What is Demutualisation?

Globally, capital markets play a crucial role in mobilising domestic resources and channelling them efficiently to productive uses, thus raising national productivity. Therefore the fair and efficient functioning of a stock exchange is of significant benefit to all stakeholders. Facilitating the efficient raising of capital will immensely benefit the corporate sector which in turn will have a positive impact on the country's overall economy.

Starting in the early 1990s, stock exchanges around the world have been undergoing major organisational and operational changes. One of the most visible has been the trend towards demutualisation - the process of converting exchanges from non profit, member-owned organisations to for-profit, share holder owned corporate entities. In simple terms, demutualisation is the segregation of ownership and management from the trading rights of the members of an exchange. International experience suggests that increasingly, demutualised structures are preferred to mutual structures as a mechanism to improve exchange performance.

A stock exchange in its "mutual" form can be likened to a private members club. Thus, there is a close identity between the organisation and the direct users of its trading services with the members enjoying rights of management, decision making (one member one vote) and trading. A Demutualised Exchange on the other hand is a for-profit company limited by shares (one vote per share), paving the way for majority based decision making accountable to shareholders with a greater focus on the strategic interests of the exchange over the self interests of the members.

Traditionally, stock exchanges have been organised as mutual associations (Table 1) and the Colombo Stock Exchange (CSE) is no different, which is a company limited by guarantee and controlled by fifteen full member broker firms. By nature of the present structure of the exchange, despite having the majority decision making powers and the trading rights, the member brokers do not have access or a say in the distribution of its assets or profits. The objective of such associations primarily is to manage the interests of the members which would not be in the best interest of all other stakeholders. However, demutualisation induces a change in the objectives of the exchange to that of a profit oriented entity focused on maximizing shareholder value by focusing on generating profits. This should induce the independent management of an exchange to be very pro active and engage in more revenue generating measures to improve performance.
In 1993, the Stockholm Stock Exchange became the first exchange to demutualise, which was followed by many others with most other exchanges across the globe having either recently converted, are currently in the process, or are considering demutualisation. (Table 2)

Usually the demutualisation of an exchange is followed by the listing of the new entity on its own exchange. Once the shareholder structure of the new company is decided a significant portion of it is issued to the public via an initial public offering (IPO). For example, following the demutualisation process that began in 1996, the Australian Stock Exchange issued shares to the public and listed on its own exchange in 1998 and London Stock Exchange followed suit, which converted into a for-profit entity in June of 2000 and became fully listed in July of the following year. Malaysia's demutualisation process was driven by its desire to compete in the global marketplace particularly against the Hong Kong and Singapore exchanges. It took 3 years from the drawing board to completion but in 2004 Malaysia emerged with an exchange that was more customer driven and more market orientated with a governing structure that was representative of a broader spectrum of stakeholders, including public interest and state.

Demutualisation in emerging markets differs in certain significant respects from the process followed in more developed markets. Particularly, it should be noted that demutualisation in emerging markets is often centrally planned by the government and regulator, as opposed to being driven by the exchanges themselves. In general, emerging market regulators have made substantial progress in strengthening practices and improvements to infrastructure in their capital markets by following this route. It is important that regulators and market participants continue to work together to create policies and market conditions that are conducive to such changes and are in the overall best interest of the market.

To ensure that the objectives of demutualisation are safe guarded, the regulators generally impose caps on ownership and voting rights (Table 3) and introduce "Public Interest Directors" to better ensure the integrity of the regulatory processes plus adopt other measures to address possible conflicts of interests that may arise from a for-profit exchange been listed. There must be a balance between the profit motive and the goal of investor protection and the regulators must ensure that an exchange does not sacrifice effective regulation to achieve the goal of maximizing shareholder profits.

Reasons for Demutualisation

The drive towards demutualisation globally has been mainly as a result of exchanges needing the ability to be better financed, more flexible decision making ability to respond quickly to a fast changing and competitive market place and due to the discipline, accountability and transparency it brings into the organization.

Stock exchanges owned by members tend to work towards the interest of members alone, which could on occasion be detrimental to rights of other stakeholders. Separation of ownership and management from trading rights of members can lead to a balanced approach, remove conflicts of interest, create greater management accountability, and take into consideration the interest of all other stakeholders.

There is an inherent conflict of interest in a mutual exchange that is owned and controlled by members. The possible conflict between the interests of members with those of the exchange, investors, issuers and other market participants is also recognized as a potentially significant competitive handicap.

Among the more practical reasons for demutualisation of many exchanges has been the fact that the mutual structure generally limits an exchange's ability to mobilise capital, which, among other things, could be used to upgrade their systems and attract high-calibre personnel. In other words, to cope with competition, stock exchanges require funds. While member-owned stock exchanges have limitations in raising funds, publicly owned stock exchanges can tap capital markets.

Advantages of Demutualisation

There are several benefits of a Demutualised Exchange to the capital market in general and the economy as a whole. Broadly, some of these are:

- An efficient capital market to compliment the banking sector as an alternative fund raising option thereby diversifying the risks in the financial system
- Ability to tap foreign expertise to enhance the strategic interests of the exchange and opportunities for greater inflow of foreign direct investment from potential alliances
- a more flexible governance structure fostering decisive action in response to changes in the business environment;
- Wider stakeholder participation in the ownership and governance of the exchange;
- Access to wider sources of finance and more efficient allocation of financial resources;
- A wider range of investment products and sources of revenue for the exchange;
- A more efficient and competitive business environment encouraging innovation;
- Financial benefits for the initial shareholders of the new exchange to realise value at an IPO for their contribution to develop the exchange;
- Publicly owned stock exchanges can be more professional in their business dealings in comparison to member-owned organizations;
- With the role played by shareholders to strengthen the management and the organisation would result in greater transparency in dealings, accountability and market discipline.

