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By Muhammad Shafiqur Rahman

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Ajmalul Hossain *QC*

Senior Advocate
Supreme Court of Bangladesh

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Demutualised Stock Exchanges: Self-regulation and Conflicts of Interest

By MUHAMMAD SHAFIQUR RAHMAN

Introduction:

"Demutualisation" is a term which not many people are *au fait* with. A mutual company is a company owned by its members or users for the benefit of those members or users. Insurance companies often have the word "mutual" in their name, when they are mutually owned by their policyholders as a group. In demutualisation, the members give up their rights and receive shares in the company in return, which they may then sell. Demutualisation is thus a process through which a non-profit customer-owned mutual organisation or co-operative becomes a shareholder-owned corporate entity. It entails separation of trading rights from ownership rights and management rights. This means that a broker who trades in securities does not necessarily have to be a shareholder of the exchange, and similarly a shareholder does not have to trade in securities.

The distinguishing feature of a mutually-owned stock exchange is its cooperative structure of governance. The owners, the decision-makers and the direct users of its trading services are the same persons: the member brokerage firms. In contrast, a demutualised enterprise is organised as a corporation with share capital under which the owners of the company, the decision-makers and the principal customers may be three separate groups.

This write-up looks into the history of the stock exchanges in general, leading up to its current demutualised state. It then highlights the typical roles of the stock exchanges, and then elaborates the potentials for conflicts of interest, not least because of the stock exchanges' traditional self-regulatory position. Finally, the paper discusses possible solutions for avoidance of such conflicts, with particular focus on how the stock exchanges of Bangladesh have fared compared with stock exchanges of other jurisdictions.

Demutualisation And Potentials For Conflict

Background

At the beginning of stock trading, when a buyer wanted to purchase a certain number of securities, he had to find a seller who possessed the same number of securities and was willing to sell them at an agreed price. For determination of an appropriate price the buyer also needed adequate information about the securities. Similarly a seller of securities needed to identify a suitable buyer and information necessary for arriving at the correct value of the security. The transaction was done at the individual level, and the cost of transaction was uneconomical. The traders gradually felt the need of a mutual organisation where securities could be bought and sold and information about securities could be obtained. This organisation came to be known as "stock exchange", which provided the service of organized trading. Almost all ancient stock exchanges began as such a mutual firm. Traditionally the brokers, who were members of the stock exchange, accepted buy or sell orders of securities and manually matched the orders to complete the transactions. Brokers gathered at the physical location of the exchange floor where trading of securities took place. Not long ago, the traditional floor trading gave way to electronic screen trading. This is called an automated trading system which provides on-line real time facilities to the investors for buying and selling of securities on electronic matching basis against competitive bids. The automated trading system has put in place a solid and efficient system which takes care of order-matching based on a set of certain predefined rules.

The history of Dhaka Stock Exchange-DSE is, however, somewhat different. It started as a public company limited by shares, which was registered in 1954 in the name of "East Pakistan Stock Exchange Association Ltd." Formal trading began in 1956. It was renamed as "Dhaka Stock Exchange" in 1964. Although the legal form of the exchange was that of a company limited by shares, the essential character of the organisation and its operation resembled that of a cooperative or mutual enterprise. It was a non-profit organisation for the benefit of its members, and the broker members assumed all the three roles of being the owners, the managers and the users. Chittagong Stock Exchange-CSE too was born as a limited company, which was approved by the Bangladesh Securities and Exchange Commission-BSEC in 1995. Both DSE and CSE introduced computerized automated trading system in 1998.

The electronic trading system eliminated the need for a physical trading floor, and the market place became virtual. The reason for the members to assemble at a place and transact was no longer there, and so the cause of mutuality was lost. Hence many stock exchanges in the world with electronic trading system have either become demutualised or are rapidly moving towards demutualisation. The Stockholm Stock Exchange was the first exchange to demutualise in 1993, followed by Helsinki (1995), Copenhagen (1996), Amsterdam (1997), the Australian Exchange (1998) and Toronto, Hong Kong and London Stock Exchanges in 2000. DSE and CSE have been demutualised with effect from 21 November 2013. This was achieved by operation of Exchanges Demutualisation Act, 2013.

