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# Demutualization of Financial Exchanges: Business as Usual?

By *Caroline Bradley*\*

## I. INTRODUCTION

In August 2000, OM Gruppen, the owner of the Stockholm Stock Exchange made a hostile tender offer for the London Stock Exchange, Europe's largest stock exchange. The London Stock Exchange fought a vigorous battle to fend off the offer, and was ultimately successful.<sup>1</sup> The London Stock Exchange was vulnerable to take-over because it had followed the growing trend among financial exchanges to change from a mutual business structure to a shareholder-owned for-profit business structure. This article examines the ways in which such structural changes in the organization of exchanges implicates public interest concerns.<sup>2</sup> The article considers ways in which these concerns may be mitigated.

The article begins by outlining some of the history of mutual business forms, and the recent demutualization movement. Then, after examining the idea of exchanges as proprietary businesses, the article examines three new problems caused by demutualization: how shares in an exchange will be traded; how a proprietary exchange can function as a regulator; and the risk that a proprietary exchange will become a take-over target. The article concludes that there is no perfect arrangement for trading in an exchange's

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\* Professor of Law, University of Miami School of Law. Thanks to Michael Froomkin, Stephen Halpert, Frances Hill, and Roberta Karmel for helpful comments. I would like to thank Angie Padin for research assistance. © Caroline Bradley 2001. All rights reserved. This article is not intended to reflect developments after March 2001.

<sup>1</sup> See, e.g., London Stock Exchange Defence Document, 1 (Oct. 2000), available at <http://www.londonstockexchange.com/defence/pdfs/80898.PDF> (last visited Feb.16, 2001).

<sup>2</sup> See, e.g., TECH. COMM., INT'L. ORG. OF SECS. COMM'NS, Discussion Paper on Stock Exchange Demutualization, 1 (Dec.2000) available at [http://www.iosco.org/download/pdf/2000-stock\\_exchange\\_demutualization.pdf](http://www.iosco.org/download/pdf/2000-stock_exchange_demutualization.pdf) (last visited Feb. 22, 2001) ("A fair and efficient capital market is a public good. A well-run exchange is a key part of the capital market.").

shares; that, if proprietary exchanges are allowed to act as regulators, they should be subject to some constraints as to how they perform this function; and that, contrary to the ordinary case where we have reason to believe that markets discipline firms, a vigorous market for control of exchanges could have harmful effects. The concern that underlies these conclusions is a concern that a country's national interest in protecting its domestic capital markets for the benefit of domestic enterprise and investors is likely to be undermined in a world where exchanges act just like any other business.<sup>3</sup>

Financial exchanges developed as informal collective organizations of traders in particular financial instruments in many jurisdictions.<sup>4</sup> Over time, the exchanges developed their own rules and procedures.<sup>5</sup> Subsequently, the states in which these informal, collective organizations were based moved to regulate financial exchanges, usually as part of a more general regulation of financial and investment activity.<sup>6</sup> Today, regulation of financial exchanges is based on the idea that investors will only trade financial instruments in markets which work properly, which are not rife with fraud, which have accurate information about the price of the financial instruments readily available, and in which trading, clearing, and settlement procedures are efficient.<sup>7</sup> Because exchanges are an important element in the capital formation process, they must be seen to be clean.<sup>8</sup> The public interest<sup>9</sup> in

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<sup>3</sup> See, e.g., Roberta S. Karmel, *Turning Seats into Shares: Implications of Demutualization for the Regulation of Stock Exchanges*, paper presented at the AALS Annual Meeting in January, 2000 ("A non-profit organization enjoys a greater aura of acting in the public interest than does a for-profit corporation. There is a risk that turning exchanges into ordinary public companies, likely to have much smaller capitalizations than their listed companies, will undermine public confidence in these symbols of capitalism.").

<sup>4</sup> *Discussion Paper on Stock Exchange Demutualization*, *supra* note 2, at 1 (last visited Feb. 22, 2001) (stating "[h]istorically, most exchanges were not-for-profit organizations owned by their members").

<sup>5</sup> See, e.g., Stuart Banner, *The Origin of the New York Stock Exchange, 1791-1860* 27 J. LEG. STUD. 113, 132 (1998) ("From its inception, the New York Stock and Exchange Board operated a miniature legal system, with its own rules governing securities trading and its own mechanism for resolving trade-related disputes.").

<sup>6</sup> See, e.g., Paul Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1457 (1997) ("for most exchanges, comprehensive governmental regulation of rules and procedures is a twentieth-century phenomenon."). In the U.S., securities markets are regulated under the Securities Exchange Act of 1934, 15 U.S.C. § 78a, et seq. (the "Exchange Act"); in the U.K., exchanges are currently regulated under §§ 36-41, 119-120 Financial Services Act 1986, 1986 Ch. 60. §§ 285-300 Financial Services and Markets Act 2000, 2000 Ch. 8, will replace the provisions of the 1986 Act when the 2000 Act comes into force.

<sup>7</sup> One of the U.K. Financial Services Authority's primary objectives is to maintain investor confidence in the financial system. See § 2 Financial Services and Markets Act 2000, *supra* note 6 (establishing the FSA's regulatory objectives) (not yet in force) available at <http://www.legislation.hmso.gov.uk/acts/acts2000/20000008.htm>. Section 3(2) of the Act makes it clear that the "financial system" includes "financial markets and exchanges".

<sup>8</sup> "The FSA aims to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal." Financial Services Authority Press Release, Consultation launched on changes to the U.K. listing regime, FSA/PN/007/2001, Jan. 17, 2001, available

ensuring the ready availability of capital for productive enterprise requires that financial exchanges must be regulated, but there are issues about how that regulation should be carried out.

Many states have adopted systems for the regulation of exchange activity that rely, at least partly, on self-regulation.<sup>10</sup> Self-regulation allows regulators to defer to the expertise of exchange participants about what rules and procedures are necessary to make the exchanges work.<sup>11</sup> Exchanges are, therefore, a locus of collision between the private and the public, often combining private membership or ownership with responsibilities that have public characteristics.<sup>12</sup> They are important national assets that serve public and private interests.<sup>13</sup>

Ownership structures of exchanges have also reflected public and private elements: in different societies, exchanges have been privately constituted structures or organizations created by an act of the state.<sup>14</sup> Where

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at <http://www.fsa.gov.uk/pubs/press/2001/007.html> (last visited Feb. 15, 2001). Cf. TECH. COMM., INT'L ORG. OF SECS COMM'NS, *Supervisory Framework for Markets* (May 1999), available at [http://www.iosco.org/download/pdf/1999-supervisory\\_for\\_markets.pdf](http://www.iosco.org/download/pdf/1999-supervisory_for_markets.pdf), 2 (last visited Feb. 26, 2001) ("Regulators in all markets acknowledge that investors want fair, honest and orderly markets. Thus, the integrity of the markets is an important matter of public interest and regulators should take actions that promote these objectives of fair and efficient capital markets.").

<sup>9</sup> See, e.g., 15 U.S.C. § 78b ("transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto").

<sup>10</sup> See, e.g., INT'L ORG. OF SEC. COMM'NS, *Objectives and Principles of Securities Regulation*, ii, (May 1998) available at <http://www.iosco.org/download/pdf/1998-objectives-eng.pdf> (last visited Feb. 25, 2001) ("The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.")

<sup>11</sup> See, e.g., SRO Consultative Comm., Int'l Org. of Secs. Comm'ns, *Model for Effective Regulation*, 4 (May 2000) available at [http://www.iosco.org/download/pdf/2000-effective\\_self-regulation.pdf](http://www.iosco.org/download/pdf/2000-effective_self-regulation.pdf) (last visited Feb. 25, 2001) (noting that "In an environment characterized by a variety of different markets and different types of participants, a specialized and thorough knowledge is very beneficial.").

<sup>12</sup> Although cf. Richard Grasso's comment that: "Anachronistic views of the Exchange as a quasi-public utility have no place in today's world." Richard A. Grasso, Chairman And Chief Executive Officer, NYSE, before the Senate Banking Committee Hearing on September 28, 1999, available at <http://www.nyse.com/events/NT00024586.html> (last visited Mar. 1, 2001).

<sup>13</sup> See, e.g., Securities Exchange Act of 1934, § 11A(a)(1)(A), 15. U.S.C. § 78k-i(a) (describing the securities markets as "an important national asset which must be preserved and strengthened.").

<sup>14</sup> Ranald Michie states that a formal stock exchange was first created in Paris in 1724, after the speculation provoked by John Law's activities. The Exchange's membership was limited to 60 by the government. Ranald C. Michie, *THE LONDON STOCK EXCHANGE. A HISTORY*, 3 (1999).

exchanges originated as spontaneous collective organizations, they have taken the legal form of a mutual organization: in some jurisdictions exchanges were unincorporated associations, in others they were incorporated mutual entities.<sup>15</sup> In the last few years, however, these exchanges have begun to demutualize, to transform their business organization from a mutual business form to a proprietary business form.<sup>16</sup> In other jurisdictions, stock exchanges functioned historically as public institutions.<sup>17</sup> The move to private ownership of these exchanges<sup>18</sup> is comparable to the movement to privatize state owned enterprises generally.<sup>19</sup>

Financial markets are not immune to globalization.<sup>20</sup> Exchanges are engaged in cross border business, through listing securities of foreign issuers, and through allowing foreign persons to trade through their facilities. Members of exchanges may be multinational firms. Exchanges may themselves be multinational enterprises.<sup>21</sup> So, it is not surprising that bodies that

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<sup>15</sup> For example, before its demutualization, the Chicago Mercantile Exchange ("CME") was an Illinois not-for-profit corporation. *See, e.g.,* Chicago Mercantile Exchange, Inc., Amendment No. 5 to Form S-4 Registration Statement, 4 (Apr. 25, 2000) *available at* [http://www.cme.com/news/cme\\_s-4.pdf](http://www.cme.com/news/cme_s-4.pdf) (last visited Feb 15, 2001) [hereinafter "CME Registration Statement"].

<sup>16</sup> The U.K.'s Treasury Select Committee described the distinction between mutual and proprietary businesses as follows: "Mutual organisations are those whose owners and customers are, generally speaking, the same people. They are distinguished from proprietary organisations, owned by a body of shareholders distinct, or largely distinct, from those who have financial dealings with the organisation." Treasury Select Committee, Ninth Report, Demutualisation, Volume I- Report and proceedings of the Committee, ¶ 1 HC 605-I (July 27, 1999)(Session 1998-9), *available at* <http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmselect/cmtreasy/605/60502.htm> (last visited Feb. 20, 2001).

<sup>17</sup> The Cayman Islands Stock Exchange (established 1997) is "a private limited company owned by the Cayman Islands Government but operated as an independent entity." <http://www.csx.com.ky/> (last visited Feb. 26, 2001).

<sup>18</sup> For example, the Athens Stock Exchange was established in 1876 under the Stock Exchange Law, based on the French Commercial Code, as a self-regulated public institution (In 1918, Law 1308 set up the Athens Stock Exchange as a public entity). The Exchange was transformed into a joint stock company in 1995 by Law 2324 of 1995, and Law 2533 of 1997 laid the groundwork for its privatization, although the Greek State currently owns 48.3% of the exchange. Athens Stock Exchange Factbook, *available at* <http://www.ase.gr/FactBook.htm> (last visited Feb. 14, 2001).

<sup>19</sup> *See, e.g.,* Andrei Schleifer, *State Versus Private Ownership*, 12 J. OF ECON. PERSPECTIVES 133 (1998) (discussing arguments against government ownership). Shleifer suggests that non-profit firms are "a private alternative to profit-maximizing suppliers that attenuates the incentives for quality-reducing cost-reduction". *Id.* at 140.

<sup>20</sup> The global financial market is not a new phenomenon. *See, e.g.,* Maurice Obstfeld, *The Global Capital Market: Benefactor or Menace?*, 12 J. OF ECON. PERSPECTIVES 9, 11 (1998) (noting that "[b]efore World War I, a vibrant, free-wheeling capital market linked financial centers in Europe, the western hemisphere, Oceania, Africa, and the Far East.>").

<sup>21</sup> Euronext is an exchange which is being formed through the merger of the Paris, Amsterdam, and Brussels Stock Exchanges. *See, e.g.,* Euronext, *The European "Hub" of the*

are responsible for harmonizing approaches to financial regulation should have begun a process of developing agreement on the critical features of regulation of financial exchanges.<sup>22</sup> Increased competition between exchanges and non-exchange securities markets, exchange mergers, and demutualizations raise issues at the international level, as well as at the domestic level. These transnational issues are considered in Section VII, but the article first examines mutual businesses, including exchanges, and demutualization, from a domestic perspective.

## II. MUTUAL BUSINESSES

Mutual businesses are businesses that are designed to be run by managers for the benefit of their members. They differ from traditional partnerships and corporations in that the members do not have traditional ownership rights in respect of the firm, nor do they typically have rights to share in revenues of the business. Members have equal rights to participate in decision-making.<sup>23</sup> The business will accumulate revenues, rather than distributing them.<sup>24</sup> Mutuals trace their origins to medieval guilds in northern Europe, which were member associations.<sup>25</sup> These guilds were originally linked to the boroughs in which they were established, so were part of a public authority, although they later separated from the boroughs and came to be seen as private.<sup>26</sup> In contrast to the situation in northern Europe, business activity in Italy was carried on through joint stock enterprises characterized by investment of capital, rather than associations of people.<sup>27</sup>

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*Global Network*, available at <http://www.bourse-de-paris.fr/fr/sbf6/pdf/Euronext.pdf> (last visited Feb. 14, 2001).

<sup>22</sup> See, e.g., Supervisory Framework for Markets, *supra* note 8.

<sup>23</sup> See, e.g., Discussion Paper on Stock Exchange Demutualization, *supra* note 2, at 2 (“Decisions are usually made on a one-member, one-vote basis.”); Revised Model Nonprofit Corporation Act (1987) § 7.21.

<sup>24</sup> See, e.g., Revised Model Nonprofit Corporation Act (1987), § 13.01. Mutuals may be allowed to purchase memberships if they do not become insolvent as a result, and may be permitted to distribute funds to members on dissolution. *Id.* at § 13.02.

<sup>25</sup> See, e.g., Swiss Re, Are Mutual Insurers an Endangered Species? Sigma No 4/99, 10 (1999) available at <http://www.swissre.com/e/publications/publications/sigma1/sigma499.Paras.0002.File.pdf> (last visited Feb 22, 2001) (“European mutuals have their roots in the Middle Age guilds that protected members and their families in the event of sickness or death. Even after the guilds disbanded, they continued to function as mutual insurers.”). On guilds, see, e.g., C. A. Cooke, CORPORATION, TRUST AND COMPANY, 21-31 (1951).

<sup>26</sup> See Cooke, *supra* note 25.

<sup>27</sup> E. Hilton Young contrasted the use by the Italian business world of joint stock entities with the Northern European Guild: “In northern Europe, on the other hand, commercial association grew from a different root, and assumed a different form. The parent stock was the Teutonic guild, which was an association of craftsmen for the purpose of their trade, and in which, since the society was concerned not only with the business of its members, but with the regulation of their whole lives, there was an association not of capital only, but of men.”

The joint stock company spread to Northern Europe by 1700, but its development was slowed in England by the Bubble Act of 1720.<sup>28</sup> During the 18<sup>th</sup> century a number of petitions for incorporation were rejected by the Crown, and businesses were formed as partnerships instead.<sup>29</sup> By the beginning of the 19<sup>th</sup> century, there were increasing numbers of joint stock companies in England.<sup>30</sup>

Even after the joint stock company form was available for businesses, the mutual form was sometimes attractive. The U.S. has seen mutual savings banks, trust companies, savings and loan associations, and credit unions.<sup>31</sup> Mutual insurance companies established in the U.S. in the mid 19<sup>th</sup> century successfully challenged existing joint stock insurance companies by cutting their prices.<sup>32</sup> A number of insurance companies in the U.S. began as stock companies and converted into mutuals at the beginning of the 20<sup>th</sup> century after scandals at many life insurers.<sup>33</sup> So the mutual business form was a vehicle that could promote the trust of those who might deal with the firm.<sup>34</sup>

Some financial exchanges developed as mutual businesses before the introduction of general incorporation statutes. For example, the London Stock Exchange started in coffee houses in Change Alley, moving to a building marked as "The Stock Exchange" in 1773, and charging an en-

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E. Hilton Young, FOREIGN COMPANIES AND OTHER CORPORATIONS, 3 (1912). Stuart Bruchey writes that the Italian innovations of *commenda* and *societas maris* "contributed to the success of the English colonization effort in the seventeenth century and to the efficient conduct of economic and business enterprise in America long after that." Stuart Bruchey, ENTERPRISE, 12 (1990).

<sup>28</sup> 6 Geo. I, ch.18. See, e.g., Bishop Carleton Hunt, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867, 9 (1936) ("The act of 1720 and the ensuing collapse of the great speculation arrested the development of joint-stock enterprise for many decades. In sum and in consequence, incorporation remained particular, not general.")

<sup>29</sup> See Hunt, *supra* note 28, at 11-13.

<sup>30</sup> *Id.* at 15.

<sup>31</sup> See, e.g., Henry Hansmann, THE OWNERSHIP OF ENTERPRISE, 246-64 (1996).

<sup>32</sup> See, e.g., Hansmann, *supra* note 31, at 271 (noting that "the lower premiums charged by the mutual companies do not seem explainable by advantages in avoiding moral hazard or adverse selection on the part of the company's policyholders: the mutual companies, from the beginning, were not really consumer-controlled entities, but rather were established and run by managers who were essentially autonomous and self-perpetuating, and who simply sold insurance policies on the market to strangers as did the investor-owned companies.")

