchange.

- ***Better governance structure:***

Demutualization would restructure governance at the stock exchanges on a sustainable basis. The ownership rights and trading rights would be de-linked. It would increase the role of non-member stakeholders in the affairs exchange.

- ***Access to Economic Capital:***

A demutualized exchange should be able to raise capital from many sources as a normal for-profit public limited company. An important source of economic capital would be the new shareholders, institutions and individuals. This access to economic capital would allow large investments required in the technological infrastructure to broaden access to the market.

- ***Access to Human Capital:***

With better governance structures and access to economic capital, exchanges should be able to attract highly qualified and competent management professionals. With the induction of these professionals, the management practices and culture should change and the exchange would be able to introduce new products and services.

- ***Profit Motive for Growth and Development:***

There would be sustained pressures on the exchange to grow, develop its business and to increase its profitability. It should serve as strong incentive for increasing liquidity in the market and introducing new products.

- ***Removal of Barrier to Entry for New Brokers:***

In a demutualization exchange, trading rights would be given ion the basis of qualifications. There would be no0 ceiling on the maximum number of trading rights thus removing scarcity value of a membership card. Trading rights would be non-transferable and would be granted by the exchange.

- ***Unlocking of Value of Membership Cards:***

Demutualization would separate the trading rights from ownership rights. Members would be able to retain their trading rights and be free to sell shares of demutualized exchange. Currently, a member cannot sell his membership card without foregoing his trading rights. Demutualization would unlock the value of membership cards for all members without loss of trading rights. They may invest these proceeds to upgrade their business.

- ***Greater Ability to Attract Listings:***

With an improved perception and availability of wider range of products and services, a demutualized exchange would be well placed to attract listings and facilitate capital formation.

- ***Domestic and International Recognition:***

Demutualization should lead to domestic and international recognition. A demutualized stock exchange would be an open and transparent company. This would help improve the perception of exchanges and enhance confidence of domestic and international investors.

- ***Ability to Make International Alliances***:

A demutualized exchange should be able to enter into alliances with other stock exchanges through equity swaps.

3.1.1.3 INTEGRATION:

Integration means consolidation of the three exchanges through merger. During the consultative process, the Committee has found that most of the stakeholders are of the view that existence of multiple stock exchanges in Pakistan is a core problem. The stakeholders in favor of integration of stock exchanges have put forward a number of arguments in favor of consolidation of three stock exchanges into a single exchange.

- ***SCENARIO ANALYSIS:***

The Committee considered many different scenarios of demutualization and integration to determine as to which scenario best addresses the problems facing the stock exchanges. Some of these scenarios are described below.

- ***If KSE, LSE, & ISE neither Demutualize nor Integrate***

If status quo were maintained, market would continue to suffer from both a mutual structure and a fragmented market. In that event, it would be essential to set up a new demutualized national exchange to serve the interests of investors.

- ***If KSE, LSE, & ISE Demutualize but do not Integrate***

Given their smaller size, LSE and ISE might find it difficult to undergo demutualization independently and attract new investors without a merger. If somehow the three stock exchanges demutualized independently and do not merger, there would be fierce competition among them that would aggravate the problems of market fragmentation to the disadvantage of all stakeholders. LSE and ISE may find it even more difficult to compete with the dominant KSE. It is likely that out of commercial considerations, some consolidation may take place in the long run. On the whole, this scenario does not seem desirable or feasible.

- ***If LSE & ISE Merger and Demutualize and KSE does neither***

The mutual structure prevalent at KSE would be not allow it the flexibility in decision making and the access to capital required for technological up gradation in order to effectively compete with the new stock exchange. The value of membership's cards at KSE is likely to fall sharply. In the long run, KSE would have to consider both demutualization and integration for its survival.

- ***If LSE & ISE Merger and Demutualize and KSE Demutualizes***

There would be very strong inter-exchange competition in this scenario. The market may see considerable expansion in products, services, and turnover but the problems of fragmentation would be aggravated to the disadvantage of all stakeholders. The integrated LSE and ISE might have to specialize in the derivatives, debt, or small-cap OTC market because competition with KSE in the regular market would be difficult. Given the commercial benefits of integration, the two exchanges may merge in the long run. This scenario is feasible but due to implication of fragmentation of market, it is not desirable.

- ***If KSE, LSE, & ISE Integrate but do not Demutualize***

The problems of market fragmentation would be resolved but the problems of mutual structure would remain. Access to economic and human capital would be limited and the problems of governance would continue. In this situation, it would become necessary to set up another demutualized stock exchange that would be better placed to serve the investors. It is likely that there would be intense competition in the short run but in the long run, the two exchanges may merge due to commercial considerations.

- ***If KSE, LSE, & ISE Demutualize and Integrate***

The demutualized and integrated exchange shall be well placed to develop the market and serve the economy. The market would not suffer from the problems of a mutual structure or a fragmented market. However, there would not be inter-exchange competition. If the concern about absence of competition can be addressed, then this scenario shall best meet the interest of all stakeholders.