Multiple roles of an Exchange

A demutualised exchange has a number of functions. On the one hand it is a commercial entity carrying on business for maximizing profit. Gone are the days when a mutual exchange's focus was on generating sufficient income only to cover the budget for revenue expenditure. Now the revenues must not only meet the expenditure but also earn enough profit. On the other hand, the exchange promulgates and enforces rules and regulations governing trading activities on its platform. It is a self-regulatory organization and is meant to regulate its own activities. Thus a demutualised stock exchange has apparently conflicting roles.

The commercial role of an exchange is to generate revenues by providing services. The main revenue of a stock exchange comes from licence fees, listing fees, transaction fees, market data fees etc. This revenue is derived directly from those who use or purchase services or information from the exchange: the brokers, the intermediaries, listed issuers and information vendors, and indirectly from the investing public. The typical self-regulatory functions of an exchange are the regulation of trading and listing on the exchange and the regulation of member brokers. Regulation of trading includes admitting new users to the exchange trading system, devising rules for trading and enforcing them. Regulation of member brokers includes monitoring conduct and financial resources. Regulation of listing includes determining qualifications for listing, approving new applicants and monitoring listed issuers' ongoing compliance with the listing rules.

Potentials for conflict of interest

Conflicts of interest may arise from an exchange's profit motive and the regulatory/supervisory functions that it performs. Conflicts arise because the members are asked to abide by rules and monitor and enforce rules against each other in the public interest that may negatively affect their own commercial interests. Motivation to earn profit may itself result in a conflict. When a regulatory activity of the exchange hinders revenue-earning, or compels the exchange to incur additional expenses, conflicts will arise. Further, a for-profit organisation like a demutualised stock exchange may not devote sufficient resources to regulatory activities. The senior executives of the exchange may be more interested in profit-making than offering their valuable times to regulate. The Listing Division may go easy on scrutiny of new listings, may grant waivers more readily, and may give favoured treatment to a listed company with which it conducts business. The Compliance Division may relax its scrutiny of brokers because they are now viewed as paying customers.

A major weakness of self-regulation is the inherent potential for it to favour the interests of the broker members over those of the investing public. An SRO may subvert the regulatory goals to its own business goals. Because SROs are left directly in charge of the implementation of a program of government and public policy, and are themselves owned or controlled by the industry participants who are the objects of regulation, self-regulation raises the possibility of insufficient enforcement of rules and standards.

An exchange is expected to oversee trading activities, identify suspicious trading behavior like insider trading and market manipulation etc. A major revenue of an exchange comes from transaction related activities. Therefore penalising major members will go against the business interest of an exchange, and so an exchange may not be too willing to punish a member.

Further, there is a risk that an exchange will seek to use its regulatory powers against competitors which may be listed companies or trading members, in a way that adversely affect the competitor's business interests. Conversely, the exchange may be tempted to treat more leniently a regulated user which is a business associate.

Finally, there are potentials for conflict in case of listing too. In case of its own listing, it is widely acknowledged that public interest is not well served if an exchange is allowed to supervise. The exchange is likely to face conflicts of interest in admitting itself to listing, monitoring its on-going compliance with listing rules, monitoring the trading in its securities and taking necessary enforcement action. In the case of listing of other issuers, if an exchange sets the listing criteria too high, many companies will not be able to list their securities. On the other hand, if the criteria are set too low, quality of listed securities will fall. Because a major source of revenue for an exchange is listing fees, an exchange may be tempted to lower the thresholds, resulting in deterioration of the investors' profitability.

Remedial Measures:

Methods for dealing with conflicts

The responses to the issue of conflict have varied from one jurisdiction to another, since they depend upon the prevailing legal framework and regulatory philosophy. However, there has been some consistency in dealing with the issues, and the general approach seems to be towards retaining the self-regulatory function but transferring some functions to the government.