<sup>33</sup> See, e.g., Swiss Re, *supra* note 25, at 25. The document also notes similar developments in Canada and the U.K. *Id.*

<sup>34</sup> See, e.g., Hansmann, *supra* note 31, at 248-49 (suggesting that, in the early 19<sup>th</sup> century, individuals were unwilling to deposit their money in investor owned banks because they were largely unregulated). The introduction of federal deposit insurance "decisively eliminated any remaining advantage that mutual banks had over investor-owned banks in offering safety to their depositors." *Id.* at 256.

trance fee for admission.<sup>35</sup> But the exchange “failed to control the London securities market as it was neither exclusive not [sic] dominant”.<sup>36</sup> In 1801 the Stock Exchange became a member organization.<sup>37</sup> The closing of the Stock Exchange to those who were not members was intended to enforce discipline in the market, and to finance the enforcement of discipline.<sup>38</sup> The London Stock Exchange adopted its first set of rules and regulations in 1812,<sup>39</sup> before the first general incorporation statute in England was enacted in 1844.<sup>40</sup> Before 1844 corporations were created by statute or by charter, and other businesses took the form of deed of settlement companies.<sup>41</sup> In the early nineteenth century, Parliament also produced special legislation to regulate various types of mutual enterprise, including building societies,<sup>42</sup> and savings banks.<sup>43</sup> Building societies formed in the U.K. during the eighteenth and nineteenth centuries as mutual organizations to facilitate their members’ home ownership.<sup>44</sup> Maitland points out that, in 1877, a Royal Commission suggested that the London Stock Exchange should be incorporated, but that the Stock Exchange was not interested.<sup>45</sup> The LSE

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<sup>35</sup> David Kynaston, *THE CITY OF LONDON, VOL. 1, A WORLD OF ITS OWN 1815-1890*, 16-17 (1994).

<sup>36</sup> Michie, *supra* note 14, at 32.

<sup>37</sup> Kynaston, *supra* note 35, at 18.

<sup>38</sup> Michie, *supra* note 14, at 34-36.

<sup>39</sup> *Id.* at 19.

<sup>40</sup> Joint Stock Companies Act 1844, 7&8 Vict, C 110.

<sup>41</sup> *See, e.g.*, Cooke, *supra* note 23.

<sup>42</sup> U.K. building societies are similar to savings and loan associations in the U.S. On the evolution of savings and loan associations, *see, e.g.*, Hansmann, *supra* note 31, at 253-54.

<sup>43</sup> *See, e.g.*, Cooke, *supra* note 25, at 116-17 (describing the encouragement of friendly societies under statutes culminating in the Friendly Societies Act of 1829, 10 Geo. IV, c. 56.). Cooke says that “[t]hese societies, friendly, banking and building, all came into statutory existence in the same period, a period before general incorporation laws were seriously contemplated. They continue to exist today as unincorporated companies, governed largely by the principles laid down in acts of parliament a century ago, when the trust form was equipped with some of the trappings of the company in these special fields.” *Id.* at 117.

<sup>44</sup> “Building societies began to be set up in the 18th century, and the original ones were terminating societies, meaning that they were wound up when all the members had succeeded in their purpose of building or buying a house with the money the society had lent them.” Treasury Select Committee, *supra* note 16, at ¶ 5. After 1874, because they came to be seen as investment vehicles rather than as existing for social purposes, building societies could only be formed as incorporated entities under the Building Societies Act, 1874, 37 & 38 Vict., c. 42 (1874). Cooke, *supra* note 25, at 118.

<sup>45</sup> *See* THE COLLECTED PAPERS OF FREDERIC WILLIAM MAITLAND (H.A.L. Fisher ed., 1911), Vol. III, 374 (“And so the Stock Exchange was incorporated? Certainly not. In England you cannot incorporate people who do not want incorporation, and the members of the Stock Exchange did not want it. Something had been said about the submission of the “bye-laws” of the corporation to...the Board of Trade. That was the cloven hoof. *Ex pede diabolum.*”).



finally incorporated as a private limited company in 1986.<sup>46</sup> The Buttonwood Agreement of 1792 between brokers in New York was an early stage in the development of the New York Stock Exchange.<sup>47</sup> The first New York general incorporation statute was enacted in 1811,<sup>48</sup> but the NYSE did not incorporate until 1971,<sup>49</sup> as a New York not-for-profit corporation.<sup>50</sup>

The rights of members of mutual firms vary from jurisdiction to jurisdiction, and also depend on the provisions of the mutual's constitutive documents. Decision-making procedures vary. In the same way that owners and managers of corporations find that their interests may conflict, disputes may arise about the respective rights and duties of management and members of mutuals.<sup>51</sup> The major differences between mutual firms and proprietary firms are in the financial rights of the members, and in the decision-making procedures that apply within the firms.

### III. THE DEMUTUALIZATION MOVEMENT: BUILDING SOCIETIES AND THRIFTS, INSURANCE COMPANIES AND EXCHANGES

Exchanges are not the only type of mutual business to demutualize in the last decade. U.K. building societies have demutualized, becoming more like banks.<sup>52</sup> Insurance companies in various parts of the world have also

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<sup>46</sup> See, e.g. London Stock Exchange, Information Memorandum, 9 (2000) available at <http://www.londonstockexchange.com/dealing/pdfs/demutualisation.pdf> (last visited Mar. 14, 2001).

<sup>47</sup> See, e.g., Banner, *supra* note 5, at 115 (briefly describing the Buttonwood Agreement).

<sup>48</sup> Act of Mar. 22, 1811, ch. LXVII, §1, 1811 N.Y. Laws 111. Other Stock Exchanges subsequently formed in the U.S. See, e.g., Joseph L. King, HISTORY OF THE SAN FRANCISCO STOCK AND EXCHANGE BOARD, 1 (1910) (recording the organization of the exchange in 1862).

<sup>49</sup> See <http://www.nyse.com/pdfs/historical99.pdf> (last visited Mar. 1, 2001).

<sup>50</sup> See Certificate of Incorporation of New York Stock Exchange, Inc., 2 NYSE Guide (CCH) at ¶¶ 1021-1023.

<sup>51</sup> In the U.K. recently, the House of Lords interpreted the provisions of the Articles of Association of the Equitable Life Assurance Society as precluding the directors from adopting a principle of making the final bonuses of guaranteed annuity rate policyholders dependent on how they exercised their rights under the policy. *Equitable Life Assurance Society v. Hyman* [2000] 3 WLR 529. The decision imposed significant costs on the Society, which announced that it was putting itself up for sale. See, e.g., Personal Investment Authority, *Equitable Life Assurance Society, Regulatory Update* (December 2000) available at [http://www.fsa.gov.uk/consumer/whats\\_new/equitable/RegUp82.pdf](http://www.fsa.gov.uk/consumer/whats_new/equitable/RegUp82.pdf) (last visited Feb. 23, 2001). The Halifax, a U.K. bank which was formerly a mutual building society, decided to acquire the Equitable Life Assurance Society. See *Equitable Life Assurance Society Press Release, Acquisition of the Society's Operations by Halifax Group PLC* (Feb 5, 2001) available at <http://www.equitable.co.uk/et/market.nsf/web+pages/CIPR010205E> (last visited Feb. 23, 2001).

<sup>52</sup> Building Societies Act, 1986, 1986 Ch. 53. The statute establishes the conditions under which building societies may demutualize. For litigation arising out of the conversion of building societies from mutual entities, see, e.g., *Northern Rock plc v. Thorpe* (Inspector of Taxes) [2000] STC (SCD) 317 (discussing tax treatment of conversion expenses).

demutualized.<sup>53</sup> There are three main arguments for demutualization: subjecting the firm to the discipline of the marketplace; facilitating the raising of capital; and allowing diversification into areas that would not be appropriate for a mutual enterprise.<sup>54</sup> The arguments exchange managements make for demutualization are similar to those which managements of insurance companies and other types of mutual firm (or their members) make for demutualization, but exchanges raise issues which do not arise in the context of other firms.

Demutualization tends to produce a windfall for members of the mutual organization when their interests obtain a market valuation.<sup>55</sup> Although members of a building society (savers and borrowers) are not usually considered to be its owners, when British building societies are demutualized, borrowers as well as depositors are treated as if they were owners,<sup>56</sup> and share in the financial benefits of demutualization: their ownership interests are recognized and given a market value that can be realized by selling the shares in the market. Members of many building societies have initiated campaigns for demutualization in order to produce such windfall gains.<sup>57</sup>

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<sup>53</sup> See, e.g., James A. Smallenberger, *Restructuring Mutual Life Insurance Companies: a Practical Guide Through the Process*, 49 *DRAKE L. REV.* 513 (2001).

<sup>54</sup> See Treasury Select Committee, *supra* note 16, at ¶ 7 (describing reasons for demutualization of building societies).

<sup>55</sup> See Treasury Select Committee, *supra* note 16, at ¶ 8 (describing the windfall as “the current spur to demutualisation”).

<sup>56</sup> See, e.g., a passage in the Treasury Select Committee’s report on demutualization, describing a lawyer’s explanation of ownership rights in a building society. “Mr Malcolm Waters, QC, a barrister specialising in building society law, told us that ‘the lawyer’s answer’ was that the assets of a building society are owned by the current members, in that they are the people who would share in the assets if the society were to be wound up. This is not, of course, a realistic expectation for most members—very few societies are dissolved. But Mr. Waters went on to say that it was ‘simplistic’ to describe a building society as the property of its present members, as ‘in no sense can the holder of a share in a building society be regarded as having “bought” a stake in the Society’s reserves’. He also pointed out that the buying of a shareholding in a mutual is different from one in a company, in that its value does not vary with the success of the business (unless it becomes insolvent) or with the level of a society’s reserves. He concluded that the introduction of the possibility of demutualisation, rather than being a consequence of the members’ ownership rights, is the principal cause of members coming to believe that they own the society.” Treasury Select Committee, *supra* note 16, at ¶ 25. In sum, the members of the building society have contingent ownership rights. If the society is wound up, or changes its legal form, they are the residual claimants.

<sup>57</sup> People who invest small amounts of money in a number of building societies to benefit from many windfalls are known as “carpetbaggers”. See, e.g., Chelsea Building Society Press Release, *Chelsea’s Success as a Building Society to Continue*, Jan. 31, 2001, available at [http://www.thechelsea.co.uk/html/news\\_31jan2001.html](http://www.thechelsea.co.uk/html/news_31jan2001.html) (last visited Feb. 20, 2001) (describing Mr. Naughton-Doe as “the leader of the carpetbaggers”). In 1999, the Lambeth Building Society announced that it was closing its investment accounts to new investors or introducing minimum investment amounts of £3000 to stave off carpetbaggers. See Lambeth Building Society Press Release, *Lambeth Acts to Deter Carpetbaggers* (Sept. 9, 1999)

Incumbent managements of building societies subject to such attacks fight back by arguing that members will achieve a short term gain at the cost of higher interest rates and lower savings rates which would apply if the demutualized entity needed to pay dividends to shareholders.<sup>58</sup> So, one question about building society demutualization is whether the long-term interests of the members are being sacrificed because of the lure of short-term profits.

The battle over the building societies continues to rage. Although a number of building societies have demutualized, some have decided to retain their mutual status.<sup>59</sup> In other cases, the management of the building society has rejected demutualization proposals without putting them to a member vote.<sup>60</sup> The action of building society managements in fighting off demutualization proposals has prompted some to argue that the story that managements of mutual building societies think only of the interests of their members are untrue.<sup>61</sup>

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available at [http://www.lambeth.co.uk/lb\\_pr\\_990909.htm](http://www.lambeth.co.uk/lb_pr_990909.htm) (last visited Feb. 20, 2001). See the list of Useful Web Sites for Carpetbaggers at <http://www.carpetbagger.com/links.htm> (last visited Feb. 20, 2001). The Cairngorm Demutualisation Investment Trust is a vehicle for investment in mutuals which may demutualize. See <http://www.cairngorm.co.uk/demut/demut.html> (last visited Mar. 14, 2001).

<sup>58</sup> See, e.g., Chelsea Building Society Press Release, *Chelsea Re-affirms Commitment to Remaining Mutual*, Dec. 29, 2000, available at [http://www.thechelsea.co.uk/html/news\\_29dec2000.html](http://www.thechelsea.co.uk/html/news_29dec2000.html) (last visited Feb. 20, 2001) ("By not having to pay dividends to equity shareholders, Chelsea can pay more interest to investors and charge less to borrowers. Conversion to a plc, by whatever route, would rob future generations of these benefits and remove a significant element of competition from a market increasingly dominated by profit-driven plc banks."). The Building Societies Association, a trade association for building societies in the U.K., argues that "Mutual societies have only the interests of their customers to consider and have no shareholders to whom they need to pay dividends. Generally, this means that committed mutual building societies can offer more competitive rates of interest on mortgage and savings products." See <http://www.bsa.org.uk/> (last visited Feb. 19, 2001).

<sup>59</sup> See, e.g., Building Societies Association Press Release, *Victory for Leek United*, 3 December, 1999, available at <http://www.bsa.org.uk/PressReleases/pr031299.html> (last visited Feb. 19, 2001) Britannia Building Society Press Release, *Britannia gives overwhelming vote for mutuality*, April 27, 2000, available at <http://www.britannia.co.uk/britannia/britnews/mutualvote?view=Standard> (last visited Feb. 20, 2001).

<sup>60</sup> See, e.g., Chelsea Building Society Press Release, *supra* note 58 (explaining that the Society had rejected a proposed resolution for demutualization "Following legal advice from a leading firm of City solicitors and leading counsel").

<sup>61</sup> The Building Societies Members Association describes its aim as: "To convert building societies to the true principles of mutuality - owned by members and run for members - not for directors." *Id.* at [http://www.building-societies-members.org.uk/02our\\_aims.htm](http://www.building-societies-members.org.uk/02our_aims.htm) (last visited Feb. 20, 2001). Cf. Swiss Re, *supra* note 25, at 8 ("The strength of mutuals lies in their ability to control customer-owner conflict. Mutuals fall short, however, at controlling owner-manager conflict.").

Sometimes a firm may adopt a partial demutualization strategy, involving the transfer of the business of the mutual to a proprietary company. The mutual company becomes a holding company that does not engage in business itself.<sup>62</sup>

In North America and elsewhere in recent years, many insurance companies have demutualized.<sup>63</sup> Just as with building societies in the U.K., there is a significant amount of conflict surrounding the issue of demutualization of insurance companies. Some of the members of the insurance companies support or encourage demutualization, and sometimes organizations of members of mutual insurance companies mobilize to achieve demutualization in order to benefit members financially.<sup>64</sup> Other groups oppose demutualization because they do not see the change in structure as beneficial to members.<sup>65</sup> Managements of mutual insurance companies vary in their views about whether demutualization is the right strategy for their firm.<sup>66</sup>

Similarly, in the last decade a number of exchanges have demutualized or announced plans to become proprietary entities.<sup>67</sup> Exchanges that have demutualized include the London Stock Exchange,<sup>68</sup> the Toronto Stock Ex-

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<sup>62</sup> See, e.g., Swiss Re, *supra* note 25, at 27. The conversion to a mutual holding company strategy is less expensive than a full demutualization. *Id.* at 28. U.S. Savings and loans institutions are permitted to form mutual holding companies.

<sup>63</sup> See, e.g., Swiss Re, *supra* note 25, at 4 (listing a number of large insurance companies which have demutualized). The Board of Directors of Prudential approved a demutualization plan in December, 2000. See Prudential Insurance Company of America ("Prudential") Press Release, *Prudential's Board of Directors Adopts Plan to Convert From Mutual to Stock Ownership*, (Dec. 18, 2000), available at <http://www.prudential.com/demutualization/dmzzz1001.html> (last visited Feb. 22, 2001); Prudential, *A Guide to Demutualization*, available at <http://www.prudential.com/demutualization/dmzzz1000.html> (last visited Feb. 22, 2001).

<sup>64</sup> See, e.g., the Massmutual Owners' Association website at <http://www.massmutualownersassociation.com/main.asp> (last visited Feb. 22, 2001) (advocating demutualization of the Mass Mutual and Connecticut Mutual Life Insurance Companies, and describing the campaign as one to "distribute more than \$4 Billion to policyowners"). Massmutual has no plans to demutualize. See About Mass Mutual at [http://www.massmutual.com/MMFinancial/Index/0,4174,MM\\_ABOUT\\_MASSMUTUAL,00.htm](http://www.massmutual.com/MMFinancial/Index/0,4174,MM_ABOUT_MASSMUTUAL,00.htm) (last visited Feb 22, 2001).

<sup>65</sup> See, e.g., <http://www.demutualization.org/> (last visited Feb. 22, 2001) ("We think that the demutualization of life insurers is an executive self-enrichment scheme developed by management and their corporate law firms.").

<sup>66</sup> For example, the management of Mass Mutual does not currently intend to demutualize, whereas Prudential has decided to do so. Compare notes 64 and 63 above.

<sup>67</sup> See Demutualization Discussion Paper, *supra* note 2, at 2 ("At last year's annual meeting of the Federation internationale des bourses des valeurs ("FIBV"), it was reported informally that of the 52 exchanges present, 15 had demutualized, 14 had member approval to demutualize and 15 were actively contemplating demutualization.").

