Demutualization of stock exchanges in Pakistan: Challenges and benefits

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Accepted 10 August, 2010

Demutualization is a process of segregation of ownership, management and trading membership in an exchange. Studies show that demutualization is a mechanism which minimizes the conflict of interest by reducing the overbearing influence of the members on the affairs and management of the exchange. The Government has initiated demutualization process in Pakistan as part of the capital market reforms program. This paper studies the ongoing process of demutualization in Pakistan and identifies its benefits and challenges. The benefits include better corporate governance, access to economic and human capital, enhancement in listings and international alliances. The study also identifies some challenges which are regulatory framework, conflict of interest, ownership structure issues and agency cost.

Key words: Demutualization, conflict of interest, agency cost, corporate governance, integration and alliance.

INTRODUCTION

Stock markets around the world assist the investors to analyze the condition of an economy in order to get maximum return on their investment. Its operational efficiency is important for the betterment of the financial system since like any other market it provides a forum for buyers and sellers. These exchanges connect those who seek money with those who can provide it by creating an auction mechanism which would reduce the future risk by distributing it on all the investors. It brings the financial institutions together to create money. The economies of the world rely on the stock exchanges to facilitate trade in the stocks. Stock exchanges around the world perform three major functions: regulator, development of market and operational side (Ranong, 2002). Stock exchanges work as front line regulator for market participants because of the intimate involvement in trading activities. As regulator, stock exchanges monitor the activities in the market and report any irregularities to the senior regulatory authority which is most of the time a security and exchange commission of that country. Stock exchanges monitor trading to prevent manipulation and insider trading (Akhtar, 2002). The second role is to carry out development activities both on the product and investor side, as well as with the intermediaries, in terms of the quality of service they should offer to investors. This includes the advancement of appropriate technologies for the betterment of the stock exchange operations. The third role is the business side, which can be termed as the operational side. Stock exchange provides a physical market for the trading of securities for individuals seeking to invest and for the individuals seeking to sell. Exchanges operate by charging corporate fee (Ranong, 2002) for the execution of services (Akhtar, 2002).

Development role of the stock exchange induces to make the operations improved. Stock markets around the world are going through various changes to be efficient and to provide their stakeholders with better facilities. One of the major changes is demutualization. Researchers have explored this subject and its potential benefit for the stock markets around the world as most of the exchanges have gone through this process (Mendiola and O’Hara, 2003; Hart and Moore, 1996). Many emerging markets are also considering demutualization. Demutualization in its many forms has become a widespread reality, one with growing demand in emerging market countries (Elliott, 2002). It refers to the amendment
in legal standing of the exchange from a mutual association with one vote per member, where decision making is consensus based, into a company limited by shares, with one vote per share with majority-based decision making (Akhtar, 2002). It is a step towards initial public offering (IPO) of the company. Demutualization is the process of corporatization of a stock exchange, where an exchange formerly a company limited by guarantee converts into a public limited company which issues shares to general public in order to raise capital. The concept is initially used to refer explicitly to conversion process adopted by insurance companies; it is used to describe the process through which any member owned organization becomes shareholders owned. Over the period of time and because of the positive aspects of this process demutualization is now common in savings and loan industry, stock exchanges and agricultural cooperatives around the world. Demutualization is not a new term for stock markets, as in 1993 world’s first exchange, Stockholm Stock Exchange went through the process of demutualization very successfully.

Many researchers examine the reasons or factors behind demutualization and they are agreed on two main factors: globalization and information technology (IT) (Williamson, 1999; Akhtar, 2002; Serifsoy, 2005). The world has now become a global village and it has changed everything in business or household. In business, due to globalization, mergers and acquisitions are taking place; businesses are expanding due to globalization and organizations are working worldwide. Parent company operates its branches around the globe from a single office located in one corner of the world. Similarly this phenomenon is affecting stock exchanges; listings of foreign companies, portfolio flows are few of the bounties of globalization. Globalization also helps the organizations to maintain standards of operations though out the world. This has compelled smaller organizations to adopt those standards in order to stay in competition. Better practices, effective rules, policies, and standard management tools are all the resultant of globalization. Over the last few decades progression in the field of IT has changed the whole world and things are changing fast. Stock exchanges are affected by the developments like alternate trading systems (ATD), central depository committee (CDC) etc. Such factors are also affecting the physical existence of the stock exchanges. These changes have created a pressure on stock exchanges over the world to think about becoming for-profit organization, or a public limited company. This will help them to merge with a better company or to go for an alliance.

In Pakistan, the situation confronted by the stock exchanges is not different from the rest of the world. There are three stock exchanges in Pakistan; Karachi Stock Exchange (KSE), Islamabad Stock Exchange (ISE) and Lahore Stock Exchange (LSE). KSE is the largest stock exchange in Pakistan. In 2004, Securities and Exchange Commission of Pakistan (SECP) established a 7 members committee to assess the demutualization process in Pakistani stock exchanges. The committee submitted a complete report regarding the demutualization process of stock exchanges in Pakistan. Recently an action plan has also been devised by the exchanges which would help them to easily transform. Keeping in view the importance of the matter this study reviews the demutualization process in Pakistan and the challenges which can arise during and after this process. The study also identifies some potential benefits in terms of market capitalization, number of listed companies and improvement in governance structure.