There are a number of ways of dealing with these conflicts, of which the following are the most common:

- *Separation of business and regulation*: separate the business activities of the exchange from its regulatory activities;
- *Reinforcing mandate*: reinforce the public interest mandate of the exchange by amending existing law;
- *External supervision*: subject the regulatory activities of the exchange to external supervision;
- *transfer of function*: transfer regulatory functions to government regulators;
- *Disclosure*: disclose how the exchange has dealt with specific regulatory issues, for example in an annual report;
- *Restriction on ownership*: limit those who can control or influence exchange activities.

Separation of business and regulation

Many exchanges have a history of clear separation of regulatory operations from business functions. A unique approach is Australian Stock Exchange's (ASX) creation of an independent entity, ASX Supervisory Review, to supervise the delivery of its regulatory functions. ASX SR has its own board and acts as an independent auditor of ASX's handling of regulation and conflicts of interest. Further, ASX has created a separate Investigations and Enforcement Unit which, prior to demutualisation, was blended with 'membership' administration. The Stock Exchange of Thailand (SET) has moved its regulation functions to a separate department reporting directly to its president, and also separated market surveillance from market operations. Hong Kong and Singapore have a category of public interest directors who are appointed by the government, in recognition of the exchange's express public interest obligations.

In case of DSE, potentials for conflict were expressly recognized in its Demutualization Scheme itself. Section 5 of the Scheme provides as follows:-

"**5. Separation Of Business From Self Regulation**

5.1 **Reasons for separation**

Demutualisation of stock exchanges raises new conflicts of interest in exchanges carrying out front line regulatory roles. It is generally perceived that performing a dual role of a commercial entity and a self-regulating organization is the primary source of conflicts of interests. Globally, this is a highly debated area as to the best models that can be used to mitigate this risk. The solution often prescribed is the separation of an exchange's SRO functions from its commercial activities.

5.2 **Proposed process & model for DSE**

The suggested SRO model for DSE is Strong Exchange SRO Model.

Under this model, DSE's potential conflict of interest will be managed through setting up separate regulatory committee/divisions (i.e. Regulatory Affairs Committee, Regulatory Affairs Division) that will function totally independent from any committees/ divisions of DSE involved in commercial functions.

The segregation will be envisaged through setting up of a Regulatory Affairs Division ("RAD") that will be headed by a Chief Regulatory Officer ("CRO"); the overall supervision of RAD will be vested with a Regulatory Affairs Committee ("RAC"), which will be comprised of independent directors of the board. The RAC will function as a 'Chinese Wall' between the regulatory functions and commercial activities of the exchange and will be responsible for developing and measuring RAD's effectiveness in implementing the overall regulatory plan, processing all regulatory amendments, recommending budget and staff allocations for the RAD, recommending appointment and removal of the CRO."

In furtherance of these separation objectives, new regulations were framed, in the form of Dhaka Stock Exchange (Board and Administration) Regulations 2013 ("DSE Board Regulations"), which have clearly demarcated the two functions. Commercial interests are overseen by the Chief Executive Officer (CEO), while the regulatory/supervisory functions are overseen by the Chief Regulatory Officer (CRO), who has an entire Division under his control called the Regulatory Affairs Division. A separate committee in the board of directors of the exchange was set up called the Regulatory Affairs Committee. Regulation 15(2) provides that RAC "shall act as the vehicle for separation of business and regulatory activities of the Exchange."

CSE has similar arrangements too, by virtue of Chittagong Stock Exchange (Board and Administration) Regulations 2013 ("CSE Board Regulations").

The presence of public interest or independent directors is considered to be an important safeguard against conflicts of interest. The Board of Directors of both the exchanges comprises

13 members, of which 7 are independent directors. Significantly, all members of the RAC are independent directors. This will ensure effectiveness of the RAC. Further, the chairman of the RAC cannot become a member of any other committee.