<sup>68</sup> LSE Press Release, Exchange Votes to Demutualise (March 15, 2000), available at <http://www.londonstockexchange.com/press/releases/15-03-00.asp> (last visited Feb. 19, 2001).

change,<sup>69</sup> and the Australian Stock Exchange.<sup>70</sup> Late in 2000, NASD announced its decision to spin off the Nasdaq market, retaining only a minority interest,<sup>71</sup> and it completed a private placement in January 2001.<sup>72</sup> The NYSE has also announced its intention to demutualize.<sup>73</sup>

Exchanges demutualize for reasons similar to those identified by other types of mutual firms. The Chicago Mercantile Exchange, which demutualized in November 2000, becoming Chicago Mercantile Exchange Inc.,<sup>74</sup> identified five major objectives for its demutualization: a governance and

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<sup>69</sup> See Toronto Stock Exchange Act, R.S.O. 1990, c. T.15, § 13.0.1 (providing that Toronto Stock Exchange might apply to be continued under the Business Corporations Act). See also Toronto Stock Exchange, A Blueprint for Success, 1 (Oct. 8, 1998), available at [http://tsers.com/cgi-bin/uni\\_framset.cgi?content%3Dpdf/TSEbook.pdf](http://tsers.com/cgi-bin/uni_framset.cgi?content%3Dpdf/TSEbook.pdf) (last visited Feb. 21, 2001) (proposing strategies for improving the exchange's competitive position, including demutualization). The Boston Consulting Group did the research that led to the Toronto Stock Exchange's proposal for change in structure in 1998. *Id.* at 1. The Toronto Stock Exchange was established as an unincorporated association, and later incorporated by a statute of 1878. An Act to Incorporate the Toronto Stock Exchange, Ch. 65, Statutes of Ontario, 1878. Section 6 of the Act notes the existence of an "unincorporated Toronto Stock Exchange".

<sup>70</sup> See, e.g., Australian Stock Exchange, Listing Information Memorandum (Aug. 28, 1998) available at <http://www.asx.com.au/shareholder/pdf/InfoMemorandum1.pdf>; <http://www.asx.com.au/shareholder/pdf/InfoMemorandum2.pdf>; and <http://www.asx.com.au/shareholder/pdf/InfoMemorandum3.pdf> (last visited Feb. 16, 2001). The exchanges which joined together to form the Australian Stock Exchange dated back to the 19th century. Australian Stock Exchange, *History of the Market*, at [http://www.asx.com.au/about/History\\_AA2.shtml](http://www.asx.com.au/about/History_AA2.shtml) (last visited Feb. 16, 2001) ("The ASX (Australian Stock Exchange Limited) was formed in 1987 by legislation of the Australian Parliament which enabled the amalgamation of six independent stock exchanges that formerly operated in the state capital cities. Each of those exchanges had a history of share trading dating back to the 19th century.")

<sup>71</sup> See, e.g., Robert R. Glauber, CEO and President, NASD, Opening Remarks at NASD Fall Securities Regulation Conference, San Francisco, California (Nov. 17, 2000) available at [http://www.nasdr.com/1420/glauber\\_01.htm](http://www.nasdr.com/1420/glauber_01.htm) (last visited Feb. 23, 2001) ("As you know, we are completing the spin-off of the Nasdaq Stock Market - from the NASD into the hands of private owners. When the second round is completed - likely before the end of the year - NASD will own only a modest minority position in Nasdaq."). See also Order Approving Proposed Rule Change Amending the Nasdaq By-laws and Restated Certificate of Incorporation, SEC. & EXCH. COMM'N, Exchange Act Release No. 34,42983, 65 Fed. Reg. 41116 (Jul. 3, 2000). NASD is strictly, not an exchange, but is regulated as a securities information processor under Section 11A of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. § 78k-1 (1994). See, e.g., Regulation ATS, *supra* note 115, at 70,852. Nasdaq does plan to register as an exchange. Order Approving Proposed Rule Change Amending the Nasdaq By-laws and Restated Certificate of Incorporation, *Id.*

<sup>72</sup> Nasdaq Press Release, Nasdaq Completes Private Offering and Expands Board, (Jan. 25, 2001) available at [http://www.nasdaq.com/about/pr\\_private\\_offering\\_012501.stm](http://www.nasdaq.com/about/pr_private_offering_012501.stm) (last visited Mar. 19, 2001).

<sup>73</sup> Grasso, *supra* note 12.

<sup>74</sup> See, e.g., Chicago Mercantile Exchange Press Release, CME Becomes a For-Profit Corporation (Nov. 13, 2000) available at <http://www.cme.com/news/00-149corp.html> (last visited Feb. 21, 2001).

managerial structure that could respond quickly to competition; a financial decision-making model based on stockholder value; the possibility of pursuing new business strategies; unlocking members' equity values; and facilitating working with strategic partners.<sup>75</sup> The Toronto Stock Exchange said that being a "for-profit" business ... will help the organization to become more competitive, more entrepreneurial, and more customer-focused."<sup>76</sup> One of the reasons for the Australian Stock Exchange's demutualization was that the interests of large and small brokers were diverging and it was difficult for the exchange to represent both interest groups and remain competitive.<sup>77</sup> Richard Grasso, of the NYSE, has expressed this last concern even more forcefully, arguing that members of the exchange can only "realize economic value from their right to trade on the NYSE floor," which "skews the interests of member-owners toward the value of the floor trading privilege."<sup>78</sup> In addition, the diversity of the interests of members "is a continual source of tension and conflict. At times it leads to careful deliberations and consensus judgment. All too often it can lead to cumbersome decision-making and strategic gridlock."<sup>79</sup>

Potential windfalls from demutualization distort incentives. In building societies where the members could just as easily invest in or borrow from another financial institution, they have no definitive commitment to the future of the society, and cannot necessarily be trusted to reach the right decision about whether the society should become a proprietary company or not.<sup>80</sup> It is not clear whether the same distortion is likely to occur in the context of exchange conversions. Membership of an exchange is different from membership in a building society and, although exchange members may look forward to realizing gains from selling some of their shares in the demutualized exchange, they may be more likely to be thinking of their continuing position in relation to the exchange when they vote on a conversion.

Demutualizations of businesses such as insurance companies and exchanges are different in another way. One of the concerns about demutuali-

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<sup>75</sup> CME Registration Statement, *supra* note 15, at 19-20.

<sup>76</sup> Toronto Stock Exchange, Demutualization of the TSE, at [http://www.tse.com/tse\\_inc/demutual.html](http://www.tse.com/tse_inc/demutual.html) (last visited Feb. 21, 2001).

<sup>77</sup> ASX Managing Director, Richard Humphry, ASX in the New Millennium - Operating in a Globalised Market, Presentation to the Securities Institute of Australia, 9 May, 2000, available at [http://www.asx.com.au/shareholder/I3/SP090500\\_AS3.shtm](http://www.asx.com.au/shareholder/I3/SP090500_AS3.shtm) (last visited Feb. 21, 2001). This view contrasts with Craig Pirrong's model which suggests that where members of an exchange are homogenous, exchanges would be for profit, whereas heterogenous members would want a non-profit business form. Craig Pirrong, *A Theory of Financial Exchange Organization*, 43 J. LAW & ECON. 437, 438 (2000).

<sup>78</sup> Grasso, *supra* note 12.

<sup>79</sup> *Id.*

<sup>80</sup> The carpetbaggers illustrate this point. People who invest in a society with a view to benefiting financially from a demutualization are not likely to vote against the conversion.

zation of mutual banks and insurance companies is that the proprietary company will pay less attention to the social functions of the firm in order to maximize profits.<sup>81</sup> The social functions of exchanges and insurance companies are different. The activities of insurance companies and banks have a direct impact on customers who are consumers. Securities exchanges provide their services primarily to businesses, rather than to consumers, so, in one sense, the public interest in the exchanges' business form may be less. On the other hand, there is a public interest in the exchanges as a central element of the capital raising process.<sup>82</sup>

Clearly, to the extent that firms wish to raise capital, it is easier for them to do so as proprietary entities than as mutual entities.<sup>83</sup> Mutual entities can look to their members as sources of funds;<sup>84</sup> proprietary entities can look to a wider range of potential investors. U.K. building societies have tended to use demutualization as a means of returning capital to their members rather than one of raising capital, but exchanges are technologically intensive businesses, so their needs for capital may be greater. On the other hand, note that one of the CME's objectives was to unlock members' equity values.<sup>85</sup> The Toronto Stock Exchange sold the idea of demutualization to its members by suggesting that it would give the members new rights to any surplus of the exchange and that it would limit their risk of liability.<sup>86</sup>

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<sup>81</sup> See, e.g., Etienne Pflimlin, *Demutualisation of Financial Co-operatives*, (October 1999) available at <http://www.coop.org/europe/rareports598.html> (last visited Mar. 14, 2001) ("This is of course an economic and financial challenge: choosing between short-term profitability for shareholders only or long-term development for all. But it is also a social and political choice, or even an ideological and cultural choice – the right to exist and maintain the co-operative difference - aimed at building a democratic and caring community.").

<sup>82</sup> Competition from alternative trading systems may prompt exchanges to become more competitive, but these systems free ride on the existence of the exchanges. See, e.g., the Report of Grant Samuels on the Sydney Futures Exchange's demutualization proposal. Sydney Futures Exchange, *Proposal to Demutualise Information Memorandum*, 177 (June 19, 2000) available at <http://www.sfe.com.au/site/html/shareholder/demut.htm> (last visited Mar. 14, 2001) ("In fact, while ECNs are often seen as the way forward they could not operate without the underlying exchange structure fulfilling its regulatory role. In effect, they "piggy back" on it.").

<sup>83</sup> Nonprofit firms cannot raise capital in the financial markets. See, e.g., Hansmann, *supra* note 29, at 240 (Nonprofit firms, by definition, are incapable of obtaining equity capital").

<sup>84</sup> See, e.g., *Blueprint for Success*, *supra* note 69, at 20 (stating "Contrary to widely held belief, the legal structure of the Exchange does not vest the seatholders with any residual ownership interests of the assets of the Exchange; seatholders however, bear unlimited liability for discretionary levies by the Exchange.").

<sup>85</sup> See text at note 75.

<sup>86</sup> Toronto Stock Exchange, *Information Circular providing members with information regarding demutualization of the Toronto Stock Exchange and the market realignment in Canada*, 1 (1999), available at [http://tsers.com/cgi-bin/uni\\_framset.cgi?content%3Dpdf/infocirc.pdf](http://tsers.com/cgi-bin/uni_framset.cgi?content%3Dpdf/infocirc.pdf) (last visited Feb. 21, 2001) (The Board believes that members will reap many rewards for their support. Today TSE seats have a static value unrelated to the TSE's asset base. Members have no right to

NYMEX stated that, although it would not guarantee a market in the exchange's shares, it would be able to pay dividends to stockholders.<sup>87</sup>

Another set of reasons for demutualization involves introducing new governance structures into exchanges: moving from a world of consensus, based on one vote per member, to a world of voting according to the level of investment in the enterprise and a model of taking account of the interests of shareholders in decision-making. The move from a consensus-based system should increase the ease of decision-making.<sup>88</sup> In addition to changing procedures for decision-making, demutualization may be a tool for changing the culture of a firm.<sup>89</sup>

There is also a public relations advantage: in a world where traditional exchanges are being challenged by a range of non-exchange service providers which compete with the services offered by exchanges,<sup>90</sup> one of the major advantages the exchanges derive from demutualization is that they look less like dinosaurs than mutual exchanges do.<sup>91</sup> Exchange managements portray demutualization as a forward-looking strategy. For example, the chairman of the New York Mercantile Exchange stated that demutualization was "indicative of the progressive and innovative manner in which we will proceed as a for-profit corporation to reposition the Exchange as a 21st century business enterprise that will create and pursue profitable new opportunities, react rapidly and decisively in an increasingly competitive marketplace, and explore interest by outside investors."<sup>92</sup>

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any surplus, while the risk of liability is of increasing concern in the new environment. Fundamentally, members have outgrown the need for seats.")

<sup>87</sup> See NYMEX Holdings, Inc., Amendment No. 1 to Form S-4 Registration Statement, 1 (Apr. 14, 2000) available at [http://www.nymex.com/news/s4\\_April.pdf](http://www.nymex.com/news/s4_April.pdf) (last visited Mar. 19, 2001). These statements also appeared in the proxy statement and prospectus dated May 12, 2000 available at <http://www.freedgar.com/>

<sup>88</sup> See, e.g., Toronto Stock Exchange Information Circular, *supra* note 86, at 5 ("Since the Exchange has historically attempted to resolve issues by consensus, the current governance model is becoming an increasingly low and cumbersome method of making decisions. Action is delayed by lengthy consultation, making it difficult for the Exchange to respond quickly and decisively to changes in the market."). Note that what the TSE is referring to here is the constraint imposed by the Exchange's norms, rather than by legal rules. The change in legal form is to be what allows a change in the norms which apply within the exchange.

<sup>89</sup> See, e.g., Swiss Re, *supra* note 25, at 23 (At some mutual insurers, managers sense a need to effect a cultural change within their organizations to promote greater efficiency, cost cutting, and general market sophistication...Converting to a stock often helps facilitate a switch to a more efficient mode of operation.")

<sup>90</sup> The Toronto Stock Exchange said in 1998 that "volume and liquidity is being drawn away from traditional stock exchanges." Blueprint for Success, *supra* note 69, at 4.

<sup>91</sup> Cf. Swiss Re, *supra* note 25, at 4 (asking whether mutuals have become an anachronism).

<sup>92</sup> NYMEX Press Release, *Exchange Demutualizes*, (Nov. 20, 2000) available at [http://www.nymex.com/news/pr\\_detail.cfm?id=319](http://www.nymex.com/news/pr_detail.cfm?id=319) (last visited Mar. 19, 2001).



When mutual exchanges convert to proprietary companies, they substitute the need to maximize profits to benefit shareholders<sup>93</sup> for the need to consider the interests of members.<sup>94</sup> The calculus of decision-making changes. Rather than running the business with a view to what the members may agree to, the management of a proprietary exchange will be managing the business as if it were any other type of business. A rational management will adopt business strategies that promote the interests of exchange shareholders in maximizing the returns on their investment. Managers may be even more likely to do so if they have a financial stake in the value of the exchange's shares because of share option schemes.<sup>95</sup> To the extent that the demutualized exchange has shareholders who are not participants in the exchange's market, there may be a divergence between the interests of owners and customers of the exchange.<sup>96</sup> Some argue that increased competition between financial markets is one reason why market participants no longer need mutual exchanges.<sup>97</sup> Competition between markets should also encourage proprietary exchanges to consider the interests of market participants as part of their profit maximizing strategies.

These advantages may be realized, but at a cost. If nothing else, there is an immediate financial cost to the enterprise, and its owners, as demutualization is not cheap. Prudential reported demutualization expenses of

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<sup>93</sup> Ruben Lee suggests that for-profit exchanges define their objectives in wider terms than mere profit maximization, and that "[t]he assumption that the maximization of profits is the prime, let alone the sole goal of such exchanges is therefore open to question." Ruben Lee, *WHAT IS AN EXCHANGE?*, 24 (1998).

<sup>94</sup> See, e.g., Hansmann, *supra* note 31, at 62 ("Investor-owned firms have the important advantage that their owners generally share a single well-defined objective: to maximize the net present value of the firm's earnings. The costs of collective decision making are thus relatively low for investor-owned firms.").

<sup>95</sup> Grant Samuel's report on the Sydney Futures exchange's demutualization proposal identifies "an ability to incentivise management appropriately" as an advantage of demutualization. SFE, Information Memorandum, *supra* note 82, at 162. The London Stock Exchange introduced such a scheme as part of its demutualization. LSE Information Memorandum, *supra* note 46, at 26-27. The Share scheme was "designed to develop quickly a stronger commercial culture within the Exchange and to align closely senior management's interests and actions with the interests of the Ordinary Shareholders." *Id.* at 26. NYMEX suggested its ability to "retain and attract professional management" would be improved if it could implement "stock-based incentive plans." NYMEX Registration Statement, *supra* note 87, at 8.

<sup>96</sup> The Sydney Futures Exchange recognized that demutualization might disadvantage members because the exchange would focus on maximizing shareholder value. SFE, Information Memorandum, *supra* note 82, at xvii, 21.

<sup>97</sup> See, e.g., SFE, Information memorandum, *supra* note 82, at 12 ("Mutual organisations were set up for a variety of reasons, including to provide purchasers of a product or users of a service with additional protection against the exercise of market power... Today, the importance to the participants in the market of retaining mutual ownership of an exchange is reduced. As previously discussed, electronic trading systems make it much easier for alternative providers, or even the market participants themselves, to offer competitive products and services, limiting any potential market power.").

\$113 million in the nine months leading up to the end of September 2000, before the completion of its demutualization.<sup>98</sup> The Sydney Futures Exchange stated that it would spend Aus\$4.8 million on its plan, whether or not it demutualized.<sup>99</sup> Furthermore, there may be other costs in terms of how the market values shares in the firm after conversion, and in terms of the increased vulnerability of the firm to hostile takeover attempts. Financial regulators may incur additional costs in monitoring the conflicts of interest that may arise in proprietary exchanges.

#### IV. EXCHANGES AS PROPRIETARY BUSINESSES

In order to begin to think about the implications of exchanges being proprietary businesses, rather than mutual enterprises, it is helpful to think about the business of exchanges. Exchanges' business is different from that of firms engaged in other businesses. Exchanges sell listings for financial instruments that satisfy their requirements.<sup>100</sup> They also provide facilities whereby people can trade in financial instruments.<sup>101</sup> They sell information about the prices at which financial instruments trade.<sup>102</sup> They sell regulation of their members. The exchanges do not sell the financial instruments themselves, but merely allow market participants to buy and sell the instruments. Successful exchanges attract trades in securities because of the depth<sup>103</sup> and liquidity of the markets.<sup>104</sup> Depth and liquidity are a function

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<sup>98</sup> See Prudential, Third Quarter 2000 Fast Facts, available at [http://media.corporate-ir.net/media\\_files/PRIV/10693/reports/fastfacts\\_december00.pdf](http://media.corporate-ir.net/media_files/PRIV/10693/reports/fastfacts_december00.pdf) (last visited Feb 22, 2001).