3.1.1.4 RECOMMENDED MODEL BY SECP:

The SECP committee has recommended two alternate models, which are compared as below:

COMPARISON OF CURRENT & RECOMMENDED STRUCTURES

TABLE 4

	Current	*FIDE*	*NE*
Number of Exchanges	3	1(subject to the need to license another stock exchange)	4(KSE, LSE, ISE and NE) the number may reduce due to subsequent mergers, if any
Corporate Structure	Not –for- profit public companies limited by guarantee, without share capital	A listed for-profit public company Limited by shares	A listed for-profit public company Limited by shares
Number of Shareholders	Members are implicitly owners of the exchange and membership is	No upper or lower ceiling on number of shareholders	No upper or lower ceiling on number of shareholders

	restricted to 200		
Types of Shareholders	Do	Financial institutions, general public, former members of KSE, LSE, and ISE.	Financial institutions and general public.
Election of Directors	Through Annual General Meeting on a one-member one vote-basis	Through Annual General Meeting on a one-member one vote-basis	Through Annual General Meeting on a one-member one vote-basis
Number of Trading Right Holders	Limited to the number of members of stock exchanges registered with the SECP as brokers	Members of KSE, LSE, and ISE during the moratorium period. Afterwards, any number of persons that meet the criteria of FIDE and are registered with the SECP as brokers.	Any number of persons that meet criteria of NE and are registered with the SECP as brokers.
Types of Members of Clearinghouse	All members are trading members as well as clearing members	Two types, Trading-only and Trading & Clearing members	Two types, Trading-only and Trading & Clearing members
Sources of revenue	Listing fee, service/laga charges on transactions etc	Transaction charges/Laga, information services, clearing and settlement fee, listing fee, custody fee, other business ventures etc	Transaction charges/Laga, information services, listing fee, other business ventures etc
Access to Economic Capital	Restricted due to not-for-profit mutual structure	All channels, including capital market, available to a listed public company shall be available to FIDE	All channels, including capital market, available to a listed public company shall be available to NE
Room for making international alliances through equity stakes	None	FIDE would be well placed to enter into alliances with international exchanges	NE would be well placed to enter into alliances with international exchanges

Maximum number of Trading Rights	Maximum number of trading rights in an exchange are limited to maximum number of members in that exchange, i.e. 200	After the moratorium period, there would be no cap or floor on number of trading rights	There would be no cap or floor on number of trading rights
Transferability of Trading Rights	Transferable- can be freely sold or purchased from members or exchanges, as applicable	Transferable during moratorium period. Non- transferable after moratorium period and given by FIDE based on qualification	Non- transferable given by NE based on qualification
Status of CDC	A public company limited by shares that is owned by KSE, LSE, and ISE and other financial institutions.	A public company limited by shares that shall be a partially owned subsidiary and service provider of FIDE	CDC shall be a service provider to the NE just as it is a service provider to the existing stock exchanges
Status of NCC	A private company limited by shares that is owned by KSE, LSE, and ISE and other financing institutions and acts a service provider to the existing exchanges	A private company limited by shares that would be a partially owned subsidiary of FIDE and act a service provider to FIDE and other institutions, if desirable and feasible	A private company limited by shares that shall be a service provider to the NE just as it is a service provider to the existing stock exchanges
Composition of the board	A total of 10 directors; 5 directors are elected by members, 4 are nominated; Managing Director is a director by virtue of his office	A total of 10 directors; 6 are elected by shareholders, 3 are nominated by SECP; Managing Director is a director by virtue of his office	A total of 10 directors; 6 are elected by shareholders, 3 are nominated by SECP; Managing Director is a director by virtue of his office
Chairman of the board	Members, usually an active broker	Not associated with brokerage business	Not associated with brokerage business
Tenure for a Director	1 year	3 years	3 years
Broker Committees	A number of broker committees are used by exchanges	No broker-committees would share any direct or	No broker-committees would share any direct or

	as supplementary decision making bodies	indirect role in decision-making. User forums may be established by the FIDE for on-going feedback on services	indirect role in decision-making. User forums may be established by the NE for on-going feedback on services
Management of systemic risk	Responsibility of the exchanges	Responsibility of the NCC	Responsibility of the NE
Ceiling on Shareholding	Not applicable	A broker should not be allowed to exercise voting rights of more than 1% of total voting rights in a general meeting. Those who do not have trading rights in FIDE and are not associated with those holding trading rights should not hold more than 5% of voting shares without prior approval of the SECP.	A broker should not be allowed to exercise voting rights of more than 1% of total voting rights in a general meeting. Those who do not have trading rights in NE and are not associated with those holding trading rights should not hold more than 5% of voting shares without prior approval of the SECP.

3.1.2 FOREIGN LITERATURE:

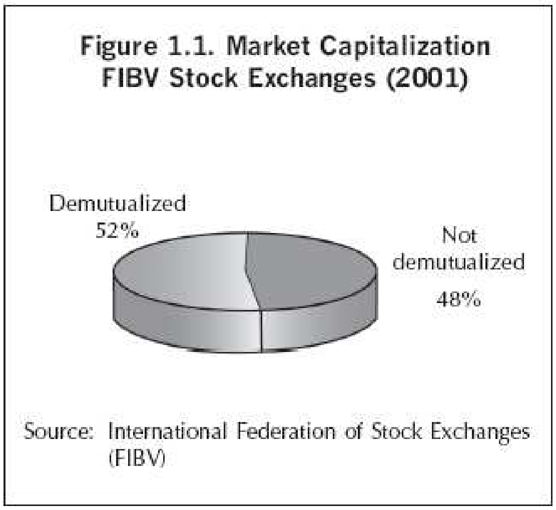
3.1.2.1 DEMUTUALIZTION INTERNATIONALLY[3]:

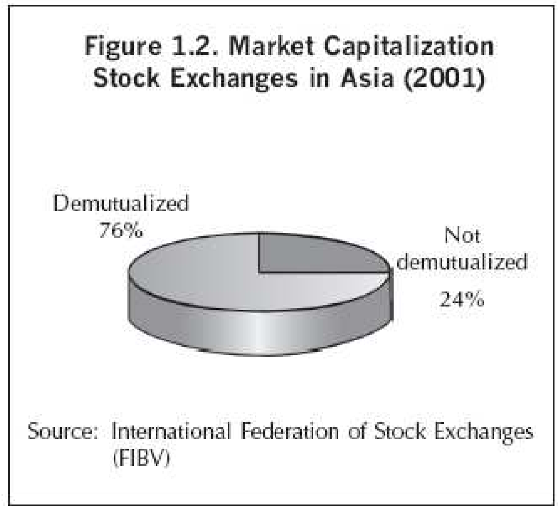
Demutualization, in the strictest sense, refers to the change in legal status of the exchange from a mutual association with one vote per member (and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making). Demutualization makes sense if it induces a change in the exchange's objective from managing the interests of a closed member-based organization with a central focus on providing services for the benefit primarily of the members/brokers and keeping costs and investments limited to financing agreed by members, into a company set up with the objective of maximizing the value of the equity shares by focusing on generating profits from servicing the demands of their customers (brokers and investors) in a competitive manner.

The number of exchanges that have privatized or listed has been increasing since the Stockholm Stock Exchange demutualized in 1993. In 1999, 11 stock exchanges had been privatized or listed and this number rose to 21 by early 2002, with several other exchanges either considering demutualization or already having stated their intent to do so. Of the World Federation of Stock Exchanges-formerly the International Federation of Stock Exchanges (FIBV)-member exchanges, around 52% of stock market capitalization is accounted for by demutualized exchanges. In Asia, demutualized stock exchanges including the Tokyo Stock Exchange now account for 76 % of the region's market capitalization.

[3] *Demutualization of Asian Stock Exchanges—Critical Issues and Challenges*

FIGURE 2





3.1.2.2 REASONS FOR DEMUTUALIZATION[4]:

- **Rationalized Governance**

The mutual association model functions well if an exchange is a provider of trading services with limited competition and the interests of members are homogeneous. If greater competition exists and the interests of members diverge from one another and from the exchange, the mutual governance model ceases to function well. Consensus decision-making becomes slow and cumbersome. The exchange is unable to respond quickly and decisively to changes in the market.

[4] *Background Information on Demutualization*

The product of a stock exchange demutualization is, ideally, a corporation that operates in a more customer-focused manner and is able to respond more easily and quickly to changes in the business environment and meet competitive challenges.

The corporate model will enable management to take actions that are in the best interests of customers and the exchange itself. With the separation of ownership and trading privileges, an exchange will achieve greater independence from its members with respect to its regulatory functions. Owner's interests will be aligned with those of the exchange—both will seek to maximize the profits of the exchange. In a governance structure in which consensus need not necessarily be reached and owners will be able to influence decision-making, strategic decisions will be able to be made by management in a much more efficient manner. One of the great advantages of a corporate structure versus a mutual or co-operative one is the requisite degree of transparency. Demutualized exchanges will be forced to account to their shareholders not only regarding the bottom line, but also regarding issues arising in corporate governance.

- **Investor Participation**

The new corporation will be more profit-oriented due to shareholder accountability. However, in today's competitive environment, a stock exchange must be responsive to the needs of its many stakeholders, including participating organizations, listed companies, and institutional and retail investors. Exchanges may perceive a need to shift power within the exchange from one group of members to another and to afford institutional customers direct access to exchange facilities. Separating exchange membership from ownership may be a politically and economically feasible way to affect such a shift and resolve conflicts of interest between exchange members and between exchanges and their members.

Unlike a mutual structure where often only broker-dealers may be members, a demutualized exchange affords both institutional investors and retail investors the opportunity to become shareholders. The assets managed by institutional investors have grown significantly in recent years and the trading needs of institutional investors differ dramatically from those of retail investors. In particular, institutional investors have a strong preference for anonymity when they are affecting large block trades. Institutional investors also require much greater liquidity to accommodate block trading and place far more emphasis on negotiating the lowest price. A demutualized exchange will have greater flexibility to accommodate the needs of institutional investors as customers, and potentially, as owners.

- **Competition from ATSs and Upstairs Trading**

The threat of competition from alternative trading systems (ATSs) has forced traditional exchanges to examine their role as trading arenas and to take measures that facilitate more competitive future strategies.

An ATS is a privately operated computerized system that performs many of the functions of an exchange by centralizing and matching buy and sells orders and providing post-trade information. They are often operated by exchange members or member-affiliates and are similar to exchanges because they allow two participants to meet directly on the system and are maintained by a third party who also serves a limited regulatory function by imposing requirements on each subscriber.

Although some ATSs have been in operation for many years, technological advances, trading value increases and pressures on trading profits have enabled some of them to become serious competitors to exchanges. The US Securities and Exchange Commission (SEC) became concerned that ATSs would impair the fair and orderly functioning of markets. In December 1998, SEC implemented the Regulation ATS that permitted ATSs to continue to be regulated as broker-dealers, but required them to comply with rules designed to improve transparency and surveillance, as well as systems capacity, integrity and security of ATSs. The Canadian Securities Administrators have also proposed a rule governing ATSs.