Regulatory Affairs Division has a somewhat semi-autonomous character, whose sole function is to conduct regulatory activities. The CRO is supposed to be disinterested in the business of the exchange and will only perform regulatory functions. He must not be connected to the CEO, the broker-members or the strategic investors, and he or his family is not supposed to engage in any investment activity. Although the CRO is appointed by the exchange's board of directors, his appointment must be approved by Bangladesh Securities and Exchange Commission (BSEC). His removal too needs BSEC's approval. Unlike other Divisional Heads, he does not report to the CEO but directly to the RAC (although he has an administrative reporting obligation to the CEO). More importantly, the report on regulatory compliance status, which he submits to the RAC every month, is simultaneously submitted to the BSEC too. Thus the CRO can be said to have a direct connection with the government regulator. The RAD's job is to ensure continuous monitoring and surveillance of the market, investigate violations of rules and regulations in place, ensure compliance of listing regulations, monitor compliance of the requirements in place for the holders of Trading Rights Entitlement Certificate (TREC) holders, handle and process investor complaints through a dispute resolution mechanism, continually liaise with the exchange and BSEC on regulatory matters, and so on.

Reinforcing public interest mandate

As a means of addressing conflicts between the exchange's business and the public interest, the jurisdictions may reinforce the existing public interest mandates in course of approving demutualization. This has occurred in the U.S., Australia and Canada. In Hong and Singapore, the law expressly states that in the event of any conflict between public interest and the exchange's business interests, the public interest must prevail.

In Bangladesh, section 19 of the Exchanges Demutualization Act 2013 provides that the exchange shall, at all times, work for public interest and preserve the interest of the investors, and if there is a conflict between the exchange's interests and the public interest/investors' interest, the exchange shall give priority to the latter. Similarly, DSE Board Regulations provide (Regulation 8(3)(a)) that the Board of Directors of the exchange shall ensure performing activities of the exchange to uphold the interest of public, and give priority to the interest of public even it is conflicting with the interest of the exchange or its shareholders. It further provides that the directors shall place priority for redressing public grievances (Regulation 8(3)(b)). It also provides that the directors shall ensure that the exchange comply with all the provisions of securities laws, rules and regulations, and circulars, directives issued by BSEC and other government authorities (Regulation 8(3)(b)). Similar provisions are in place in the CSE Board Regulations.

Most importantly, a separate committee in the board of directors was set up called the Conflict Mitigation Committee. The primary function of this committee is to satisfy the board that any perceived or actual conflict of interest between the exchange's regulatory responsibilities and its commercial interests has been adequately addressed. It will review the adequacy of arrangements in this regard and periodically notify BSEC.

External supervision

Effective government oversight is considered essential to ensuring that if any conflict arises, it will not lead to lower standards. More stringent oversight of an exchange's disciplinary processes and management of enforcement cases should be imposed to ensure that they are not influenced by conflicts or business considerations. In some countries government regulators have explicit new powers to intervene where there are concerns about how the exchange is carrying out SRO obligations or public interest mandate. For example, Financial Services Authority (FSA) of UK, Australian Securities and Investments Commission (ASIC), and Monitory Authority of Singapore (MAS) have power to issue directives to the exchanges in their countries respectively. In Canada, which does not yet have a single securities regulatory authority at the federal government level, most of the provincial securities commissions have power to make a decision for the exchange (or reverse a decision). ASIC and Hong Kong's Securities and Futures Commission (SFC) have power to directly assume an exchange function or handling of a file on request of an issuer.

BSEC, Bangladesh's market regulator, has strong control over the country's two bourses. It exercises its control by regularly issuing rules, regulations, notifications, directives and orders. BSEC promulgated several Rules governing different aspects of the market. However, no such rules/regulations/notifications have been promulgated/issued so far addressing the specific issue of conflicts of interest. The Commission has specific powers under Exchanges Demutualisation Act to issue Rules (section 22) and Regulations (section 23) relating to aspects of demutualisation, but it has not exercised these powers yet. There should be explicit provisions entailing specific powers of the Commission with regard to concerns about conflict.

