Demutualization of Stock Exchanges

Poonam Mehra
Demutualization of Stock Exchanges

*Demutualization* is the process by which a customer-owned mutual organization (*mutual*) or co-operative changes legal structure to form a joint stock company. Historically stock exchanges started as a mutually governed, self-regulated structures where profit was not a very strong motive. The stock exchanges were authorized to promulgate by-laws to govern their functioning. They were physical locations with trading floors. The stock exchanges had a mutually dependent, co-operative structure. However with technological innovation came electronic trading system. The concept of floor trading no longer held ground, hence the physical presence of the trader was no longer important, which in turn meant that the cost of inducting additional member fell drastically, reducing the overall trading cost. The membership fee did not have much of significance. This in turn reduced the importance of mutual dependence and co-operation. The outcome of this was demutualization (Saha, 2005).

Generally, three methods are adopted for demutualization. These are full demutualization, sponsored demutualization, and mutual holding company. In a full demutualization, the mutual firm is completely converted into a stock company where the (newly issued) stock, cash, and/or policy credits are passed on to the members or policyholders. In case of a sponsored demutualization the mutual firm is fully demutualized and its policyholders or members are compensated. The difference between full demutualization and sponsor demutualization is that in the latter case the mutuality is bought by a stock corporation. A mutual holding company comprises partly of a stock company and partly of a mutual company. Technically, the members still own over 50% of the company as a whole.

The first exchange to get demutualized was the Stockholm Stock Exchange in 1993. After that many exchanges have demutualized. This includes the major stock exchanges like New York Stock Exchange, Chicago Mercantile Exchange, London Stock Exchange, Australian stock Exchange, Deutsche Börse, Toronto Stock Exchange, Singapore Stock Exchange to name a few.

**Advantages of Demutualization**

The advantages of demutualized stock exchange are as follows. Firstly, demutualization results in more flexible governance structure fostering decisive action in response to changes in the business environment. Secondly, it leads to greater investor participation in the governance of the exchange. Thirdly, it yields an improved platform in response to potential competitors in the form of alternative trading systems. Further, demutualization allows greater flexibility and access to global markets. Fifthly, it also facilitates faster and more complete consolidation of stock exchanges to enhance available synergies. And finally, it ensures increased access to resources for capital investment raised by way of equity offerings or private investment (Hughes and Zargar, 2006).
Critical Issues related to Demutualization

Conflict of interest arises broadly from two sources. Firstly, regulatory activity can hinder source of revenue. On the other hand, regulatory activity can compel expenditures which cannot be recouped easily. So far as the demutualization of stock exchanges is concerned it has raised some specific conflict of interest issues pertaining to listing activity, regulatory market operation and business continuity planning as discussed below briefly, following Saha (2005):

**Conflict of Interest in Listing Activity**

Traditionally, listing has been viewed as a “signaling” function endorsing quality. If exchange set the listing criterion to be too high, many firms may not be able to list their securities in the trading platform. This in turn implies that exchange will lose revenue from listing fees. On the other hand, if the eligibility criterion is set too low poor quality securities will get listed which would eventually result in deterioration of investor’s profitability thereby adversely affecting reputation. Earlier it was assumed that this trade off would lead to an equilibrium set of criterion for listing by exchanges. However this argument regarding equilibrium holds true so long as listing and trading takes place in one exchange. With multiple exchanges, listing and trading have been separated i.e. it is not necessary that a security trades only in the exchange where it is listed. Hence the listing exchange may not necessarily face reduced order flows. Revenue becomes important for owners. Thus revenue generating mechanisms may take precedence over quality so far as owners are concerned. In the process, members might face the adverse effects of loss of order.

**Conflict of Interest in Regulating Market Operations**

Exchanges are responsible for regulating trading activities on one hand. At the same time they are supposed to promulgate rules that govern trading activities. Regulation includes overseeing trading activities, identification suspicious activities, their detection and taking appropriate action in case of misconduct. This creates a conflict of interest between the regulatory and business function. Due to competition with other exchanges, the exchange might fall under pressure to attract order flow.

**Conflict of interest in Business Continuity Planning**

Apart from this it is argued that security and capacity issues are of great importance to an Exchange and these concerns are congruent to business interest. This argument may be flawed because firstly, such planning does not yield any direct return. Secondly, it entails agency issues, in terms of public good versus private benefit. If these arguments stand, then emphasis on business interest may adversely affect long term developmental plans of an exchange.

In this article we briefly discuss the trends, advantages and concerns related to demutualization. Given the recent trends in demutualization and the advantages therewith, one needs to ensure that the regulatory role of exchange is not jeopardized to ensure the overall success of demutualization.
Reference