Many broker-dealers have internal systems to automate the firm's execution of customer orders, particularly firms that internalize or purchase order flow. These systems are not generally considered ATSs because all trades affected on internal systems, generally referred to as "upstairs trading," involve only the operator of the system and not external parties. Upstairs trading occurs when a stock exchange member matches customer orders against other customer orders or against its own inventory position within the firm, rather than exposing the order to auction on the exchange. The market only learns of the trading activity after the fact.

In Canada, upstairs trading has been on the rise as a result of several factors, among them regulatory changes in he 1970s and 1980s that permitted investment dealers to trade as principals and to internalize orders. Consolidation of investment dealers and their willingness to commit capital to facilitate trades have improved the services offered. As trading moves away from the central order book of a traditional exchange, the exchange's ability to maintain sufficient liquidity is impaired. Block trades in the upstairs market account for the majority of the volume and value of the transactions on the TSE.

Although traditional exchanges offering bundled services may offer scale and liquidity advantages, there is a growing role for specialty, niche player exchanges. It is unclear how demutualization will improve the competitive position of traditional exchanges against ATSs. However, it is unlikely that traditional exchange business models, offering more integrated services than ATSs, will become obsolete so long as they remain competitive in terms of price, variety and quality of their services.

- **Globalization and Consolidation**

Historically, brokers and exchanges were locally focused. Exchanges did not face meaningful competition from exchanges in distant places. National exchanges developed when the telegraph and telephone made it easier to deal on a distant exchange.[9] Modern telecommunications have enabled issuers and investors to access foreign capital markets. As nationality has become less of a defining characteristic of capital markets, global centers have grown in importance, and the relevance of national exchanges has been challenged. This challenge is more acutely felt in relatively small home markets such as Canada. Today, either the New York Stock Exchange or the NASDAQ Stock Market (NASDAQ) is the major market for 88 Canadian-based TSE listings.

Strategic alliances and consolidations are also affecting capital markets and exchanges globally. Mergers among stock and derivative exchanges in the US are redefining North America's competitive landscape and creating super-exchanges. The merger of NASDAQ and the American Stock Exchange (Amex) for instance, created an exchange with a market capitalization of US$1.9 trillion offering an unprecedented variety of products. Alliances and consolidation are also occurring in Europe (Euro next, for example) as well as in other parts of the world. These alliances are motivated by a variety of factors. Scale is increasingly important, particularly in leveraging technology costs and other investment opportunities. Through alliances, exchanges seek to attract more investors by harmonizing distinct trading environments and by offering greater product variety. Alliances are a means of pursuing the conventional wisdom that "liquidity attracts liquidity."

- **Resources for Capital Investment**

A competitive stock exchange must be able to respond quickly to global competitive forces and technological advances. With the capital raised from an Initial Public Offer (IPO) or private investment and a heightened awareness of accountability to stakeholders, a stock exchange should have both the incentive and the resources to invest in the competitiveness of its information systems. To be competitive, products and services must not only be timely and cost-effective, but also reliable. One of the drivers of stock exchange demutualization is screen trading, which has replaced floor trading on most exchanges. Once customers have direct access to screens, exchange memberships no longer have as much economic value and clearing firms rather than traders become a dominant force in exchange activities. Also, the move from floors to screens has required considerable capital investment. Demutualization offers an opportunity to buy out trader interests since they are no longer necessary and shift power to other firms, while raising capital for continued modernization of trading information systems. Continued investment in technology may serve as an effective way to meet competition from ATSs and upstairs trading as well as justifying the scale of the traditional integrated exchange model.

3.1.2.3 ADVANTAGES FOR PUBLIC OWNERSHIP:

Here are some two major advantages for the exchanges as public ownership:

- An IPO and the capital it provides will allow exchange to continue to improve its market by allowing exchange to compete effectively with domestic and international competitors, facilitating the exchange sale of its remaining equity ownership, and creating a liquid acquisition currency for exchange.

- An IPO will provide a valuation benchmark and liquidity for current investors. An IPO will allow exchange to control the development of the trading market for its stock. Exchange interest will be aligned with the interests of key participants. Exchange will have both an initial infusion of capital and easier ongoing access to capital.

3.1.2.4 ISSUES RELATED TO DEMUTUALIZATION[5]:

- **Ownership**

The nature of the ownership issues confronting an exchange changes when the exchange is transformed from a mutual to a for-profit company.

  - ***Ownership Issues Faced by Mutual***

[5] *The Structure of a Demutualized Exchange — the Critical Issues*

Mutual stock exchanges arose out of the need for stockbrokers to provide a means of quality assurance for individuals contemplating investment in the securities of local companies. Stock exchanges supervised the activities of brokers, and the mutual form of ownership helped to ensure that brokers were judged reasonably—which is to say, by their peers—and that the livelihoods of brokers were protected.

Competition faced by exchanges has increased markedly in the last decade. Local companies and investors are now able to switch between markets, relatively easily; and there is now a much greater and more urgent need for exchanges to think and act strategically and to adapt quickly to changing circumstances.

- ***Additional Ownership Issues Faced by For-Profit Exchanges***

The introduction of share ownership can help to address the shortcomings associated with a mutual structure noted above: it is a powerful catalyst for change but it is not, of itself, a sufficient condition to ensure that change occurs. It is possible, for example, for brokers to convert the form of ownership of the exchange to shares—to become shareholders— but for there to be no market for the shares. The result, inevitably, would be that little changes other than ownership by shares.