Regulatory Challenges and Conflicts of Interest

Despite its advantages, demutualisation is not without its distinct regulatory challenges, such as how to rationally divide governance of the Demutualised Exchange among the exchange, the government and other self regulatory organizations (SROs). However, one of the most important regulatory challenges inherent in the demutualisation of stock exchanges is the management of conflicts of interest. The for-profit nature of a Demutualised Exchange raises the possibility that exchanges may be so preoccupied with profits that it may:

(1) Abuse its position as both market participant and market regulator to its own advantage; and

(2) Sacrifice effective regulation in order to achieve the short term goal of maximizing shareholder profits.

Managing Conflicts of Interest

Conflicts of interest can be managed in a number of ways, notably by reorganizing the corporate structure of the exchange itself. Many Demutualised Exchanges have addressed conflicts of interests by the functional separation of the commercial activities of the exchange from its regulatory functions with the latter being subject to governmental oversight. Legislation provides another means by which conflicts of interest can be managed with the regulator limiting share ownership and voting rights in a Demutualised Exchange so as to avoid giving a single shareholder undue influence over the affairs of the exchange may impose stringent reporting obligations ensure that the Exchange is in compliance with its supervisory obligations.

Demutualisation of the Colombo Stock Exchange

In the year 2010 the Cabinet of Ministers officially approved the Demutualisation of the CSE by means of a special Act of Parliament. Upon the approval being granted by the Cabinet of Ministers, the SEC initiated the process with the Legal Draftsman in respect of preparing a Special Act to be passed in Parliament with regard to the Demutualisation of the CSE. The contents of the draft Act is currently being fast tracked to be finalized. The Special Act will pave the way for the Demutualisation process to be officially implemented.
The draft modality for share ownership, governance structure etc. has already been developed and will be finalised after discussions with the relevant stakeholders.

International experience (Board composition)
Table 03 – Post demutualisation Board

Country	Post-demutualisation Board	% for brokers
Australia	9 member board: 4 including the Chairman are ASX Members/Affiliates	44
Singapore	11 member board: 4 represent brokers	36
Philippines	15 member board: 7 represent brokers	47
Hong Kong	15 member board: 8 Public Interest Directors	NA

	appointed by the Financial Secretary, 6 appointed by shareholders, CEO of HKEx- ex-officio (No specific rights to the brokers).	
Malaysia	13 Directors: 4 Public Interest Directors appointed by the Ministry of Finance, 8 Independent Non Executive Directors and there is 1 Executive Director, who is also the CEO. Guidelines on the composition of the Board by the Capital Markets and Services Act 2007 (CMSA) ; - At least 1/3 shall be Public Interest Directors appointed by Ministry of Finance, - at least 1/3 shall be Independent Non Executive Directors appointed by Nomination and Remuneration Committee (NRC) with the concurrence of the Securities Commission - Remaining Directors shall also be appointed through NRC with the concurrence of the Securities Commission including the CEO	NA
Japan (Tokyo)	11 member board: 5 represent brokers	45
India	As per the SEBI guideline, maximum of 25% of the Board can be composed of trading member directors and a minimum of 25% should comprised of Public Interest Directors and balance should consist of shareholder directors.	25

International experience (Ownership)
Table 01 – Broker ownership pre and post demutualization

Country	**Broker ownership(Pre-demutualisation)**	**Broker ownership(Post-demutualisation)**	**Government & others post demutualisation**
Australia	100%	40% - Members	Approximately 16,000 other shareholders
Singapore	100%	28% - Members	47% - Public 25% - SEL Holdings (Ultimately owned by Taemasek, a SG government company)
Malaysia	100%	30%- Members 10%- Remisier ***(Note 01)***	Ministry of Finance - 30% Market Development Fund - 30%
Philippines	100%	100% was given to members expecting them to bring down the	NA

		ownership to 20%. At the moment broker ownership is ~ 40%	
Hong Kong ***(Note 02)***	100%	41% - Members	49% - overseas institutional investors 15% - Custodian Banks (In 2006)
India	100%	49% - Members	51% - Non members
Pakistan ***(Note 03)***	100%	32% - Members	20% - General Public 48% - Financial Institutions

Note 01

Remisier is a licensed trading representative who is attached to the Malaysian member broking firm and receives 40% of the commission.

Note 02

As of March 2002, the two Central clearing Systems (CCASS) Participants held 28.8% and 12.1% of HKEx's issued share capital.

Note 03

The information provided is based on the guidelines stipulated by the Expert Committee on Demutualization and Integration/ Transformation, 2004, Karachi.

Table 02

Demutualization status of Exchanges in selected Emerging Markets

Jurisdiction	Considered	Status
Brazil	No	Not demutualised
China	No	Not demutualised
Poland	No	Not demutualised
Sri Lanka	Yes	In the process
Thailand	Yes	In the process
Indonesia	Yes	In the process
Pakistan	Yes	In the process
Turkey	Yes	In the process
Chile	Yes	In the process
South Africa	Yes	Demutualised
India	Yes	Demutualised
Hungry	Yes	Demutualised
Malaysia	Yes	Demutualised
Philippines	Yes	Demutualised
Chinese Taipei	Yes	Demutualised

Sources:
Exchange websites
World Federation of Exchanges
Australian Securities and Investment commission
Journal of Applied Corporate Finance – A Morgan Stanley Publication, 2006