<sup>99</sup> SFE, Information Memorandum, *supra* note 81, at xv. ("SFE will incur an estimated \$4.8 million in costs associated with the development of the Proposal, whether or not the Proposal proceeds. If the Proposal does proceed, SFE will incur additional costs of approximately \$534,000 in connection with the development of the Proposal.")

<sup>100</sup> In the year ending March 31, 1999, 16% of the London Stock Exchange's turnover from continuing activities (excluding regulatory activities) was from company services (fees for admission to trading and annual fees). LSE Information Memorandum, *supra* note 46, at 12.

<sup>101</sup> In the year ending March 31, 1999, 27% of the London Stock Exchange's turnover from continuing activities (excluding regulatory activities) was from trading services. LSE Information Memorandum, *supra* note 46, at 13.

<sup>102</sup> The sale of information may contribute substantially to the exchange's earnings. In the year ending March 31, 1999, 49% of the London Stock Exchange's turnover from continuing activities (excluding regulatory activities) was from information services. LSE Information Memorandum, *supra* note 46, at 14.

<sup>103</sup> See Oliver Hart & John Moore, *The Governance of Exchanges: Members' Cooperatives Versus Outside Ownership*, 12 OXFORD REV. OF ECON. POLICY 53, 55 (1996) ("Perhaps above all, the key asset of an exchange is market depth: the fact that traders know that they can deal with many others at the exchange (i.e. there is an agglomeration effect).").

<sup>104</sup> For a suggestion that liquidity is "one dominant vector along which exchanges compete", see Jonathan R. Macey & Maureen O'Hara, *Globalization, Exchange Governance and the Future of Exchanges*, in Robert E Litan & Anthony M. Santomero (Eds.) BROOKINGS WHARTON: PAPERS ON FINANCIAL SERVICES: 1999 (1999), 1-23, at 2. See also Humphry, *su-*

of the number of participants who are attracted to a particular market to trade there, and part of what attracts market participants is likely to be confidence in the trading arrangements in that market. Exchanges, therefore, are in the business of selling services that are partly constituted by rules they develop themselves.<sup>105</sup>

Don Cruickshank, chairman of the LSE, described the LSE's "three main revenue and profit-generating activities" as "broker services; issuer services; information services; supported by two core business areas of market supervision and systems plus the usual central services."<sup>106</sup> Jonathan Macey and Maureen O'Hara suggest that the "business of operating an exchange has changed from being a relationship business to being a commodity business."<sup>107</sup> But an established exchange with deep, liquid markets has a competitive advantage over newly created markets, not so much because of relationships, but because large numbers of people are in the habit of trading through its facilities.

In contrast to exchanges, stores are commonly the vendors of the products and services they sell, rather than facilitators. Moreover, stores have a limited ability to set the rules according to which transactions are accomplished within their premises. Exchanges are much more like auction houses, or dating services, than they are like stores. Auction houses are proprietary businesses that provide facilities for people to buy and sell products according to the rules established by the auction house. Typically, the number of transactions that pass through an auction house has been much smaller than the number of transactions on an exchange (although the dollar value of some individual auction house transactions may be enormous). Online auctions can produce large numbers of completed transactions.<sup>108</sup> The Internet has given birth to numerous business-to-business

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*pra* note 77 ("If there is one task that I have got, it is to try and preserve Australia's capital markets ... to make them deeper and larger and more liquid, to have the liquidity which will attract investors into the market and make our companies want to stay here and not to move into other markets."); New York Stock Exchange Special Committee on Market Structure, Governance and Ownership, Market Structure Report, 16 (2000) available at <http://www.nyse.com/pdfs/marketstructure.pdf> (last visited Feb. 26, 2001) ("A securities market that does not attract liquidity cannot deliver accurate price discovery or best order executions.").

<sup>105</sup> See, e.g., LSE, Rules & Regulatory Guidance. Overview of Our Regulatory Role, at <http://www.londonstockexchange.com/regulation/regulation.asp> (last visited Feb. 19, 2001) ("The attractiveness of the Exchange's markets is maintained by providing an efficient and well regulated market place.").

<sup>106</sup> Don Cruickshank, Speech to the Securities Institute, Oct. 25, 2000, available at <http://www.londonstockexchange.com/press/releases/25-10-00.asp> (last visited Feb. 19, 2001).

<sup>107</sup> Macey & O'Hara, *supra* note 104, at 2.

<sup>108</sup> Online auctions set their own rules for transactions. For example, e-bid, a U.K.-based site states: "Our site acts as the venue for sellers to conduct auctions and for bidders to bid on sellers' auctions. We are not involved in the actual transaction between buyers and sellers."

("B2B") websites that are geared to facilitating transactions between businesspeople. Although B2B websites may involve issues, particularly of antitrust law, regulators have focused on the risks of electronic commerce for consumers.<sup>109</sup>

The analogies of stores, auction houses, and B2B websites<sup>110</sup> suggest that there is nothing inherent in the idea of a market that requires that it should not be a proprietary business. People do own markets.<sup>111</sup> These analogies suggest that the legal rules that should regulate exchanges should be rules to enhance competition, and rules to prevent fraud. People who own markets should not be able to use them to make monopoly profits or to defraud their customers.

Interestingly, however, the legal rules that regulate exchanges do not seem to reflect a close analogy with auction houses. Unlike auction houses, financial exchanges are subject to their own particular regulatory scheme, which includes rules designed to prevent fraud and market manipulation, and they exist in a context of significant regulation of disclosure by issuers of securities and others. Financial exchanges may be protected from the operation of antitrust laws,<sup>112</sup> although the SEC is required to ensure competition between exchanges and between exchanges and non-exchange

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As a result, we have no control over the quality, safety or legality of the items advertised, the truth or accuracy of the listings, the ability of sellers to sell items or the ability of buyers to buy items. We cannot and do not control whether or not sellers will complete the sale of items they offer or buyers will complete the purchases of items they have bid on. In addition, note that there are risks of dealing with foreign nationals, underage persons or people acting under false pretence." See <http://dev.ebid.co.uk/cgi-bin/objects/normal.cgi?mo=register-main> (last visited Feb. 14, 2001). FED. TRADE COMM'N, *Internet Auctions. A Guide for Buyers and Sellers*, available at <http://www.ftc.gov/bcp/conline/pubs/online/auctions.pdf> (last visited Feb. 14, 2001). FED. TRADE COMM'N, *Going, Going, Gone. Enforcement Efforts to Combat Internet Auction Fraud*, (Feb. 2000) available at <http://www.ftc.gov/bcp/reports/int-auction.pdf> (last visited Feb. 14, 2001).

<sup>109</sup> See, e.g., FED. TRADE COMM'N, *Consumer Protection in the Global Electronic Marketplace. Looking Ahead*, (Sept. 2000) available at <http://www.ftc.gov/bcp/icpw/lookingahead/electronicmkpl.pdf> (last visited Feb. 14, 2001); OECD, *Recommendation of the OECD Council Concerning Guidelines for Consumer Protection in the Context of Electronic Commerce*, available at <http://www.ftc.gov/opa/1999/9912/oecdguide.htm> (last visited Feb. 14, 2001).

<sup>110</sup> For example, Yet2.com is a marketplace for licensable technologies. See <http://www.yet2.com> (last visited Feb. 14, 2001).

<sup>111</sup> LVMH owns Phillips, de Pury & Luxembourg. Phillips was founded in 1796. See [http://www.phillips-auctions.com/usa/ph\\_intro/intro.html](http://www.phillips-auctions.com/usa/ph_intro/intro.html) (last visited Feb. 14, 2001).

<sup>112</sup> See, e.g., *Gordon v. New York Stock Exchange*, 422 U.S. 659, 688-91 (1975) (holding that the antitrust laws are deemed repealed to the extent necessary to permit the securities laws to function as intended by Congress). Cf. *Roskind v. Morgan Stanley Dean Witter & Co.* 80 Cal. App. 4th 345, 352 (2000), cert. denied 148 L. Ed. 2d. 781 (2001) (holding federal securities laws did not pre-empt California's unfair competition law).

petition between exchanges and between exchanges and non-exchange markets for securities.<sup>113</sup>

The differences between the legal treatment of financial exchanges and other markets may be explained by the economic significance of the financial markets.

In the U.S., securities trading systems are regulated either as securities exchanges,<sup>114</sup> or as broker-dealers<sup>115</sup> subject to the requirements of Regulation ATS.<sup>116</sup> Before the SEC registers a national securities exchange it must be satisfied that the exchange is capable of enforcing compliance by its members with the securities laws, that the rules of the exchange provide for fair access to the exchange, fair representation of members of the exchange, and fair disciplinary procedures.<sup>117</sup> The exchange's rules should not impose unnecessary or inappropriate burdens on competition,<sup>118</sup> and they should be:

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate

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<sup>113</sup> Securities Exchange Act of 1934, § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) requires the SEC "to assure ... (f)air competition among ... exchange markets and markets other than exchange markets."

<sup>114</sup> The Securities Exchange Act of 1934 defines an "exchange" as "any organization, association, or group of persons ... which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood." Section 6 of the 1934 Act, 15 U.S.C. § 78f. 15 U.S.C. § 78 (c)(a)(1). *See also* Regulation 3b-16, 17 C.F.R. § 240.3b-16 (April 2000), which defines an exchange to cover "any organization, association, or group of persons that: (1) brings together the orders of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade."

<sup>115</sup> Broker-dealers are required to register with the SEC under Section 15(a) of the 1934 Act, 15 U.S.C. § 78o(a). *See also* 17 CFR § 240.301(b)(1) ("The alternative trading system shall register as a broker-dealer under section 15 of the Act.").

<sup>116</sup> Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844 (Dec. 22, 1998) (codified at 17 C.F.R. pts. 202, 240, 242, 249) (providing that securities markets could choose to be regulated as exchanges, or as broker-dealers subject to alternative trading system rules, including new rules to promote price transparency), corrected by 64 Fed. Reg. 13,065 (1999); 64 Fed. Reg. 19,450 (1999) (making technical amendments to final rule) [hereinafter Regulation ATS].

<sup>117</sup> 15 U.S.C. §78f.

<sup>118</sup> 15 U.S.C. §78f(b)(8).

by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange.<sup>119</sup>

In addition to its powers to decide whether or not to register an exchange, the SEC also has the power to approve or disapprove proposed exchange rule changes.<sup>120</sup> At the beginning of 2001, the SEC proposed to amend the rules for SRO filing of proposed rule changes with the SEC to allow the SROs to compete more freely with their non-SRO competitors.<sup>121</sup> The proposal would permit exchanges to alter the majority of their trading rules without waiting for SEC approval.<sup>122</sup> The SEC states that the proposed rule change would not apply to “fundamental issues of market structure and fairness to customers, members, and non-members, including potentially anti-competitive or discriminatory conduct on the part of the SRO's market.”<sup>123</sup>

Under Regulation ATS, non-exchange securities markets are required to comply with rules that vary according to their trading volume.<sup>124</sup> A market with less than five percent of the trading volume in all securities it trades must file a notice of operation and quarterly reports with the SEC, must maintain records, including an audit trail of transactions; and must not use words such as “exchange,” or “stock market,” in its name.<sup>125</sup> An ATS

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<sup>119</sup> 15 U.S.C. §78f(b)(5).

<sup>120</sup> 15 U.S.C. § 78s(b).

<sup>121</sup> SEC. & EXCH. COMM'N, Proposed Rule Changes of Self-Regulatory Organizations, Exchange Act Release No. 34, 43860, 66 Fed. Reg. 8912 (Feb. 5, 2001) (“Enhancing the SROs' ability to implement and to respond quickly to changes in the marketplace should encourage innovation and better services to investors, such as further automating the execution of trades. Investors should also benefit from a competitive environment in which SROs may easily adapt their trading rules to respond to market opportunities.”).

<sup>122</sup> *Id.* at 8914. This would not apply to “a trading rule that would make fundamental structural changes to the market, and that would significantly affect the protection of investors or the public interest or impose a significant burden on competition”. *Id.*

<sup>123</sup> *Id.* at 8916.

<sup>124</sup> See Regulation ATS, *supra* note 116, at 70847-8; 17 C.F.R. § 242.301. An exchange with a low level of trading volume may be exempted from the requirement under §5 of the 1934 Act to register as a national securities market. The Arizona Stock Exchange operates under a limited volume exemption. See Securities Exchange Act Release No. 28899 (Feb. 20, 1991), 56 Fed. Reg. 8377 (Feb. 28, 1991). Tradepoint also benefits from such an exemption. See SEC. & EXCH. COMM'N, Tradepoint Financial Networks plc; Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 34, 41199, 64 Fed. Reg. 14953 (Mar. 29, 1999). As of February 5, 2001, Tradepoint has changed its name to virt-x PLC. See <http://www.tradepoint.co.uk/> (last visited Feb. 16, 2001). Virt-x plc is the result of a merger between SWX Swiss stock Exchange and Tradepoint. See, e.g., Tradepoint Press Release, *Tradepoint signs agreements with SWX Swiss Stock Exchange and Tradepoint Consortium relating to the creation of the virt-x market for pan-European blue chip stocks* (Oct. 23, 2000).

<sup>125</sup> See Regulation ATS, *supra* note 116, at 70847; 17 C.F.R. § 240.301(b) (April 2000). 17 C.F.R. § 240.301(b)(11) provides: “The alternative trading system shall not use in its

with five percent or more of the trading volume in any national market system security that registers as a broker-dealer must "integrate its activities into the national market system".<sup>126</sup> Such a system must be linked with a registered market and must feed the best priced orders in national market system securities displayed in their systems (including institutional orders) into the public quote stream, and they must comply with the rules governing execution priorities and other obligations that apply in the registered market to which they are linked.<sup>127</sup> An ATS with twenty percent or more of the trading volume in any single security must grant or deny access based on objective standards applied in a non-discriminatory manner; and it must establish procedures to ensure adequate systems capacity, integrity, and contingency planning.<sup>128</sup> The SEC also announced in 1998 that it intended to work with the SROs on the development of ongoing, real-time surveillance for market manipulation and fraud and surveillance procedures specifically targeted to ATSS.<sup>129</sup>

The 1934 Act's model of the regulation of exchanges involves those exchanges acting as operators and regulators of their markets, subject to the supervision of the SEC. Securities markets regulated as ATSS do not have a regulatory function. The SEC has decided that exchange markets may be proprietary businesses,<sup>130</sup> and that existing exchanges may demutualize.<sup>131</sup> This decision by the SEC increases the scope for competition<sup>132</sup> between

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name the word "exchange," or derivations of the word "exchange," such as the term "stock market."

<sup>126</sup> See Regulation ATS, *supra* note 116, at 70847.

<sup>127</sup> See Regulation ATS, *supra* note 116, at 70847; 17 C.F.R. § 240.310(b)(3) (April, 2000).

<sup>128</sup> See Regulation ATS, *supra* note 116, at 70848; 17 C.F.R. §§ 240.310(b)(5)-(6) (April, 2000).

<sup>129</sup> See Regulation ATS, *supra* note 116, at 70848.

<sup>130</sup> See Regulation ATS, *supra* note 116, at 70848. Tradepoint, a U.K. based exchange which also operates within the U.S., was founded as a proprietary company. On Tradepoint, see Elizabeth M. McCarroll, *Regulation of Electronic Communications Networks: An Examination of Tradepoint Financial Network's SEC Approval to Become the First Non-American Exchange to Operate in the United States*, 33 CORNELL INT'L L.J. 211 (2000).

<sup>131</sup> See Regulation ATS, *supra* note 116, at 70848.

<sup>132</sup> SEC Chairman, Arthur Levitt, *The National Market System: A Vision That Endures*, speech at Stanford University, Stanford, California, (Jan. 8, 2001) available at <http://www.sec.gov/news/speeches/spch453.htm> ("In these fiercely competitive times, when the survival of time-honored institutions is in question, when the viability of business models is up for debate, when careers and fortunes hang in the balance, crafting markets that serve the public interest presents an even greater challenge. Market participants threatened by change may seek refuge in reform they believe will simply buy them time. And market reformists likewise may advocate changes artfully crafted to suit their unique business interests. Prudence is critical as we consider changes to a market system that must never cease to function, day in and day out, for the benefit of America's investors - not for any one institution or interest. And that prudence extends to the Commission's role. The SEC's objective or function is not to dictate a particular market model, but rather, to allow the natural interplay

traditional exchange markets and newer markets that may wish to acquire exchange status.<sup>133</sup>

Futures exchanges are currently regulated by the CFTC,<sup>134</sup> which has recently adopted new rules for its oversight of futures markets,<sup>135</sup> covering three categories of market: exempt markets, designated contract markets and registered derivatives transaction execution facilities.<sup>136</sup> In proposing the new rules, the CFTC stated that the “proposed rules implement statutory changes that profoundly alter federal regulation of commodity futures and option markets.”<sup>137</sup> The CFTC has the power to decide whether a contract market meets the criteria for designation,<sup>138</sup> whether a derivatives transaction execution facility meets the criteria for registration,<sup>139</sup> or whether a market is an exempt market.<sup>140</sup> The statute allows the CFTC to make rules about these matters, but also establishes criteria. For example, the CFTC should only designate markets that have rules in place to prevent market manipulation, and to ensure fair and equitable trading.<sup>141</sup> The market should also provide for the financial integrity of transactions, and should have disciplinary procedures to ensure compliance with the statute.<sup>142</sup> It should provide the public with access to its rules, regulations, and contract specifications.<sup>143</sup> The criteria, therefore, resemble those that apply to securities exchanges. As the SEC proposes to relax its approach to SRO rule

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of market forces to shape markets according to the demands of investors. Put another way, the Commission has been charged by Congress to facilitate the development of a National Market System. And this begins by providing the catalyst for market infrastructure refinements that serve the investing public.”).