- ***Foreign Ownership***

Another ownership issue that presents itself is whether, given the important role that exchanges play in capital formation, allocation and redistribution—and hence domestic employment and savings—there should be any restrictions imposed on foreign ownership.

- **Corporate Governance**

In all issues concerning corporate governance, a stock exchange, as the body that supervises listed company behavior, may be viewed as a 'standard setter' for other listed companies—and this is so whether an exchange is demutualized or not. It is, therefore, appropriate that an exchange board embody what are generally accepted to be sound principles of corporate governance. In this regard, reference should be made to local corporate governance guidelines if they exist, and in any case to the Organization for Economic Co-operation and Development's (OECD's) corporate governance principles, which provide common elements of good corporate governance. The latter principles can be adapted to reflect local economic, social, legal and cultural circumstances.

- ***Board Appointments***

Demutualization will typically involve a fundamental change in the way that board members are appointed. When ASX was a mutual, its constitution required that a majority of directors comprise broker-appointed "member directors" and that:

(i) Member directors be elected by a ballot of members on the basis of one vote per member; and
(ii) The board includes Member Directors from each State within the Commonwealth of Australia.

- ***Board Representation***

It has been suggested by some commentators that an exchange's board should include representatives from major interest groups, such as investor and company director associations.

- ***Board Committees***

In Australia it is normally regarded as good corporate governance practice for boards to establish audit, nomination and remuneration committees, and for such committees to:

(i) be comprised of a majority of independent directors;

(ii) have an independent director as a chairperson; and

(iii) have clearly defined terms of reference.

- ***Share Dealing Rules for Directors and Managers***

Given an exchange's market position and the role that it plays in the community, even a suggestion of insider-trading by a director or staff member can do great harm to the individual as well as to the exchange, irrespective of whether insider-trading actually took place or is proven. It is therefore essential that a demutualized exchange put in place arrangements for directors, management and committee members where relevant, which govern transactions by them in the exchange's own securities. These arrangements should be made public, in order to enhance confidence in the governance of the exchange.

- ***Continuous Disclosure Procedures***

It is also very important for an exchange to lead best practice in the continuous disclosure of information relevant to the making of investment decisions in its securities. It is accordingly beneficial to put in place procedures to ensure that material information is released to the market in a coordinated and efficient way.

- ***Accountability and Transparency of Supervisory Decision-Making***

Demutualization places a spotlight on the ability of the exchange to quarantine and protect regulatory or supervisory information, to discharge its supervisory responsibilities with integrity and impartiality and to effectively manage conflicts which arise between its supervisory responsibilities and commercial aspirations.

This requires an exchange to review its policies and procedures for supervisory decision-making and ensure that they best promote transparency and accountability.

- **Access Rights**

Demutualization involves the separation of ownership rights from customer or access to market facility rights. Complexities arise where the trading rights are in the form of seats.

Where seats exist, an exchange in the process of demutualizing will need to decide whether these should continue to exist after demutualization; and if it should be decided that seats are not to continue, what (if any) compensation should be paid to holders. Where there is recent experience of trading participants paying large amounts for seats in the home market, it may be necessary, in order for demutualization to be approved by exchange members, either to continue to allow seats to exist6 or for the exchange to pay compensation to brokers for loss of transferability of their trading rights.

- **Risk Management**

Risk is an unavoidable aspect of all organizational activity and therefore the characterization of organizational risks should be a key annual activity for an exchange. An exchange's board should set the framework for the management of organizational risk including the level of risk allowable in certain activities or projects. To assist it in fulfilling its responsibilities, a board should consider establishing a risk management committee.

- **Financial Management**

    - ***Sources of Funds***

A mutual exchange may have the power to levy assessments upon its members in order to obtain debt finance. A demutualized exchange has broader avenues open to it for raising capital, notwithstanding that, unlike the levying of mutual members; shareholders have no financial liabilities beyond their fully paid-up shares.

- ***Investor Expectations***

The process of demutualization and listing brings with it investor expectations concerning financial management and performance. These expectations will have a major impact on the financial policies adopted by an exchange.

- ***Financial Governance***

An exchange's board is directly responsible for financial governance of the entity. The board sets the financial policies that guide the Chief Executive Officer in his/her financial management. These policies address matters such as budgeting criteria, day-to-day financial management, protection of assets, employee remuneration and benefits, investment practices and financial reserves.

3.1.2.5 CASE STUDIES:

- **AUSTRALIAN STOCK EXCHANGE[6]:**

- **Introduction:**

The Australian Stock Exchange (ASX) was the first stock exchange to both demutualized and be admitted to its own official list of companies.

- ***Background to the Australian Stock Exchange Demutualization:***

ASX was created in 1987 by the Australian Stock Exchange and National Guarantee Fund Act 1987, which deemed the Exchange to be incorporated under Australian companies' law and to be a company limited by guarantee. ASX was formed by the amalgamation of six State based exchanges located in Sydney, Melbourne, Brisbane,

[6] *Australian Stock Exchange – The Conversion of Demutualized Exchange: ASX's Experience*

Perth, Adelaide and Hobart. Each of the State exchanges had a long history, being formed between 1871 and 1898.

ASX's demutualization and listing process began in 1995 when the ASX Board formed a task force, comprised of ASX Board and Management representatives, to examine options to change the Company's structure. Were the task force to consider it appropriate, then it was to formulate a proposal to change the relationship between ASX and its members and to remove the requirement that access to ASX's markets should hinge on membership of the Exchange.
At the time that the topic of demutualization was being considered by ASX, the Exchange had two classes of members: Corporate Members (Member Organizations) and Natural Person Members (members). Neither class of members was able to transfer their rights to another party directly2 (i.e., that is, there were no seats). Furthermore, Corporate Members were numerically in the minority, but they dominated trading.