Transferring regulatory functions

A number of jurisdictions have transferred regulatory responsibilities from the exchanges to government regulators, and accordingly reduced the scope of self-regulation. In Hong Kong, for example, the SFC assumed responsibility for broker/member regulation as part of the demutualisation process. The exchange only does market regulation to the extent of exchange trading rules, which are most "business rules"; all breaches of law, including manipulation and insider trading are the responsibility of SFC, including surveillance and monitoring. The UK, France and Mexico are other examples where similar transfers have taken place. Bangladesh has not followed suit yet, though BSEC already has adequate regulatory control over the exchanges. Manipulation and insider trading are overseen by BSEC under the Securities and Exchange Commission (Prohibition of Insider Trading) Rules 1995. Further, BSEC has direct connection with the CRO of the exchanges who sends to it copies of reports on regulatory activities.

Imposing ownership restrictions

Many exchanges have set limit on the share ownership of any one person or company. Hong Kong and Singapore exchanges have ownership caps of 5% but the regulator or the government has power to raise the cap. In Australia, Financial Services Reform Act 2001 imposes a 15% ownership restriction. Toronto Stock Exchange (TSX) raised its limit from 5% to 10% in conjunction with its listing in 2002, by agreement with its supervising Commission. Ownership limits are necessary, in that it will prevent a takeover of an exchange by one user or control group, and will limit potential conflicts between the interests of shareholders and the interests of user-stakeholders.

In Bangladesh, similar ownership restriction of 5% has been imposed. Crucially, however, this is not applicable to the strategic investors, who will have a special status. One strategic investor can hold 25% shares, and even more if the Commission approves. This has potential for conflict, and the permissible percentage of shareholding of strategic investors should be lowered.

Disclosure

Exchanges of all jurisdictions have a duty of disclosure of regulatory issues to the government regulator. In Bangladesh, directors of both exchanges have a duty of disclosure as per their respective Board Regulations of 2013. According to section 6(2) of Securities and Exchange Ordinance 1969, stock exchanges are to submit to BSEC an annual report and periodic returns relating to the exchanges' activities. However, the form in which these returns are to be filed, Form II of Securities and Exchange Rules 1987, does not have provision to report on conflicts of interest. Information on conflicts of interest should be included in the exchanges' returns. Further, the annual reports of the exchanges should address regulatory issues relating to any perceived or actual conflict.

Conclusion:

The underlying objective of stock market regulation is ensuring market integrity such that users will have confidence in using the markets. This means adopting processes that result in markets being transparent, users being treated fairly, the price formation process being reliable and the markets being free of misleading, manipulative or abusive conduct.

Whichever method is chosen for dealing with conflicts, it is important regularly to review existing arrangements to help ensure that an exchange builds for itself a reputation for integrity, efficiency and transparency. In view of the increasing globalization of markets there is also a need to monitor international developments in governance of supervisory activities and to assess whether the model chosen will best equip an exchange to embrace international alliances.

DSE became a member of World Federation of Exchanges in 2015. The successful transition to a fully functional demutualized exchange and strategic alliance with major bourses of the world will result in significant growth of the exchange.

It is clear that Bangladesh has not fallen much behind in addressing the issues of conflicts of interest. The two bourses of the country have successfully separated their business activities from their self-regulatory activities; they have reinforced their public interest mandates through various provisions of law; there are some supervision by BSEC; there are restrictions on ownerships; and there are disclosure obligations on the exchanges. However, there are still a few shortcomings, as pointed out above, which need to be addressed, e.g. lack of rules specifically providing for supervision by BSEC of the exchanges' regulatory activities in matters where there are potentials for conflict, high ownership limits for strategic investors, and lack of adequate disclosure obligations on the exchanges in matters relating to conflicts.

The exchanges have not been listed yet, as per the provision of section 17 of the Exchanges Demutualization Act 2013. When time will come, they will have to be included in their own official lists. It remains to be seen whether DSE and CSE can demonstrate, in relation to their own listings, that they are able to adhere strictly to the highest standards set for other companies.

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