<sup>133</sup> For example, “Island”, an ECN, has announced plans to register with the SEC as an exchange. See Press Release, The Island ECN, Inc., Island Takes First Steps Toward Becoming Registered Stock Exchange (April 30 1999) <http://www.isld.com/pressroom/releases/043099.htm> (last visited Feb. 25, 2001).

<sup>134</sup> The CFTC derives its powers from the Commodities Exchange Act of 1974, 7 U.S.C. § 1 et seq., as amended by the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114Stat. 2763 (2000) (CFMA 2000).

<sup>135</sup> COMM. FUT. TRADING COMM’N, A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 42256 (Aug. 10, 2001) (hereinafter “New Regulatory Framework”). For the CFTC’s proposal which led to the new rules, see COMM. FUT. TRADING COMM’N, A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 14262 (Mar. 9, 2001).

<sup>136</sup> New Regulatory Framework, *supra* note 135, at 42256

<sup>137</sup> *Id.*

<sup>138</sup> 7 U.S.C. § 7, §7a, as amended by CFMA 2000, §110.

<sup>139</sup> The Commodity Futures Modernization Act of 2000, *supra* note 134, amended the CEA to introduce derivatives transaction execution facilities. CFMA 2000, § 111.

<sup>140</sup> 7 U.S.C. § 6(c) allows for the exemption of agreements, contracts, or transactions, “[i]n order to promote responsible economic or financial innovation and fair competition”.

<sup>141</sup> CFMA § 110, amending 7 U.S.C. § 7.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*



changes, so the CFTC proposes to adopt a relaxed approach to requiring notification of changes to contract market rules.<sup>144</sup>

Meanwhile, Europeans are engaged in a discussion of how to achieve a single European market in financial services,<sup>145</sup> which includes discussions of the appropriate regulation of exchanges and alternative trading systems.<sup>146</sup> At the international level, an IOSCO working group has suggested what a supervisory framework for the regulation of securities markets should look like.<sup>147</sup> The framework reflects the approach of securities regulators in different jurisdictions to the regulation of the securities markets.<sup>148</sup> An appendix to the document provides "some examples"<sup>149</sup> of regulation in a number of different jurisdictions: Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Spain, the U.K., and the U.S.<sup>150</sup> The framework includes rules to ensure an orderly market,<sup>151</sup> and to promote transpar-

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<sup>144</sup> Proposal for a New Regulatory Framework, *supra* note 135, at 14263 ("In light of the past successful conduct of its oversight duties without the submission of every rule change, the Commission believes that it is in the public interest to exempt contract markets from the requirement that they certify all rules. The Commission also believes that this additional flexibility is consistent with the overall intent and structure of the recent amendments to the Act.").

<sup>145</sup> See, e.g., EU Commission, Financial Services: Building a Framework for Action, (1998) *available at* [http://www.europa.eu.int/comm/internal\\_market/en/finances/general/fsen.pdf](http://www.europa.eu.int/comm/internal_market/en/finances/general/fsen.pdf) (last visited Feb. 27, 2001) ("A single deep and liquid financial market which can serve as the motor for growth, job-creation, and improved competitiveness of the European economy is within reach.") This discussion is not new. See, e.g., Caroline Bradley, 1992: *The Case of Financial Services*, 12 N. W. J. INT'L L. & BUS 124 (1991).

<sup>146</sup> See, e.g., EU Commission, Financial Services: Implementing the Framework for Financial Markets: Action Plan, 6 (May 1999) *available at* [http://www.europa.eu.int/comm/internal\\_market/en/finances/general/actionen.pdf](http://www.europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf) (last visited Feb. 27, 2001) (noting the need for a common European approach to the regulation and supervision of alternative trading systems).

<sup>147</sup> Supervisory Framework for Markets, *supra* note 8.

<sup>148</sup> See Supervisory Framework for Markets, *supra* note 8, at 1 ("The Technical Committee Working Group on the Regulation of Secondary Markets..was given the mandate to survey the methods and scope of members' supervision of regulated markets in order to share information on regulators' experiences.").

<sup>149</sup> Supervisory Framework for Markets, *supra* note 8, at 14. It is not clear to what extent the members of the Working Groups relied on other examples, or other jurisdictions, in drafting the report.

<sup>150</sup> Supervisory Framework for Markets, *supra* note 8, at Appendix A.

<sup>151</sup> Supervisory Framework for Markets, *supra* note 8, at 3-4. Such rules include trading rules; default procedures, such as procedures for trading halts; and rules to ensure operator and systems competence. In addition a regulator should oversee the market operator and have a role in review of products to be traded. Access to the system should be fair and objective, and the regulator should supervise admission criteria and procedures. *Id.*

ency,<sup>152</sup> and rules to prohibit unfair trading.<sup>153</sup> In addition, the report suggests that regulation should seek to secure appropriate risk identification and management,<sup>154</sup> and to ensure that clearing and settlement systems are effective.<sup>155</sup>

We know that, in practice, exchanges do not always operate in accordance with the various criteria of IOSCO's framework, so, assuming the IOSCO criteria are the right ones to apply to securities markets,<sup>156</sup> there are some questions about the effectiveness of regulation of exchanges. Some of these questions involve problems of enforcement. Insiders engage in insider trading. People manipulate the securities markets. Other questions involve the substantive content of an exchange's rules. The NYSE's Market Structure Report pointed out that exchange markets other than the NYSE effectively allowed broker-dealers to internalize trades, which might not produce the best price for their customers.<sup>157</sup> If demutualization of exchanges were to increase the likelihood that exchanges would operate in accordance with IOSCO's framework, that would be a good outcome.<sup>158</sup> In theory, there are some reasons to believe that this might be the case. On the other hand, there are also reasons for doubt.

In addition to being subject to regulation, proprietary exchanges will, arguably, be subjected to the discipline of a number of different markets,

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<sup>152</sup> Supervisory Framework for Markets, *supra* note 8, at 4. Transparency includes disclosure of information about issuers, securities, trading halts, bid and offer prices, completed transactions, and order routing and execution procedures. *Id.*

<sup>153</sup> Supervisory Framework for Markets, *supra* note 8, at 4-5. Such rules would prevent deceptive and fraudulent conduct such as market manipulation, misleading conduct, and insider trading; they would control conflicts of interest, sales practices, access criteria, and the conduct of market participants. *Id.*

<sup>154</sup> Supervisory Framework for Markets, *supra* note 8, at 5-6. Risk management includes issues of operator competence, capital adequacy of market participants, margin requirements, large exposures, and cross-market conduct (involving cash and derivative markets). *Id.*

<sup>155</sup> Supervisory Framework for Markets, *supra* note 8, at 6.

<sup>156</sup> The criteria are expressed at a level of such generality - they tend to specify the subject-matter of the rules which should apply to securities markets, rather than their content - that it is difficult to disagree with them.

<sup>157</sup> Market Structure report, *supra* note 104, at 10-11 ("One presenter stated that his firm directed its order flow to a regional exchange rather than the NYSE because it could trade those orders with an affiliated specialist at that exchange. In urging us to facilitate internalization by NYSE member firms, the presenter said that "[t]he ability to internalize is directly linked to our ability to bring our business back to the [NYSE].")

<sup>158</sup> Paul Mahoney argues that competition between stock exchanges is likely to produce better rules than those which would be produced by government regulation. *See* Mahoney, *supra* note 6, at 1463 (although "stock exchanges may lack the incentive to adopt optimal rules" this does "not necessarily provide a strong basis for substituting government agencies for exchanges as the principal regulators").

which should increase their efficiency.<sup>159</sup> The managements of proprietary exchanges should have an incentive to maximize revenues and minimize costs,<sup>160</sup> because their managements have a legal obligation to maximize profits for owners,<sup>161</sup> and because the owners will expect them to do so. If an exchange needs to go to the market to raise new capital its cost of capital will depend on the attractiveness of its securities to investors.<sup>162</sup> If the owners of a proprietary exchange are dissatisfied with its performance they may sell their shares, depressing the share price, and providing an opportunity for a predator to move in to acquire the exchange and fire the incumbent management.<sup>163</sup>

But the discipline imposed on the managements of proprietary exchanges by their need to maximize profits may harm the interests of the exchanges' customers. Where exchanges need to maximize profits from attracting listings and trades, their rules may either benefit the managements of issuers, or encourage trading. If managements of issuers of securities have the power to decide where the issuer's securities should be listed (or re-listed) they may decide to list with the exchange with the rules that give them the most leeway.<sup>164</sup> Thus rules that would benefit shareholders in the exchange might harm the interests of shareholders of other issuers listed on the exchange. Exchange rules that encourage speculative stock trading may

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<sup>159</sup> Incentives should be different given different ownership structures. *See, e.g.*, Phillip A. Wellons, Prototypes of Securities Regulation for Africa: Key Issues, Consulting Assistance on Economic Reform II Discussion Paper No. 47, August 1999, available at [http://www.hiid.harvard.edu/caer2/html/content/papers/paper47/paper47.htm#\\_Toc482167556](http://www.hiid.harvard.edu/caer2/html/content/papers/paper47/paper47.htm#_Toc482167556).

<sup>160</sup> Schleifer, *supra* note 19, at 140 (noting that non-profits may avoid problems of quality reducing cost reduction which may occur in profit maximizing firms, and that the non-profit structure may, therefore, be appropriate for hospitals, schools, and day care centers.).

<sup>161</sup> *See, e.g.*, *Dodge v Ford Motor Co.*, 170 N.W. 668, 684 (S. Ct. Mich. 1919) (stating that a "business corporation is organized and carried on primarily for the profit of the stockholders").

<sup>162</sup> For example, junk bond issuers paid very high rates of interest on their bonds to compensate for the risks associated with the investments. *See, e.g.*, Michael D. Floyd, *Junk Bonds: Do They Have a Value?* 35 *Emory L.J.* 921, 924 (1986) ("Junk bonds appeal to a certain segment of the investment community because they have historically provided higher returns than less risky alternatives. ")

<sup>163</sup> *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law*, 112 (1991) ("Corporate control transactions can reduce agency costs if better managers obtain control of the firm's assets or if they alter the incentive structure facing existing managers. This means, in turn, greater wealth for all. The gains from control transactions may be exceedingly great.").

<sup>164</sup> Marcel Kahan, *Some Problems with Stock Exchange-based Securities Regulation*, 83 *VA. L. REV.* 1509, 1511-1512 (1997) (suggesting stock exchanges may adopt rules which benefit the managers of corporate issuers who make the listing/relisting decision, rather than investors).

benefit exchange members but reduce collective investor welfare.<sup>165</sup> The maximization of profits for the benefit of the shareholders of the exchange may therefore be inconsistent with the interests of investors in issuers whose securities list on, or trade through, the exchange. From the perspective of investors in general, profit maximization may not, therefore, be a substitute for regulatory control of the exchange.

Within proprietary exchanges, conflicts may arise between the interests of owners and those of managers, just as they may do in any proprietary business. This means that proprietary exchanges have the same need for good corporate governance as do ordinary businesses, in addition to being subject to the constraints imposed by market mechanisms and legal rules. However, there are reasons to doubt the effectiveness of corporate governance measures as protections for the interests of shareholders, even in more ordinary businesses.<sup>166</sup> For example, some commentators focus on executive pay that increases even at times when returns to shareholders decrease.<sup>167</sup> But even if corporate governance measures do work to protect the interests of shareholders, they are not designed to protect non-shareholder interests.<sup>168</sup>

## V. ARRANGEMENTS FOR TRADING IN EXCHANGE SHARES

Exchanges choose different procedures for demutualizing, and different arrangements for owners of shares to trade those shares after demutualization. If an exchange wishes to reach a large and diverse investor group, it will want to ensure a public market in its shares. However, in practice, exchanges seem to move slowly towards this goal. The Toronto Stock Exchange's plan for demutualization involved issuing 20 common shares to each seat-holder.<sup>169</sup> The initial plan did not envisage any rapid development of a trading market in the exchange's shares, as restrictions on transfer

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<sup>165</sup> *Id.* at 1513 (citing Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 656-91 (1995)). This problem is probably more likely to arise in mutual stock exchanges than in proprietary exchanges.

<sup>166</sup> *See, e.g.*, William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C.L. REV. 1861, 1862 (1995) (describing corporate law as "a self-regulatory system, composed of firms and state lawmaking institutions, in which competition among the states ensures the system's capture by corporate management influence.").

<sup>167</sup> *See, e.g.*, Graef Crystal, *GE CEO Welch's Pay Shows Capitalism's Ugly Side* (Mar. 16, 2001), available at <http://www.bloomberg.com> (last visited Mar. 19, 2001) (noting that Jack Welch of General Electric received an 80% increase in remuneration while total shareholder return fell by 6%).

<sup>168</sup> *See, e.g.*, Margaret M. Blair, *OWNERSHIP AND CONTROL*, 13 (1995) ("the suspicion that shareholder interests may, at times, be at odds with important social goals lurks behind some of the more heated corporate governance debates.").

<sup>169</sup> *See* Toronto Stock Exchange Information Circular, *supra* note 86, at 7.

would apply for a period of two years.<sup>170</sup> Similarly, the London Stock Exchange stated that “an interim period is required whilst the Exchange’s business evolves and the consequences and benefits of these changes have time to take full effect.”<sup>171</sup> This was one reason for the initial decision not to list the exchange’s shares.<sup>172</sup> Other exchanges have initiated IPOs to make their foray into the market. The NYSE’s plan is to separate members’ rights into a trading right and shares of stock and to “structure the IPO to create incentives so that a percentage of their shares are sold to non-member institutions and public investors.”<sup>173</sup> Nasdaq’s plan involved a two-stage private placement of common stock and warrants to NASD members, Nasdaq issuers, institutional investors and strategic partners.<sup>174</sup> The Sydney Futures Exchange stated, as part of its proposal to demutualize in June, 2000, that it did not plan to list shares immediately, although it would be preferable to list its shares in due course.<sup>175</sup> The SFE arranged for its shares to be traded on an exempt market operated by Austock from the beginning of November 2000.<sup>176</sup>

Trading arrangements vary. Shares in the Australian Stock Exchange are listed on the exchange itself.<sup>177</sup> London Stock Exchange shares are traded on the exchange’s main market.<sup>178</sup> Shares of the holding company of the Hong Kong Stock Exchange, Hong Kong Exchanges and Clearing Limited, are listed on the Hong Kong Stock Exchange.<sup>179</sup> Shares in Tradeport

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<sup>170</sup> See *id.* at 9.

<sup>171</sup> LSE Information Memorandum, *supra* note 46, at 8.

<sup>172</sup> *Id.* Another reason was that the Exchange had no immediate need for capital. *Id.*

<sup>173</sup> See Grasso, *supra* note 12.

<sup>174</sup> Order approving Proposed Rule Change Amending the Nasdaq By-laws and Restated Certificate of Incorporation, *supra* note 69.

<sup>175</sup> SFE, Information Memorandum, *supra* note 82, at vii, 38.

<sup>176</sup> See, Sydney Futures Exchange Press Release, SFE Shares to List on Austock Market, (Oct. 23, 2000), available at [http://www.sfe.com.au/content/media/mediarelease/2000/mr\\_20001023\\_01.htm](http://www.sfe.com.au/content/media/mediarelease/2000/mr_20001023_01.htm) (last visited Mar. 14, 2001). See also SFE Disclosure Document, Austock Exempt Market Listing (updated Jan. 10, 2001) available at [http://www.sfe.com.au/site/html/shareholder/austock\\_disclosure.pdf](http://www.sfe.com.au/site/html/shareholder/austock_disclosure.pdf) (last visited Mar. 14, 2001).

<sup>177</sup> “ASX was originally a mutual organisation of stockbrokers, like its predecessor State stock exchanges. However, in 1996, its members decided to demutualise and list, which required legislation of the Australian parliament. The change of status took place on October 13, 1998, and the following day ASX listed on its market.” ASX Overview and Structure, at [http://www.asx.com.au/shareholder/13/ASXOverview\\_AS3.shtml](http://www.asx.com.au/shareholder/13/ASXOverview_AS3.shtml) (last visited Feb. 16, 2001).

<sup>178</sup> See London Stock Exchange, Introduction to the Official List Sponsored by Schroder Salomon Smith Barney for Listing in July 2001, available at <http://www.londonstockexchange.com/dealing/pdfs/c82754CL.pdf> (last visited Oct. 1, 2001).