By way of background, seats were abolished by the old State-based exchanges during the period 1984 to 1986, by the process of buying back by the exchanges. Thereafter access to the market was available to any applicant who met ASX's Business Rule requirements, which included the payment of a one-off fee at the time of initial application and an ongoing annual maintenance fee.

- ***Obtaining Members Approval:***

On 24 September 1996, ASX distributed a Notice of Special General Meeting to its members, together with an explanatory memorandum. The Notice included a recommendation by the ASX Board for a demutualization proposal.

Members of ASX were asked to vote on a proposal to mandate the ASX Board to seek from the Australian Parliament legislation that would change the nature of existing membership rights and simultaneously convert ASX from a company limited by guarantee to a company limited by shares.

- ***Mechanism used for conversion:***

The main resolution approved by ASX members was that a new article should be inserted into ASX's Articles of Association, which would mandate the board to approach government for legislation to convert ASX to a company limited by shares.

- ***Changes to the corporation law:***

Following the overwhelmingly positive vote by ASX members, management of ASX worked closely with the Australian Government to develop the legislation necessary to achieve the change in structure. This legislation was released in Bill form for public comment on 6 August 1997 and it came into effect on 16 December 1997.

New provisions were inserted in the *Corporations Law*, which clarified ASX's responsibilities as a self-regulatory organization and ensured appropriate accountability to the Australian Securities and Investments Commission (ASIC) and to the government in carrying out those responsibilities.

- ***The Demutualization process:***

ASX undertook the following actions in the lead-up to demutualization and listing:

- It amended its listing rules on 1 July 1998 to introduce a special chapter dealing with its listing.

- It rewrote its Memorandum and Articles of Association and its Business Rules. The amendments included a mechanism for downsizing the Board and changing the Board's broker-dominated composition.

- It conducted road shows and consulted extensively with its Members concerning these amendments and the issues pertinent to demutualization.

- It separated Board and management functions by reviewing the role of committees.

- It implemented a due diligence program for the conversion and listing of ASX including detailed briefings to Board and senior management and the establishment of data management processes for the due diligence process.

- It created employee share plans to incentives and retain staff and developed rules concerning dealing in the securities of ASX by directors and staff.

- It introduced obligations on directors and staff designed to promote compliance with the continuous disclosure requirements of the listing rules.

- It developed a dividend policy and a policy on the use of cash balances.

- It issued a detailed Information Memorandum dated 28 August 1998 to support its listing.

- It made application to ASIC on 31 August 1998 for ASX to be demutualized.

- ***Memorandum of understanding (MOU) with (ASIC)***

As noted above, ASX and ASIC entered into an MOU in relation to ASX's self-listing. This MOU set out the way that ASX, the Australian Settlement and Transfer Corporation Pty Ltd (ASTC) and ASIC relate to each other in monitoring ASX's compliance as a listed entity with the Listing rules, the *SCH Business Rules* (ASX's settlement rules) and the *Corporations Law*. The MOU also addressed ASIC's supervision of ASX as a listed entity.

- ***Demutualization and listing outcomes:***

Demutualization of ASX occurred on 13 October 1998 and as part of the demutualization process former eligible members were issued shares in ASX. The issue of shares occurred on the following basis:

- Each of the 606 eligible former Corporate and Natural Person Members received 166,000 shares resulting in a total issued capital of 100,596,000 shares.

- There was no "cash out" offer for members, and there were no additional shares offered or funds raised by ASX.

- There were no special restrictions placed on members concerning the sale of ASX shares.

- There were no minimum shareholding requirements placed on members.

Following demutualization, ASX made an application to ASIC for admission to ASX's own official list and for quotation of its shares. Listing of ASX and quotation of its shares occurred on 14 October 1998.

- ***Subsequent supervisory development:***

A demutualized exchange needs to be constantly looking at ways of innovating, and of enhancing its reputation for integrity. In this context, earlier this year, ASX established an entity with a charter which, among other things, empowered it to review ASX's supervisory activities.

- ***Changes in ASE's focus and activities:***

Since demutualization ASX has experienced a number of significant changes in its focus and activities. These include:

(i) increased flexibility in decision-making;

(ii) increased customer focus; and

(iii) expansion of activities.

<u>FIGURE 3</u>

Stock Price Performance of Australian Stock Exchange

- **<u>TORONTO STOCK EXCHANGE[7]:</u>**

The TSE can be broadly broken down into three broad lines of business: equities trading, listings and the sale of market data. In addition, TSE supports these business lines through market regulation, information technology, marketing and investor education programmes and internal administration. Previously, TSE operated derivative and unlisted over the - counter trading markets. Pursuant to an agreement among the Canadian stock exchanges, these businesses were transferred to the Montreal Exchange (ME) and the Canadian Venture Exchange (CDNX) respectively. The TSE is now the sole Canadian exchange for senior equity issuers, the CDNX is the sole market for junior issuers and the ME is the sole derivatives market.

- ***The Demutualization decision:***

In 1998, the TSE's Board of Governors undertook a strategy development process which involved an assessment of the TSE's capabilities and competitive position, a review of the experiences of other exchanges, a survey of the TSE's constituents' needs and attitudes, and a consideration of governance alternatives. This process was motivated by recognition that the TSE's future was threatened and that a strategic direction was required to enable the TSE to succeed in the future.

The result of this process was a strategy blueprint, entitled *A Blueprint for Success*, which was released to members (and to the public) in October 1998. A cornerstone to executing the strategic directions articulated in the blueprint was a new ownership and governance structure for the TSE.

- ***The Demutualization process:***

Demutualization required member approval. This was obtained, and as of 1 April 2000:

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[7] *Toronto Stock Exchange – From Toronto Stock Exchange to TSE Inc.: Toronto's Experience with Demutualization*

- TSE became The Toronto Stock Exchange Inc., a for-profit corporation. Members became shareholders and the Board of Governors was renamed the Board of Directors.

- TSE is no longer a seat-based, member-owned company. Seats were exchanged for shares on the basis of 20 shares per seat.

- Share ownership is constrained. No person or persons acting jointly or in concert may beneficially own or control more than 5% of the outstanding shares unless the prior consent of the OSC is obtained. A member that received more than 5% of the outstanding shares pursuant to the seat exchange was "grandfathered," but is not able to exercise more than 5% of the votes outstanding. This actually slightly increased the voting power of those members—previously, members that held more than three seats (out of 127 at the time) were restricted to three votes.
- For two years, shares of TSE cannot be transferred unless the consent of the board of directors or of a majority of shareholders is obtained. After this date, resales will be restricted by securities legislation unless
- TSE files a prospectus or relief from applicable prospectus requirements is available.

- Access to the TSE's trading system is now based on contract, not ownership. Brokers granted access to trading is now known as "Participating Organizations" rather than members. Existing members at the time of demutualization were given access and are not required to remain shareholders of TSE Inc. in order to trade.

- TSE continues to approve new applications for trading privileges. However, applicants only have to execute a Participating Organization Agreement to be able to trade. They are not required to own shares of TSE Inc. Conversely, access rights do not entitle Participating Organizations to participate in the ownership or governance of the TSE.

- The number of member governors who are not affiliated with a member was increased so that they form 50% of the Board. Previously, the Board nominated these "public" governors subject to confirmation by the Ontario Ministry of Finance. Today, they are elected by shareholders at the annual meeting.

- Demutualization required several steps after member approval was obtained:

- Demutualization was approved by the OSC and the Ontario Minister of Finance—as part of the process, the TSE had to submit a new recognition order to the OSC for approval setting out the terms and conditions under which TSE would be permitted to continue to operate as an exchange; and

- The Ontario Legislative Assembly passed legislation providing for the continuance of the TSE under the Ontario Business Corporations Act (previously, TSE had been incorporated under special purpose legislation).

- **INDIAN STOCK EXCHANGES[8]:**

- ***The Status of SEs in India***

The present status of SEs reveals that out of all the 23 stock exchanges operating in India only two i.e. OTCEI and NSE are demutualized. Further, 3 of them (Bombay, Ahmedabad and Madhya Pradesh) are operating as Association of Persons and 7 as company limited by guarantee. Thus before any demutualization of the rest of the exchanges i.e. 21; these 10 (i.e. 3 + 7) exchanges are to be converted into companies limited by shares.

[8] *Prospective Governance Problems in Demutualized Stock Exchanges of India: Issues and Prescriptions*

The viability of the stock exchanges as presented in Table-1 portrays a quite gloomy picture for the regional bourses. In recent years nine of them have no turnover and many of them have shown negative growth of business. NSE and BSE combinedly are commanding more than 90 percent of the total volume of turnover, thus raising a question mark on the viability of other regional stock exchanges.

Looking at the turnover of the Indian stock exchanges the obvious question arises, whether we need such a number of regional stock exchanges (RSEs). After the advent of information technology the need of regional stock exchanges has been marginalized. In this respect SEBI has also felt that with the nationwide reach of BSE and NSE and poor performance of regional exchanges the very concept of such exchanges are to be abolished. Thus there is a need for either closer of regional SEs or consolidation by merger. The latter would be a better option in the interest of brokers and investors. There could be at best 4 regional exchanges catering to the need of East, West, North and South provinces of the country. Besides NSE, exchanges like Calcutta, Bombay, Delhi and Madras could cater to the needs of these four provinces respectively. Other stock exchanges currently operating in these provinces could think of merger with these four SEs. Although there are many road blocks in this process but the recent cabinet approval on the amended SCRA laws shall come handy for the possible merger cases.

- ***Forces behind the Demutualization***

In the first place the primary function of a demutualization is to reduce the control of (particularly local) intermediaries over the strategic positioning of the exchange. This is in recognition of the fact that exchanges operating in a competitive financial market must ultimately be able to reduce capital costs for a significant subset of companies, and raise investment returns for a significant subset of investors. For example, the growing competition among some of the European exchanges makes it difficult for members to protect their intermediation franchise, and therefore makes them more open to governance reform and outside ownership.

Secondly, the internationalization of membership also facilitated demutualization. Local players (mostly brokers) have a strong incentive to maintain institutional barriers to disintermediation of their services, whereas international players tend to see governance reform as an effective weapon for increasing their strategic control of the exchange *vis-à-vis* the locals (typically by replacing "one member, one vote" and committee-based decision making with decision-making tied more directly to the size of the ownership stake).