<sup>179</sup> Memorandum of Understanding for the Listing of Hong Kong Exchanges and Clearing Limited on the Stock Exchange of Hong Kong Limited Between Securities and Futures

are traded on the London Stock Exchange's Alternative Investment Market ("AIM").<sup>180</sup> The CME stated in April 2000 that it had no current plans to list its shares on an exchange.<sup>181</sup> Euronext stated in August 2000 that it planned to list its shares on Euronext.<sup>182</sup>

No solution to the problem of how to create a market in the exchange's shares is perfect. If the shares are not listed on any exchange, the market in the shares is likely to be thinner and less liquid than if the shares were listed. Some investors who might be interested in holding the exchange's shares will not invest if the shares are not listed. If the demutualization plan is primarily geared to improving the exchange's governance, and if the shareholders do not mind that the market for their shares is relatively illiquid, this may not matter. The London Stock Exchange chose not to list its shares on demutualization, although its Chairman has suggested that the Exchange may list its shares in the future.<sup>183</sup>

If the exchange does plan to list its shares to maximize the attractiveness of the shares to outside investors and to obtain as liquid a market for those shares as possible, it will need to decide where to list the shares. If the exchange decides to list its shares on a competitor exchange, this may suggest a lack of self-confidence. On the other hand, for an exchange to list its own shares looks strange,<sup>184</sup> and raises the specter of conflicts of interest. It is doubtful whether an entity responsible for evaluating compliance with initial and continuing listing requirements can legitimately apply those requirements to itself.

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Commission, Hong Kong Exchanges and Clearing Limited, and the Stock Exchange of Hong Kong Limited, 19th June 2000. Documents available from Hong Kong Stock Exchange website available at <http://www.hkex.com.hk/relation/relation.htm> (visited 29 January, 2001). Shares in OM Gruppen, the holding company of the Stockholm Stock Exchange, are traded on the SSE. See, e.g., *Blueprint for Success*, supra note 68, at 12 ("OM Gruppen is listed on the SSE").

<sup>180</sup> See, e.g., [http://www.londonstockexchange.com/aim/companies\\_list.asp](http://www.londonstockexchange.com/aim/companies_list.asp) (last visited Mar. 19, 2001).

<sup>181</sup> CME Registration Statement, supra note 15, at 5.

<sup>182</sup> Euronext Press Release, *New Step Toward Creation of Euronext: Shareholders Circular Sent to Euronext Shareholders* (Aug. 7, 2000) available at <http://www.bourse-de-paris.fr/en/news7/p77252.htm> (last visited Feb. 21, 2001) ("EURONEXT shares will be listed on EURONEXT as soon as it is practicable after the closing date.").

<sup>183</sup> Don Cruickshank referred to the LSE as "a commercial company - in due course a listed company - subject to the ordinary commercial disciplines of the market economy." See Don Cruickshank, *Speech*, supra note 106.

<sup>184</sup> The Chairman of the ASX stated "We...decided to list which created great hilarity at the time because we listed on ourselves, and that was seen as being a very strange thing to do. But we needed to list somewhere and it seems to have worked quite well. From an operational perspective, essentially listing has energised the ASX to become focused on what it was doing and to become more responsive to its customer demands and market developments." Humphry, supra note 77.

The Australian solution to the problem of an exchange listing its own shares is to transfer the day-to-day responsibility for monitoring compliance by the exchange with listing requirements to the Australian Securities and Investments Commission ("ASIC").<sup>185</sup> The Australian Stock Exchange retains the general responsibility for regulating listings in Australia. This solution appears to deal with conflicts of interest issues, although the cost is that the body that supervises compliance by the ASX with listing requirements is not one which is generally in the business of monitoring compliance with listing requirements.

The Australian strategy of listing its shares has produced a substantial group of investors. When the exchange listed its securities in 1998 it had 606 shareholders who had been members before demutualization. In 2000, the Exchange had about 16,000 shareholders, of whom about 385 were original member shareholders.<sup>186</sup> Slightly more than 10,500 shareholders held 1000 or fewer shares.<sup>187</sup>

## VI. PROPRIETARY BUSINESSES AS REGULATORS (PRIVATIZED REGULATION)

In many jurisdictions, financial regulation involves a significant component of self-regulation.<sup>188</sup> The reason for this is partly historical. Exchanges which grew from relatively informal beginnings found that they needed to impose rules on market participants. In England, Barnards Act of 1734 made time bargains illegal, so that regulation of these transactions was, necessarily, extra-legal.<sup>189</sup>

The main justification for self-regulation in the financial context is that self-regulatory bodies have expertise that external regulators might not have access to.<sup>190</sup> Self-regulation may have another advantage: the regulated

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<sup>185</sup> "ASIC supervised ASX's listing and undertakes the day-to-day supervision of its compliance with the listing rules to ensure ASX is subject to the same independent scrutiny as all other listed entities." ASX Overview and Structure, *supra* note 177.

<sup>186</sup> See, ASX REPORT TO SHAREHOLDERS 2000, 38 (2000) available at <http://www.asx.com.au/shareholder/pdf/AnnualReport2000.pdf> (last visited Mar. 19, 2001).

<sup>187</sup> *Id.* at 63.

<sup>188</sup> See, e.g., Supervisory Framework for Markets, *supra* note 8, at 11 ("In most jurisdictions, the model has shifted from the pure self-regulatory model, so that both the market authority and the regulator perform regulatory responsibilities. However, the extent to which self-regulation is used varies.")

<sup>189</sup> See, e.g., Michie, *supra* note 14, at 31.

<sup>190</sup> See, e.g., Arthur Levitt, *Dynamic Markets, Timeless Principles*, 2000 COLUM. BUS. L. REV. 1, 7 (2000) ("For the better part of this century, self-regulation has proved effective, in large part, because of its ground-level familiarity with the markets as well as its members' activities."); HM Treasury, Financial Services and Markets Bill, Draft Recognition Requirements for Investment Exchanges and Clearing Houses 2 (February 1999), available at <http://www.hm-treasury.gov.uk/pub/html/reg/fsmb.pdf> (last visited Apr. 17, 2001) ("Exchanges and clearing houses will be experts in the operation of their own markets and will

population may be more inclined to comply with self-regulatory rules than with rules imposed by outsiders. It is sometimes argued that self-regulation can impose a higher standard of conduct than legal rules can.<sup>191</sup> Pure self-regulation would involve an unattractive prospect of financial firms "regulating" themselves in their own interest,<sup>192</sup> so regulatory schemes often provide for self-regulation within a statutory framework creating a regulator.<sup>193</sup> In addition to the claims about the need for expertise in financial regulation, those who promote the idea of self-regulation in a statutory context often do so to achieve two potentially conflicting, objectives: to make the regulatory scheme acceptable to the regulated population, and to convince outsiders that the scheme is effective. Whether the "self" or the "regulatory" part of the self-regulator's functions is emphasized may depend on the context, or the viewpoint of the author of the description.<sup>194</sup>

In the U.S., the regulators which oversee self-regulatory exchanges are administrative agencies, which are clearly public bodies. In other jurisdictions, the situation is more murky. The U.K.'s Financial Services Authority is a private company limited by guarantee which was originally formed (as the Securities and Investments Board) to act as the U.K.'s financial services regulator, and was subsequently designated as the regulator. Although the FSA exercises public powers, the new statute which is to form the basis of the FSA's powers will require the FSA to have regard to principles of good corporate governance in carrying out its functions.<sup>195</sup> This emphasis on corporate governance underscores the private aspects of the FSA's position.

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have strong incentives to ensure those markets are run in a safe and proper manner."); Discussion Paper on Stock Exchange Demutualization, *supra* note 3, at 4.

<sup>191</sup> See, e.g., Maitland, *supra* note 45, at 375 (reporting that a London Stock Exchange representative before the Royal Commissioners told how the Exchange "did justice and enforced a higher standard of morality than the law can reach. And a terrible justice it is. Expulsion brings with it disgrace and ruin, and minor punishments are inflicted").

<sup>192</sup> See, e.g., David P. McCaffrey & David W. Hart, WALL STREET POLICES ITSELF 75 (1998) (suggesting various reasons why exchange members might not act to prevent actions that might harm investors' interests).

<sup>193</sup> The U.K. adopted a scheme based on the U.S. scheme in its Financial Services Act 1986, *supra* note 5, after Jim Gower was appointed to Review Investor Protection in the United Kingdom. See, LCB Gower, REVIEW OF INVESTOR PROTECTION: A DISCUSSION DOCUMENT, HMSO (1982); Gower, REVIEW OF INVESTOR PROTECTION. REPORT: PART 1., 1984 Cmnd. 9125; FINANCIAL SERVICES IN THE UNITED KINGDOM: A NEW FRAMEWORK FOR INVESTOR PROTECTION, 1985 Cmnd. 9432.

<sup>194</sup> See, e.g., L.C.B. Gower, *Big Bang and City Regulation*, 51 MOD. L. REV. 1, 9 (1988) ("The Stock Exchange was about to be recognised as the "competent authority" for the purposes of those Directives, thus completing its transformation from a private club to a public body...").

<sup>195</sup> Financial Services and Markets Act, 2000, *supra* note 6, at §7. ("In managing its affairs, the Authority must have regard to such generally accepted principles of good corporate governance as it is reasonable to regard as applicable to it.").



A change in the nature of a self-regulatory organization from a mutual to a proprietary firm raises the question whether the need to pay attention to the financial interests of shareholders, who may not be participants in the market run by the firm, adversely affect the ability of the firm to exercise its regulatory responsibilities.<sup>196</sup> To the extent that the basis for delegating regulatory responsibility to the firm is its expertise, the arguments for the firm to continue as a regulator would seem to remain, although one might expect a profit-oriented firm to focus on expertise in building markets, rather than regulating them. Worse, the need to focus on profits for the benefit of shareholders might result in an under-provision of regulation in the market. Of course, the need for a mutual enterprise to focus on the interests of its members might similarly result in an under-provision of regulation in the market,<sup>197</sup> and a proprietary exchange might have less need to pander to the interests of members than a mutual exchange would.<sup>198</sup> The fundamental question is whether the market can be relied upon to produce the appropriate rules,<sup>199</sup> and whether any supervisory authority over the self-regulatory firm is adequate to ensure that the SRO's new orientation does not adversely affect the level of regulation on the market.<sup>200</sup> The chairman of the Australian Stock Exchange has said that the ASX has linked concerns of responsiveness to customers with those of maintaining an orderly market "by saying the integrity of the market is not only valuable

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<sup>196</sup> See, e.g., Model for Effective Regulation, *supra* note 11, at 2 ("It may be appropriate for established SROs...to reevaluate their overall structures, as market innovations force rethinking of the traditional roles of exchanges and market intermediaries. This process of reevaluation is occurring at a number of securities and futures exchanges around the world as they consider whether demutualized, for-profit structures may allow them to be more responsive to the needs of market users through competitive forces.").

<sup>197</sup> The Chairman of the ASX has suggested that the demutualized exchange is more responsive to brokers' interests now than in the past, because it sees the brokers as customers. Humphry, *supra* note 77 ("We have discovered we have got customers and that might sound a simple thing to people from the private sector, it is not a simple thing when you are in an organisation that is steeped in a different sort of process.").

<sup>198</sup> See, e.g., Discussion Paper on Stock Exchange Demutualization, *supra* note 4, at 5 ("Where demutualization leads to a separation of the owners of an exchange from its members, the interests of the owners may act as a constraint on actions that would benefit the interests of the member firms.").

<sup>199</sup> "If exchanges face near perfect competition in the supply of financial transactions services, the economics are quite simple and direct: exchanges adopt efficient rules and governance structures because they will not survive otherwise. In contrast, if exchanges possess market power or are protected by entry barriers, things are much more interesting. Profit-maximizing members have an incentive to create rules and organizational structures that allow them to exploit this power." Pirrong, *supra* note 77, at 438.

<sup>200</sup> HM Treasury Financial Services and Markets Bill, *supra* note 190, at 2. ("In describing the circumstances in which it is appropriate to allow exchanges to exercise regulatory responsibilities the document states "the Government believes that it is in the public interest to ensure that where such bodies can be relied upon to maintain certain standards, as set out in the recognition requirements, the regulatory regime should allow them a wide degree of freedom to set and police their own market rules.").

to us as a matter of principle, it is actually valuable to us as part of the asset base of the ASX.”<sup>201</sup> Richard Grasso of the NYSE made a similar argument when he said, “Our commitment to strong self-regulatory function is a fundamental part of our long-term ambition for the Exchange: to remain the trusted marketplace of choice.”<sup>202</sup>

These market-based arguments, that exchanges will continue to act properly as for-profit regulators, are not convincing to the extent that the exchange has a monopoly with respect to a particular function. This issue could arise if an exchange is a regulator of the operator of an alternative trading system that competes for trades with the exchange.<sup>203</sup>

Critiques of the market as a regulator of firm behavior often focus on arguments that markets have short time horizons, therefore encouraging managers of corporations to focus on short-term strategies, rather than on longer-term strategies which might have greater payoffs.<sup>204</sup> In the context of an exchange, this would be a problem if the exchange decided to forgo investment in technology on the grounds that such investment was expensive and would harm shareholder value, where the failure to invest would prejudice the ability of the exchange to compete in the future. Note that this hypothetical assumes that the market will penalize exchange investments in technology for the future. It may be that there is enough consensus in the market that exchanges need to invest significant amounts of resources in technology so this is not an issue. Another problem might arise if an exchange decided to relax listing standards in order to attract new listings,<sup>205</sup>

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<sup>201</sup> Humphry, *supra* note 77; *see also*, Discussion Paper on Stock Exchange Demutualization, *supra* note 4, at 5 (“Where a reputation as a fair and efficient market is seen to be a competitive advantage (or the lack of one as a significant disadvantage), a for-profit exchange may have more resources available and greater incentives to devote those resources to activities that enhance that reputation.”).

<sup>202</sup> Grasso, *supra* note 12.

<sup>203</sup> *See, e.g.*, Discussion Paper on Stock Exchange Demutualization, *supra* note 4, at 6 (“The conflicts inherent in an exchange regulating its competitors become more apparent where the exchange is also a for-profit enterprise.”).

<sup>204</sup> *See, e.g.*, Grant Samuel’s report on the Sydney Futures exchange’s demutualization proposal in Proposal to Mutualize, Information Memorandum, *supra* note 82, at 176 (noting arguments that “the market places pressure on management to deliver short-term profit performance with little regard to long term profits.”). *Cf.* Swiss Re, *supra* note 25, at 12 (“The management of a mutual insurer has the flexibility to undertake initiatives in the long-term interest of policyholders that may not bear fruit initially...Publicly traded stock companies often lack this flexibility because they are under constant pressure to report financial results that meet or surpass investor expectations.”).

<sup>205</sup> For a suggestion that exchanges may feel pressure to relax standards, *see, e.g.*, Howard Davies, Chairman, Financial Services Authority, “Global Markets, Global Regulation,” IOSCO Annual Conference, Sydney, May 17, 2000, *available at* <http://www.fsa.gov.uk/pubs/speeches/sp45.html> (last visited Feb. 20, 2001) (“In London, for example, we have reached the conclusion that one exchange, which is competing with others, should not be the national listing authority. That function transferred to us, along with its staff, on 1 May. I have to say I feel more comfortable now with that responsibility in-house,

and maximize revenues, rather than maintaining a higher standard for listing in order to maintain the value of the exchange as a premium brand.<sup>206</sup>

In thinking about whether demutualized exchanges should act as regulators, one might distinguish between the regulation of listings and the regulation of trading, because traditional exchanges act as regulators of both.<sup>207</sup> When the LSE decided to demutualize, the exchange, the Treasury, and the Financial Services Authority agreed that the LSE should no longer act as the U.K.'s competent authority for listings, and that this function should be transferred to the Financial Services Authority.<sup>208</sup> This development was apparently, not one that was forced on the Exchange, but one that it sought.<sup>209</sup> The exchange retains the authority to set rules for admission of securities to trading, and to regulate trading.<sup>210</sup> There are close links, how-

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particularly when there are considerable pressures to relax listing standards to take account of the particular circumstances of new economy stocks. I am not saying that no change in listing requirements is possible. Indeed we have made some changes in the U.K.. But my personal view is that the public interest arguments can be better weighed by statutory regulators in this new environment, than by a profit-seeking exchange. And I am encouraged in that view by the fact that the London Stock Exchange itself reached the same conclusion.”).

<sup>206</sup> Note that this hypothetical assumes that the shareholder-value maximizing strategy would be to relax listing standards in order to attract new listings. It is possible that in a truly competitive market for listings the market would value higher quality listings more highly than lower quality listings. See, e.g., James D. Cox, *Brands vs. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 19 (2000) (“If the NYSE and NASDAQ wish to preserve their brands, they can do so through self-regulatory efforts so that issuers who list their shares on the NYSE or NASDAQ further signal to the investment community their commitment to ensure transparency, fair treatment of shareholders, and efficient execution of securities trades. That is, the NYSE and NASDAQ can preserve their franchises through strong self-regulatory efforts that preserve, and even enhance, the reputational gains of their listed companies.”).

<sup>207</sup> Exchanges also regulate the conduct of their members towards their customers.

<sup>208</sup> See HM Treasury News Release: Financial Services Authority to Become U.K.'s Competent Authority for Listing Announces Gordon Brown, 158/99, 4 October 1999, *available at* [http://www.hm-treasury.gov.uk/press/1999/p158\\_99.html](http://www.hm-treasury.gov.uk/press/1999/p158_99.html) (last visited Feb. 25, 2001); see Official Listing of Securities (Change of Competent Authority) Regulations (2000), SI 2000/968. (Note that the plan for transfer envisaged transfer to the FSA of most of the people who worked for the U.K. Listing Authority when it was part of the Exchange). See FINANCIAL SERVICES AUTHORITY, THE TRANSFER OF THE U.K. LISTING AUTHORITY TO THE FSA, 12 (December 1999), *available at* <http://www.fsa.gov.uk/pubs/cp/cp37.pdf> (last visited Feb. 25, 2001).

<sup>209</sup> See News Release, *supra* note 208 (“But in light of its proposal to demutualise and turn itself into a commercial company, the Exchange has suggested that it would no longer be appropriate for it to continue to exercise its Listing Authority function.”).