Thirdly, technology has become the main force behind any structural changes of stock exchange (Williamson, 1999). Surge of new technology, which warranted a shifting from floor trading to a screen-based trading, has helped in the expansion of the population (both broking and investing) thus created a new demand for exchange governance. According to Domowitz and Steil, (1999) "trading market automation permits demutualization", meaning that the corporate structure of organization of a stock exchange is feasible when computerized trading replaces floor trading. For example in the mid -1990s the floor trading was converted to automated trading in many of the European Exchanges due to the pressure of large international banks and subsequently most of them have transformed them into demutualized format.

In Indian context, keeping in place the present structure of the SEs, which are more or less mutual entities, it is felt that the demand of the new economy would not be properly met. The broker-owned structure is to be diffused by the infusion of professionals from the industry. It is increasingly being believed that a demutualized organization can adapt more quickly; can raise more capital; can attract better administrators; can centralize control in a small, better-equipped groups; and as a result, can deliver higher profits to its owners, i.e. shareholders (NSE, 2001). With the objective of maximizing the value to the investors as well as to the members of the SEs through the investment in new technology and to meet the competitive pressures from the environment it has become imperative that the demutualization process should be hastened with a strong footing.

The above paragraphs clearly indicate the growing concern among the investor community which has brought the need for demutualization to the fore front. The focus is obviously on the investor's side. The need for low-cost faster trading and better flexibility to adapt new situations has been cause of concerns for the investors. Demutualization is expected to bring the international technology, good governance and as well as the global competition. In all the fronts investor is going to get a better bargain. The electronization of the markets and intermediaries shall enable millions of investors to trade faster, more cheaply, and with an impressive and ever expanding universe of mostly free financial information at their command. This will help expose foreign investors to listed companies at home and local investors to companies abroad. The efficiencies created by these economies of scale can then be passed on to investors and issuers alike. Simultaneously, the enhanced governance structure shall protect their rights and privileges through the rule enforcement and other investor protection services. Since investors will remain as the primary customers as in case of other corporate houses, the new structure will definitely try to put in place all the mechanism to attract more of them and also to build a strong customer relationship base.

- ***Demutualization: The sequential steps***

As elaborated in the previous paragraphs, the process of demutualization in India should start with the conversion of all the stock exchanges into company form of organization, limited by shares. This is to be followed by the reorganization of regional exchanges through mergers. Most of the handicaps in this process have been removed through necessary amendments of Income-Tax provisions with respect to the transfer of past profits to the new entity (particularly when the "not for-profit" character is to be changed). Similar provisions have also been inserted in the Indian Stamp Act and Sales Tax laws to exempt from stamp duty and sales tax, the transfer of the assets from the mutual stock exchanges and the issuance of shares by the new entity. Further, the Securities Contract (Regulation) Act (SCRA) has also been amendmened to facilitate corporatization and demutualization. The process would result in two classes of members namely, trading members and shareholder-members. Since presently as per SCRA ‘members’ mean the members of a recognized stock exchange i.e. trading member only, it is apprehended that the regulation may not accommodate different categories. But with the ruling of Supreme Court that apprehension has been sidelined (NSE, 2001).

As the third step, the membership value of the brokers is to be fixed with their exit and entry price. The due of the exiting members may be settled with debt securities or with equity shares. The decision of the Govt. to allow the existing members as either trading members or as ownership members is a welcome measure. But as a cautious measure, brokers may be allowed to the equity participation process with a minimal holding as practiced in London Stock Exchange. i.e. to a maximum of 4.9 percent.

Next step is to put corporate governance in place with the restructuring of board. Listing of the demutualized entity in a separate listing authority, possibly with the up coming Central Listing Authority (CLA) should be the next step. After this the exchange can issue shares to the public to become a full fledged corporate house.

3.2 GAPS TO BE BRIDEGED BY THIS STUDY:

This study will be beneficial to the stakeholders of the stock exchanges because this study reflect the prons and corns of the demutualization in Pakistan, along with the international case studies. This study will help to bridge the gap between the members of the stock exchanges and the regulatory body i.e. SECP.

3.3 AREA OF FURTHER STUDIES:

The area of further study relate with this study is the feasibility of the two models which are suggested by the SECP committee along with the scenario analysis. It is important for this kind of project as it is one of the major economic decisions, which will directly affect the economy of the country.

CHAPTER 4: CLOSING UP:

4.1 SUMMARY OF THE FINDING:

The above finding shows that the existence of three exchanges results in fragmented liquidity. There is lack of management of settlement risk and the whole system of exchange is not efficiently managed.

4.2 CONCLUSION:

The study of this report derives the conclusion that, demutualization of the three stock exchanges is an important step towards the development of corporate culture. This process includes some major issues which are to be negotiated with the concern parties. FIDE is preferred for the demutualization of the exchanges in Pakistan because this is the only option which comes up with the single exchange. The FIDE will be having CDC, NC and NCEL as its subsidiary. This also provides room for the development of specialized future and derivative market as done in the developed exchanges.

4.3 RECOMMENDATION:

There are certain recommendations, which will help improve the system of implementing the demutualized structure efficiently.

- SECP needs to educate the stakeholders about the demutualization.

- While moving towards the demutualization SECP has more responsibilities on its shoulders, so as to run whole exchange democratically treating every body at par.

- While appointing an M.D. who will not be allowed to trade in the market, there is an acute need to keep the check and held the person accountable incase of violating the rules.
- There is need of system under which there should be penalties for those who violate the regulations.

- There is need of certification exams, which should be held prerequisite for the registration as broker and agent.