<sup>210</sup> See Transfer of the U.K. Listing Authority, *supra* note 208, at 9 (“It will be for the LSE, Tradepoint and any other recognised investment exchange (RIE) to decide whether it wishes to permit trading in any listed security, and to decide what procedures and standards apply to the admission to trading process on an ongoing basis.”); RIEs may decide to allow trading of securities that are not officially listed. See, *id.* at 11. The distinction between listing and trading also means that the UKLA will have the power to suspend listings, whereas the exchanges will have the power to suspend trading in securities. See, *id.* at 16.

ever, between listing rules and trading rules, and the FSA has recognized that the need for the Exchange to compete with other markets in terms of its trading rules may result in an adjustment to listing rules.<sup>211</sup> This solution to the perceived problem of having a for-profit entity act as a regulator may entail a loss of regulatory expertise,<sup>212</sup> although the LSE retains the right to make decisions about admission of securities to trading, and may continue to exert some influence on the content of the listing rules.<sup>213</sup>

In contrast to the London Stock Exchange, the Australian Stock Exchange continues to act as the regulatory body for listings in Australia, setting and applying the listing rules, although ASIC monitors the ASX's own compliance with the listing rules.<sup>214</sup> The ASX has decided to establish a new entity as part of its regulatory structure.<sup>215</sup> The Australian authorities have greater freedom than the authorities in the U.K., because the U.K.'s ability to decide on the content of its own listing rules is constrained by its membership in the EU, and the need to comply with harmonized standards for listing in the EU.<sup>216</sup> To the extent that the ability to relax listing standards is useful in the competition to attract listings,<sup>217</sup> Australia would,

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<sup>211</sup> Transfer of the U.K. Listing Authority, *supra* note 208, at 5 ("The separation of admission to listing and admission to trading standards, in a world of multiple exchanges trading the same shares, raises the prospect of allowing some adjustment to existing listing rules to facilitate competition between exchanges on trading standards.").

<sup>212</sup> See, e.g., Discussion Paper on Stock Exchange Demutualization, *supra* note 4, at 7-8 (noting potential loss of synergy between regulatory functions and market operation on transfer of regulatory functions to a regulator). The U.K. idea of transferring personnel may not work to overcome this disadvantage in the long term. Although initially the personnel responsible for regulating listings may be the same, over time, this will change.

<sup>213</sup> See, e.g., London Stock Exchange Information Memorandum, *supra* note 46, at 17-18 ("After the transfer of the role of Competent Authority, the Exchange will continue to work closely with the FSA in its new role as Competent Authority to ensure that the Exchange's markets continue to provide effective and competitive services to meet the needs of domestic and international issuers and investors.").

<sup>214</sup> *Supra* note 185. For the ASX's Listing Rules; see also [http://www.asx.com.au/about/13/ListingRules\\_AA3.shtml](http://www.asx.com.au/about/13/ListingRules_AA3.shtml) (last visited Feb. 21, 2001).

<sup>215</sup> ASX has formed AXS Supervisory Review Pty. Ltd. to complement proposed amendments to corporation law formalizing ASIC's ability to audit supervisory arrangements of market operators. Australian Stock Exchange, Media Release, AXS's Supervisory Arrangements (Nov. 9, 2000), available at <http://www.asx.com.au/shareholder/pdf/supervision091100.pdf> (last visited Feb. 16, 2001).

<sup>216</sup> See, e.g., Transfer of the U.K. Listing Authority, *supra* note 208, at 7-8 (briefly describing the framework of EU legislation within which the U.K. Listing Authority operates). See also, *id.* at 9 (distinguishing between admission to listing "in accordance with the relevant European Community directives and U.K. legislation" and admission to trading). It assumes a race to the bottom in the regulation of listings, rather than a struggle to the top. For an argument that issuers may want to seek out high quality listings, see, e.g., John C. Coffee, Jr., *The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications*, 93 NW. U. L. REV. 641, 674 (1999) ("One explanation for the abnormal price movement on a U.S. listing is that such a listing represents a bonding mechanism: the foreign issuer is increasing the share value of its public shares by

therefore seem to be better placed to be competitive in attracting listings than the U.K. There is some scope for the U.K. to engage in competition for relaxed rules, as U.K. rules exceed EU requirements in some ways,<sup>218</sup> and the U.K. authorities are conscious of the need to be internationally competitive.<sup>219</sup> As well as recognizing the need to compete in terms of standards, the FSA also recognizes that listing fees must be competitive.<sup>220</sup> To the extent that demanding listing standards are useful in the competition to attract listings, this ability to relax the rules may not matter.

The Toronto Stock Exchange adopted a third model of resolving problems of conflicts between regulatory responsibilities and responsibilities to shareholders, by separating the market regulation function from the business operations of the exchange.<sup>221</sup>

The NASD proposes to follow this third model by separating ownership of Nasdaq (the market) from the ownership of NASD (the regulator).<sup>222</sup> NASD proposes to maintain only a minority ownership interest in Nasdaq.<sup>223</sup> NASD, separated from Nasdaq, also plans to offer its services as a regulator to other markets, and other regulators within and outside the

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agreeing to comply with the generally higher disclosure standards that prevail in the United States.”).

<sup>218</sup> See, e.g., Transfer of the U.K. Listing Authority, *supra* note 208, at 8.

<sup>219</sup> See, e.g., Transfer of the U.K. Listing Authority, *supra* note 208, at 8-9 (“The UKLA’s responsibilities...include: ... ensuring that the listing rules keep pace with market developments as well as keeping a watchful eye on the regimes of comparable international markets to ensure that the U.K. market remains competitive.”).

<sup>220</sup> See, e.g., Transfer of the U.K. Listing Authority, *supra* note 207, at 13.

<sup>221</sup> See, e.g., TSE Regulation Services -- Press Release: TSE Regulation Services Introduces Minimum Compliance Procedures for Trading Supervision (Dec. 4, 2000), [http://www.tsers.com/news\\_rel/rsnews\\_01.html](http://www.tsers.com/news_rel/rsnews_01.html) (last visited Feb. 21, 2001) (“Following the demutualization of the TSE, the market regulation function is now separate from its for-profit business operations. This new division is named TSE Regulation Services or TSE RS. TSE Regulation Services provides the TSE marketplace with effective self-regulation of market conduct in a responsive and neutral manner.”).

<sup>222</sup> Glauber, *supra* note 71 (“In an era where exchanges and their competitors act more like for-profit, public companies than traditional utilities, regulation benefits from being independent of market operations. A self-regulator will never be seen as being independent when it regulates both its own market and that of competitors.”); Cf. Arthur Levitt, *supra* note 190 at 7 (“At the very least, I believe that strict corporate separation of the self-regulatory role from the marketplace it regulates is a minimum for the protection of investors in a for-profit structure.”). NASD Regulation was created in 1996 as part of a restructuring of the NASD, “a major feature of which was to separate the regulation of the broker/dealer professional from the operation of The Nasdaq Stock Market.” NASDAQ, AMEX Background, [available at http://www.nasdaqnews.com/about/about20f.htm#Regulation,Inc](http://www.nasdaqnews.com/about/about20f.htm#Regulation,Inc) (last visited Apr. 17, 2001). NASD Regulation became an independent subsidiary of the NASD. *Id.*

<sup>223</sup> See *id.*

U.S.<sup>224</sup> Within the U.S., the NASD sees one opportunity in the conversion of electronic communications networks (ECNs),<sup>225</sup> such as the Island<sup>226</sup> and Instinet<sup>227</sup> to exchange status. One consequence of such conversion would be that the new exchange would take on regulatory responsibilities.<sup>228</sup> The NASD proposes that the ex-ECN exchanges should outsource their regulatory functions to it.<sup>229</sup> NASD envisages a future as a participant in a market for regulatory services, in which the market will monitor its provision of these services.<sup>230</sup> In contrast, the NYSE suggests that spinning off NYSE's regulatory functions into a separate entity would do lasting damage to the NYSE brand.<sup>231</sup> At the NYSE "our self-regulatory duties literally permeate every part of the exchange. Severance of them would be both culturally and practically, impossible."<sup>232</sup>

One consideration relevant to the question of whether a proprietary exchange should be allowed to exercise self-regulatory responsibilities might be where the exchange's revenues come from. An exchange might be able to attract significant revenues for listings by producing listing rules issuers regard as desirable (whether such rules would be the ones investors would want, or not).<sup>233</sup> Revenues from trading on the exchange may be a more

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<sup>224</sup> Glauber, *supra* note 71. ("A second new strategic initiative we plan is to offer our regulatory services to other exchanges and regulators, again both here in the U.S. and abroad.")

<sup>225</sup> Electronic Communications Networks (ECNs) are regulated by the SEC under Rule 17a-23. 17 CFR § 240.17a-23 (April, 2000) (Recordkeeping and reporting requirements relating to broker-dealer trading systems.). ECNs match buy and sell orders electronically.

<sup>226</sup> *See, e.g.*, the Island site at [www.isld.com](http://www.isld.com) (last visited Mar. 19, 2001). A group of private equity firms agreed to acquire a majority stake in Island at the end of 2000. Island Press release: Leading Investor Group to Acquire Majority Interest in Island ECN, (Dec. 1, 2000), available at <http://www.island.com/pressroom/releases/120100.htm> (last visited Feb. 28, 2001). Island announced that it planned to step up its efforts to become the U.S.' first for-profit exchange. *See id.*

<sup>227</sup> *See, e.g.*, the Instinet site at <http://www.instinet.com> (last visited Feb. 28, 2001). Instinet is owned by Reuters.

<sup>228</sup> *See* 15 U.S.C. §78f(b)(1) (An exchange shall not be registered as a national securities exchange unless the SEC determines that it is "so organized and has the capacity to be able to carry out the purposes of this Act and to comply, and...to enforce compliance by its members and persons associated with its members, with the provisions of this Act, the rules and regulations thereunder, and the rules of the exchange.").

<sup>229</sup> *See* Glauber, *supra* note 71. ("When they do, under federal law they must take on self-regulatory obligations to police trading activity. We believe these new exchanges will find it efficient to outsource this self-regulatory task."). The juxtapositioning of "outsourcing" with "self-regulatory" is intriguing.

<sup>230</sup> *See* Glauber, *supra* note 71. ("To get and keep members who sign up voluntarily, we have to do a good job. Our members have to face this kind of market discipline every day. NASD will benefit from the same experience.").

<sup>231</sup> Grasso, *supra* note 12.

<sup>232</sup> *Id.*

<sup>233</sup> At the end of 1999 OM Stockholm Exchange had 300 listed companies. *See* OM Stockholm Exchange, Fact Book 1999, 15, available at

significant component of many exchanges' revenues than revenues from listings,<sup>234</sup> so more exchanges may want to compete for this business. In fact, alternative trading systems and newer markets are competing with exchanges for trades, not for listings. Competition for trades is more complicated than competition for listings, because it involves technology as well as rules. Even assuming good rules attract business, a less well-regulated market with better technology might attract more business. When it comes to competition between exchanges to attract broker-dealers as members to be regulated by the exchange, there are greater concerns.

The IOSCO Technical Committee suggests four possible responses to conflicts of interest in a self-regulatory environment: corporate governance requirements; regulatory oversight; transparency; and functional separation of commercial and regulatory functions.<sup>235</sup> These different responses have been adopted in different places, but all have potential weaknesses. Exchanges that demutualize do emphasize their governance arrangements,<sup>236</sup> but exchange governance arrangements are likely to share the weaknesses of governance arrangements in other corporate enterprises. Perhaps more significantly, corporate governance measures are usually seen as solutions to the agency cost problem inherent in large corporations, rather than as measures to ensure protection of the public interest. Even in jurisdictions that have adopted corporate law structures to account for the interests of groups other than shareholders, these structures have tended to privilege the interests of employees,<sup>237</sup> rather than the wider public interest.

Some exchanges have decided to deal with concerns about conflicts of interest by separating regulatory functions from market operation func-

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[http://domino.omgroup.com/www/WebTransaction.nsf/PublicUS/factbook/\\$file/Fakta99e.pdf](http://domino.omgroup.com/www/WebTransaction.nsf/PublicUS/factbook/$file/Fakta99e.pdf). The ASX had 1,381 listed companies at 30 June, 2000. See ASX, Report to Shareholders, *supra* note 186, at 6.

<sup>234</sup> Trading related revenues represent the largest component of total revenues for the OM Stockholm Exchange. OM Stockholm Exchange, *supra* note 233, at 10.

<sup>235</sup> Discussion Paper on Stock Exchange Demutualization, *supra* note 2, at 7.

<sup>236</sup> See, e.g., LSE Information Memorandum, *supra* note 46, at 24 (stating that "[t]he board intends to move to a structure which conforms with the Combined Code on Corporate Governance, with a majority of the non-executive directors being independent, as defined in the Combined Code."). *Id.* at 24-25 (describing composition of board committees). See also Levitt, *supra* note 190, at 7 ("I appeal especially to public directors to jealously guard the self-regulatory standards of the markets they oversee, particularly listing standards."). See also the NASD's statement that the NASD Regulation Board "has an equal mix of public representatives and industry professionals" which "ensures that NASD Regulation is an open organization with significant public participation in all its deliberations pertaining to regulatory policy and rule making," NASDAQ, NASDAQ Backgrounder, available at <http://www.nasdaqnews.com/about/backgrounder2.pdf> (last visited Mar. 19, 2001).

<sup>237</sup> See, e.g., Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. LAW 555, 561-565 (2000) (describing provisions for worker involvement in supervisory boards of German corporations).

tions.<sup>238</sup> When an exchange does this, however, there is a delicate issue of how the regulatory entity maintains its expertise while also maintaining its separation from the market entity. Transparency of the exchanges' regulatory arrangements may help to reduce concerns about conflicts of interest because the exchange should take care to avoid the appearance of impropriety. While transparency may derive from the demands of the market, or of regulators,<sup>239</sup> if neither the market nor the regulators demand transparency, it is unlikely to generate spontaneously.

Critical to the usefulness of these proposed solutions is a mechanism for monitoring how the exchange applies them. To the extent that the concerns about the role of a proprietary exchange as a regulator are concerns about how the exchange responds to the interests of non-shareholder constituencies, market constraints are unlikely to ensure good governance, or an appropriate separation between regulatory and market operation functions. It is not obvious that the market will require an adequate level of transparency. Thus, there remains a need for a regulator to oversee the proprietary exchange when it acts as a regulator. In practice, regulators do emphasize their oversight of demutualized exchanges. On the other hand, one might wonder whether this oversight is really meaningful. Regulators may feel pressure to defer to the expertise of exchanges. Moreover, increasingly, regulators seem to feel that they need to act to protect the competitive position of exchanges.<sup>240</sup>

## VII. COMPETITION AND CONCENTRATION OF EXCHANGES

Exchanges compete with each other in terms of pricing, efficiency, and standards. In addition, they may decide to specialize in particular sectors of the market, or in particular financial products. The Toronto Stock Exchange's demutualization was accompanied by an agreement between the Canadian exchanges to specialize. Trading in senior equities now takes place in Toronto, the Alberta and Vancouver exchanges merged to form the Canadian Venture Exchange and derivatives trading takes place on the Montreal Exchange.<sup>241</sup> The Toronto Stock Exchange has also suggested

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<sup>238</sup> See, e.g., text at note 220.

<sup>239</sup> The Securities Exchange Act of 1934 requires issuers of securities with assets over \$1 million and 500 stockholders to register their securities. 15 U.S.C. § 78l(g). Registration under the Exchange Act entails an obligation to make regular disclosures to the markets. NYMEX's and CME's disclosures are available from <http://www.freeedgar.com>.

<sup>240</sup> Note that the SEC has proposed revising the requirements for SROs to file proposed rule changes with the SEC in order to help the SROs "to be more competitive in today's marketplace." See Proposed Rule Changes of Self-Regulatory Organizations, *supra* note 121, at 8912.

<sup>241</sup> Restructuring of the Canadian Exchanges, available at [http://www.tse.com/tse\\_inc/restruct.html](http://www.tse.com/tse_inc/restruct.html) (last visited Feb. 21, 2001).



that it thinks that it has a future as a center for trading in natural resources stocks.<sup>242</sup>

In the U.S., the national market system has involved a number of regional exchanges which retain their separate identities,<sup>243</sup> but which are also linked.<sup>244</sup> Much of the debate in the U.S. is about the terms of the linkages,<sup>245</sup> rather than about the desirability of encouraging the different exchanges to merge. Europeans have been discussing the idea of creating a European securities market for a number of years, but little movement in the direction of such a market has occurred until recently. In the early 1990s people would debate which of the main European exchanges would dominate the European market: would London hold its own, or would Frankfurt or Paris succeed in taking business from London? However, competition between exchanges based in different jurisdictions is not just a European phenomenon. Regulators recognize this. When the SEC granted a limited volume exemption to the Tradepoint exchange, it did so on the basis that Tradepoint remained a low-volume exchange in its home jurisdiction.<sup>246</sup>

Now, it seems that increased competition between financial exchanges and between exchanges and non-exchange markets are producing pressures for exchanges to merge with each other. The Paris, Amsterdam and Brussels stock exchanges are merging to form Euronext.<sup>247</sup> After its demutuali-

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<sup>242</sup> Blueprint for Success, *supra* note 69, at 18 (noting that “mining companies listed on a Canadian exchange receive greater coverage and exposure to the global market, which often results in higher valuation multiples for these companies.”).

<sup>243</sup> In addition to the NYSE and AMEX, the U.S. has the Boston Stock Exchange (<http://www.bostonstock.com/>), the Pacific Stock Exchange (<http://www.pacificex.com/>), and the Philadelphia Stock Exchange (<http://www.phlx.com/>). Nasdaq acquired AMEX in 1998. See NASDAQ, NASDAQ Background, 3, available at <http://www.nasdaqnews.com/about/background2.pdf> (last visited Mar. 19, 2001).

<sup>244</sup> On the National Market System, see, e.g., Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 2 U. ILL. L. REV. 315 (1985); Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981).

<sup>245</sup> See, e.g., Sec. & Exch. Comm'n, Exchange Act Release No. 34-42450; Commission Request for Comment on Issues Relating to Market Fragmentation, 65 Fed. Reg. 10577, 10578 (28 February, 2000) (“the Commission is evaluating whether the national market system will continue to meet the needs of investors by: (1) maintaining the benefits of vigorous quote competition and innovative competition among market centers; (2) encouraging and rewarding market participants (including both investors and dealers) who contribute to public price discovery by displaying trading interest that is widely accessible and can be easily executed by other market participants; (3) assuring the practicability of best execution of all investor orders, including limit orders, no matter where they originate in the national market system; and (4) providing the deepest, most liquid markets possible that facilitate fair and orderly trading and minimize short-term price volatility.”).

<sup>246</sup> Tradepoint Limited Volume Exemption, *supra* note 124, at 14957.

<sup>247</sup> See, e.g., Euronext Corporate Brochure available at <http://www.euronext.com/pdf/Corporate-brochure-en.pdf>; Euronext Comprehensive Paper

zation in March 2000, the LSE proposed to merge with the Deutsche Börse and form a market to be called iX- International Exchanges PLC.<sup>248</sup> Opposition to this proposed merger helped to create a situation where the LSE looked vulnerable to takeover. OM Gruppen ("OM") made an offer to take over the LSE,<sup>249</sup> and the LSE pulled out of the deal with Deutsche Börse.<sup>250</sup>

The LSE's defense documents pointed out that a significant proportion of the consideration being offered to LSE shareholders consisted of OM stock, and argued that the value of this stock was uncertain.<sup>251</sup> In addition, the LSE argued that OM's technology was unproven, and that its ownership, governance and control raised "numerous questions."<sup>252</sup> Part of the LSE's objection to OM's ownership was that 9.5% of its shares were, at the time of the takeover attempt, owned by the Swedish Government, and the LSE stated that if Sweden were to hold 10% of the shares it would acquire rights to prevent a third party gaining full control of OM.<sup>253</sup>

Eventually the LSE succeeded in fighting off OM's attack.<sup>254</sup> But Gavin Casey, the LSE's Chief Executive, lost his job.<sup>255</sup> The LSE an-

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at [http://www.euronext.com/en/euronextinfo/publications/comprehensive\\_paper/](http://www.euronext.com/en/euronextinfo/publications/comprehensive_paper/) (last visited Feb. 16, 2001). Euronext has an agreement with the Luxembourg stock Exchange. See Euronext Press Release, Agreement Between Euronext and Bourse De Luxembourg (Nov. 16, 2001), available at <http://www.bourse-de-paris.fr/en/news7/p77263.htm> (last visited Feb. 21, 2001).

<sup>248</sup> See, e.g., LSE Press Release, Outline of iX-international exchanges strategy and merger benefits; International group of key market users to advise board; Board members nominated, July 17, 2000, available at <http://www.londonstockexchange.com/press/releases/17-07-00.asp> (last visited Feb. 19, 2001); Joint statement by the U.K. and German supervisory authorities on regulatory issues concerning IX-international exchanges plc, FSA/PN/111/2000 Aug. 21, 2000, available at <http://www.fsa.gov.uk/pubs/press/2000/111.html> (last visited Feb. 16, 2001).

<sup>249</sup> See, e.g., Nigel Dudley, Modernizer plots London Takeover, EUROMONEY, Oct. 2000, at 42.

<sup>250</sup> See LSE Press Release, *LSE to Focus on Defeating OM Bid - iX Merger Proposal Withdrawn*, (Sept. 12, 2000), available at <http://www.londonstockexchange.com/press/releases/12-09-00.asp> (last visited Mar. 1, 2001) (announcing that the merger proposal was being withdrawn to allow the LSE to focus on defending itself against OM's hostile bid).

<sup>251</sup> See, e.g., London Stock Exchange Defence Document, 1 (Oct. 2000), available at <http://www.londonstockexchange.com/defence/pdfs/80898.PDF> (last visited Feb. 16, 2001).

<sup>252</sup> *Id.*

<sup>253</sup> *Id.*

<sup>254</sup> See, e.g., LSE Press Release, London Stock Exchange PLC, 10 Nov. 2000, available at <http://www.londonstockexchange.com/press/releases/10-11-00.asp> (last visited Feb. 19, 2001) (noting OM's announcement that it had failed to receive sufficient acceptances for its hostile offer).

<sup>255</sup> See LSE Press Release, Chief Executive to step down, Sept. 15, 2000, available at <http://www.londonstockexchange.com/press/releases/15-09-00.asp> (last visited Feb. 19, 2001). In January, 2001 it was announced that Clara Furse would be the new Chief Executive of the LSE. See LSE Press Release, Appointment of Chief Executive, Jan. 24, 2001,

nounced the formation of an advisory group in December 2000,<sup>256</sup> and announced new independent directors in February 2001.<sup>257</sup>

The lesson from the OM attack on the LSE is that the same changes in decision-making procedures that should allow demutualized exchanges to open up possibilities for friendly linkages with other markets,<sup>258</sup> will also make the exchanges vulnerable to not-so-friendly predators. It is often easier for firms to grow through acquisitions than it is to grow organically. In theory a new exchange could start up and challenge established exchanges, but it would take time for the new exchange to grow its market to a level of depth and liquidity that would challenge established exchanges.<sup>259</sup> So, in theory, and in practice, proprietary exchanges may be subject to the threat of take-over,<sup>260</sup> or at least to control by one or more persons.<sup>261</sup>

A large amount of literature suggests that the market for corporate control is a useful mechanism for ensuring that corporate managers act in the interests of their shareholders.<sup>262</sup> One might expect that if proprietary exchanges were really taking seriously the idea of ownership as a spur to greater efficiency, they would welcome the disciplinary effects of the market for corporate control. In fact, demutualized exchanges tend to have

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available at <http://londonstockexchange.com/press/releases/24-01-01.asp> (last visited Feb. 19, 2001).

<sup>256</sup> See LSE Press Release, *Membership of New Consultative Group Announced*, Dec. 7, 2000, available at <http://www.londonstockexchange.com/press/releases/07-12-00.asp> (last visited Feb. 19, 2001).

<sup>257</sup> See LSE Press Release, *Exchange Announces Board Changes*, Jan. 24, 2001, available at <http://www.londonstockexchange.com/press/releases/24a-01-01.asp> (last visited Feb. 19, 2001). The Exchange described the increase in the number of independent non-executive directors as "providing a board structure to its commercial plc status" and as fulfilling "the commitment to sound corporate governance that the Exchange gave when it demutualised in Mar. 2000." *Id.*

<sup>258</sup> *Blueprint for Success*, *supra* note 69, at 5 ("Alliances are a means of pursuing the conventional wisdom that "liquidity attracts liquidity.").

<sup>259</sup> On Feb. 28, 2001 Island (which was set up in 1997) executed 1,265,106 trades in relation to 381,958,468 shares for a dollar volume of \$13,544,757,456.14, at <http://www.isld.com/volume/index.asp> (last visited Mar. 19, 2001). Island posts summaries of its quarterly filings with the SEC at <http://www.isld.com/resources/sec17a23/index.htm> (last visited Mar. 19, 2001). On the same date, the NYSE reported 1,263,918 trades in respect of 1,225,192,975 shares for a dollar volume of \$45,591.2 million.

<sup>260</sup> The Sydney Futures Exchange recognized this risk when it proposed demutualization. See SFE, Information Memorandum, *supra* note 82, at xv.

<sup>261</sup> The IOSCO Technical Committee suggests the public interest might require mechanisms such as restricting maximum share ownership, or requiring regulatory approval for ownership over a certain threshold. Discussion Paper on Stock Exchange Demutualization, *supra* note 4, at 9.

<sup>262</sup> See, e.g., *THE DEAL DECADE* (Margaret M. Blair ed., 1993); Note that Julian Franks and Colin Meyer have suggested that takeovers are more effective in disciplining poorly performing corporate managements in the U.S. than in the U.K. Julian Franks & Colin Meyer, *Governance as a Source of Managerial Discipline*, 3 (Apr. 2000), available at <http://www.dti.gov.uk/cld/franksreport.pdf> (last visited Feb. 26, 2001).

provisions in their constitutive documents (or in legislation that applies to them)<sup>263</sup> that restrict the percentage of votes that a single shareholder, or groups of shareholders acting together, may exercise.<sup>264</sup> The London Stock Exchange's articles of association contain a provision whereby no person or persons in the same group or acting in concert with each other may have an interest in the Exchange's ordinary shares carrying more than 4.9% of the total votes attaching to the LSE's ordinary shares.<sup>265</sup> The LSE's board is entitled to refuse to register transfers of shares where they would result in a holding over this level.<sup>266</sup> The Toronto Stock Exchange has the same restriction on the exercise of voting rights,<sup>267</sup> as does Nasdaq<sup>268</sup> and the ASX.<sup>269</sup> The Sydney Futures Exchange allows a person to hold up to 10% of the shares in the Exchange.<sup>270</sup> Other exchanges have different protections against take-over. The CME introduced anti-takeover provisions into its charter on its transformation from an Illinois not-for-profit corporation to a Delaware for-profit corporation.<sup>271</sup> Euronext has adopted a poison pill provision.<sup>272</sup>

It may be easier to protect firms against hostile takeovers in some jurisdictions than in others. Certainly, the protective techniques that are available will vary. An exchange established in a jurisdiction allowing strong protections against takeovers will more likely become a predator than a target. The corporate laws of other jurisdictions may render some exchanges more vulnerable to takeovers than others.<sup>273</sup> On the other hand,

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<sup>263</sup> See ASX Report to Shareholders, *supra* note 186, at 38.

<sup>264</sup> These provisions may be as much about avoiding domination of the exchange by one or more controlling shareholders as about avoiding the market for corporate control. For a suggestion that the danger of control might require restriction of maximum share ownership, see *supra* note 261.

<sup>265</sup> See <http://www.londonstockexchange.com/dealing/default.asp> (last visited Feb. 19, 2001). A proposal to remove this limit was defeated in Oct. 2000. See LSE Press Release, Result of Extraordinary General Meeting, Oct. 19, 2000, available at <http://www.londonstockexchange.com/press/releases/19c-10-00.asp> (last visited Feb. 19, 2001).

<sup>266</sup> *Id.*

<sup>267</sup> The Toronto Stock Exchange plan involved an upper limit on voting rights of 5% of the total votes. See Toronto Stock Exchange Information Circular, *supra* note 86, at 7-8.

<sup>268</sup> See Order approving Proposed Rule Change Amending the Nasdaq By-laws and Restated Certificate of Incorporation, *supra* note 71.

<sup>269</sup> See ASX Report to Shareholders, *supra* note 186, at 38.

<sup>270</sup> See SFE, Information Memorandum, *supra* note 82, at ix. The restriction applies for five years from the date of demutualization. *Id.*

<sup>271</sup> See CME Registration Statement, *supra* note 15, at 4.

<sup>272</sup> See Don Cruickshank, Speech, *supra* note 106 ("Euronext has a typically continental poison pill device that could automatically create enough new shares held by a mysterious foundation to block any takeover.").

<sup>273</sup> Companies in Britain are restricted in their ability to defend themselves against takeover. For example, they may not buy their own shares, see § 143 Companies Act, 1985. The Under-Secretary of State for Trade and Industry has announced plans to deregulate to allow

even where protective provisions apply, an incumbent management team may not feel comfortable about relying on them. For example, when OM Gruppen attempted to acquire the LSE, shareholders in the LSE were offered the opportunity of voting on whether to retain this restriction or not.<sup>274</sup>

Traditionally, different jurisdictions have had their own stock exchanges, and, more recently, the development of a stock exchange has been perceived as necessary to show a commitment to capitalism.<sup>275</sup> A country might be nervous about the idea of its exchange being acquired by, or merging with, a foreign entity for a number of reasons.<sup>276</sup> If it became harder for domestic enterprises to raise capital in the market as a result of the acquisition, there would be a problem for the national economy.<sup>277</sup> In addition, there is the question of which rules should apply to the combined enterprise. Should the different jurisdictions involved share responsibility for overseeing the markets, or will there be a single lead regulator? Will the different countries affected be able to agree about the right way to resolve the issue? In the U.K., the threat of an acquisition of the LSE by a U.S. entity raises

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companies to purchase shares to resell them at a later date. Dept. of Trade and Industry Press Release, Purchase by Companies of Their Own Shares for Holding in Treasury: Kim Howells Announces Proposed Change to the Law, P/99/1057 (Dec. 22, 1999), available at <http://www.dti.gov.uk/cld/bybak196.htm> (last visited Feb. 26, 2001).

English companies may not provide financial assistance to others for the purchase of shares in the company. §§ 151-158, Companies Act, 1985. The Government proposes to relax these rules. See Dept. of Trade and Industry, Company Law Reform: Financial Assistance by a Company for the Acquisition of its Own Shares - Outcome of the Nov. 1996 Consultation, (Apr. 1997), available at <http://www.dti.gov.uk/cld/finasst.pdf> (last visited Feb. 26, 2001).

Generally, where a company issues shares it may only issue them pro rata to existing shareholders. *Id.* at §§ 89-96. Other transactions may be challenged as a breach of the rules restricting when distributions to shareholders may be made. See, e.g., *Aveling Barford v. Perion* [1989] BCLC 626 (holding that the sale of property at an undervalue was an unauthorized return of capital).

<sup>274</sup> The shareholders voted to retain the restriction. See LSE Press Release, Result of Extraordinary General Meeting, October 19, 2000, available at <http://www.londonstockexchange.com/press/releases/19c-10-00.asp> (last visited 30 September, 2001).

<sup>275</sup> The Prague Stock Exchange's description of its history begins: "Emergence and evolution of exchanges are tied to the very emergence and development of market economy." See <http://www.pse.cz/burza/historie.asp> (last visited Oct. 1, 2001). This document also states that: "In the period between WW I and WW II, the exchange was undergoing a dynamic boom which was violently interrupted by the second World War. After that war, the door of the exchange did not open. But the tradition of the Czech exchange business found its continuation in the 1990s when the Preparatory Committee for the Foundation of the Prague Stock Exchange was set up, in May 1991." *Id.*

<sup>276</sup> The NYSE is "an important national asset." Market Structure Report, *supra* note 103, at 17. The London Stock Exchange was described in the House of Lords as "the jewel in the crown of British industry." Lord Saatchi, H.L. Debates, 24 May, col. 804.

<sup>277</sup> This might be the case if the market grew to a point where its listing standards had to be revised upwards to allow the listing only of very large issuers.

the specter of having U.S. rules apply in the London market, which is regarded with skepticism by those in the U.K.<sup>278</sup> A very large exchange based in more than one jurisdiction might be able to play off one regulator against others by threatening to move its business offshore.

### VIII. CONCLUSION

Managements of exchanges who promote the idea of demutualization argue that it will bring the discipline of markets to the internal workings of exchanges as businesses and allow them to compete against newer markets and markets in other jurisdictions. Demutualization is meant to promote more effective decision-making within the exchange and to allow for strategic alliances with other businesses. The rhetoric is one of competition and efficiency, with a heavy dose of market integrity as an essential element of the exchange's brand. There are some real questions about whether all of these benefits of demutualization will be realized.

This article focused on three problems associated with demutualization: arrangements for trading in exchange shares, proprietary exchanges as regulators, and the risk that a proprietary exchange will become a takeover target.

Ensuring a liquid market in an exchange's shares is problematic. If the exchange lists its shares on itself (and monitors its own listing), it risks criticism. If it lists on a competitor it seems to lack confidence. If it does not list the shares, the market will be relatively illiquid. How strong the market is in the exchange's shares will affect the extent to which the market really does discipline the exchange's management to manage the business well. Although it is too early to tell, there are reasons to doubt whether ownership by shareholders will really promote efficiency, especially where the exchange is, to some extent, insulated from the threat of takeover.

Even if the management of a proprietary exchange does act to maximize shareholder value because of market discipline, non-shareholder interests, and the public interest in particular, may be ignored. Increasingly, regulators seem to believe that they should not act to impede the ability of exchanges to compete amongst one another. But exchanges have self-regulatory responsibilities, and are a critical element of the financial regulatory system. Increased competition between exchanges and non-exchange markets is likely to involve competition on regulation as well as technology. Exchanges argue that the value of their brand depends on demanding regulation, but where the risks of lax regulation are borne by non-

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<sup>278</sup> See, e.g., Don Cruickshank, Speech, *supra* note 106 ("I also predict that a U.S. tie up or merger would raise another difficult issue, extraterritoriality - a horrible word meaning the demand by the U.S. authorities - the SEC and Government combined - that their writ should run over all the markets run by the new entity, especially if U.S. citizens were to have direct access to a market in a member state of the EU.").

shareholder constituencies, it is incumbent on the regulators to do more than acquiesce in the exchanges' regulatory decisions.

Finally, the market for corporate control might encourage exchange managements to act in the interests of shareholders, but there are other potential costs in terms of reduced access to capital for domestic businesses, and dangers of regulatory arbitrage. Each country has a national interest in protecting its domestic capital markets for the benefit of domestic enterprise and investors. If we allow exchanges the freedom to act just like any other business, we risk undermining this national interest.