**REVIEW OF LITERATURE**

Businesses around the world are going through a range of modifications as alliances, acquisitions and mergers are taking place. These changes help the organizations to work efficiently. Same myth goes for stock exchanges as well. Many stock exchanges which were limited by guarantee are now converted to public limited companies; from mutualized to demutualized exchanges (Chaddad, 2003). Demutualization is a process in which non-profit organizations turn to for profit organizations (Hughes and Zargar, 2006). Traditionally, stock exchanges operate as mutualized, non-profit organizations. Stock exchanges earn money from transactions fee, initial public offerings (IPOs), annual fee, and entrance fee from new members and sales of historic trading and market information. Stock exchanges perform different roles for its members: it works as a regulator with a mission to maintain fair, efficient and transparent market. Secondly, they operate both as a primary and secondary market for its members. This physical market gives a platform for the companies to earn money and the investors to invest.

According to Scullion (2001) demutualization is not merely converting into for profit organization owned by its members. An exchange is genuinely demutualized when it maximizes its potential of market capitalization to the fullest and alongside it also increases its shareholders value. This term was initially used for the conversion process of insurance companies only but later evolves into a more generic term. Demutualization has been happening at a faster rate in many industries since the 1980s (Chaddad, 2003). Financial exchanges, insurance companies, savings and loan associations and agricultural cooperatives have converted to publicly listed companies. Financial exchanges have different ownership structure state owned, or limited by a guarantee (DiNoia, 1999). In other words, the major customers of the services provided by the exchange-financial intermediaries, issuers of listed companies, brokers, dealers and
in institutional investors – are commonly the member-
owners of exchanges. Conventionally, exchange-
members get the profit in the form of low access fees or
other benefits. Board of directors is also nominated by
the members. Furthermore, exchanges operate as self-
regulatory organizations with members contributing their
time to governance and self-regulation to make
exchanges more effective and profitable. It is observed
that market capitalization, number of listed companies
and governance structure improve when the stock
exchanges become for profit organizations (Karmel,
2000). Many stock exchanges around the world have
gone successfully through this process after the first
stock exchange demutualized in 1993 (Serfsoy, 2005).

Process of demutualization varies from one exchange
to other. Integration, mergers and issuing shares have
been used by the exchanges to become for profit
companies. Singapore Exchange Limited (SGX) was
formed on December 1, 1999, following the merger of the
Stock Exchange of Singapore (SES) and the Singapore
International Monetary Exchange (SIMEX). It was Asia
Pacific first exchange to demutualized, integrated and
derivative exchange and on November 23, 2000 SGX’s
shares became listed on its own marketplace. As a result of
the merger of the Hong Kong Futures Exchange (HKFE)
and the Hong Kong Securities Clearing Company
(HKSCC), The Hong Kong Exchange (HKEx) was
created in 2000. Shortly three months after the merger,
HKEx shares were listed on its own marketplace on June 27,
2000. Further, after demutualization these exchanges went
on to form alliances with other exchanges around the
world to give better services to their shareholders.

Demutualization helped them in providing a platform and
their better and timely initiative assisted them to grow in
the global market. Like SGX went on to form an alliance
with Japan, NASDAQ and Australia. These alliances
helped them to run successfully, globally (Akhtar, 2002).

DEMUTUALIZATION

Gains and implications

The literature on demutualization shows many advan-
tages and challenges. One of the biggest advantages of
demutualization is corporate governance (Agarwal,
2002). It is a set of processes, customs, practices,
policies and laws which is directly affecting the way an
organization is working. Literature supports this point
that demutualization does help an exchange to improve
its corporate governance (Williamson, 1999; Steill, 2002).

Demutualization would restructure governance at the
stock exchanges on a sustainable basis (LSE, 2007) as
the ownership rights will be delinked from trading rights.
It would increase the role of non-member stakeholders in
the affairs of the exchange. Management would be in the
hands of professional people selected by the directors.

Management looks after the day to day management of
the exchange and the board of directors (BODs) will be
separated from that. There would not be involvement of
BODs in decision making; this would result in transparency,
efficiency and independence (IOSCO Emerging Markets Committee, 2004). Another advantage of
demutualization is access to economic capital. After
demutualization stock exchanges can raise capital from
many sources as normal for profit organization. Most
important source of income would be new share holders,
stitutions and individuals. Research has shown that
demutualization increases the capital and income of an
exchange as compared to a mutualized exchange. Table
1 shows the increase in income of the exchange after
demutualization. It also clearly shows demutualization
has positive impact on the income of an exchange.

Figure 1 shows the effect of demutualization on total
market capitalization. Demutualized and listed stock
exchanges have greater market capitalization which is
70% as compared to others in the world scenario.

A demutualized exchange can borrow from
conventional lenders such as banks. Whereas mutualized
stock exchanges have to look up to their guarantor for
finances. To borrow from a bank, stock exchanges have
to improve their financial policies in order to increase the
credibility of the exchange which enhances the corporate
governance. In addition to the advantages discussed
above, access to human capital is also an important
outcome of demutualization. Good governance and
access to economic capital assist exchanges to attract
better qualified human resource (Faina and Lopez, 2006).
These professionals will help to take better decisions.
Better management would also increase the efficacy of
the exchange by introducing better practices and policies
(LSE, 2007). Demutualization would also enhance the
profit motive for growth and development. After
demutualization exchanges have to earn their own bread
and butter. This will have a constant pressure on the
exchanges to grow and develop their businesses which
will increase profitability. It should work as an incentive to
enhance liquidity in the market and to introduce new
products and services. Demutualization would also help
an exchange to attract listings. Better and efficient
system of a demutualized exchange would increase the
confidence of other companies (Hart and Moore, 1996)
and this would result in greater listings. Demutualized ex-
change can go for international alliances (Akhtar, 2002)
and such alliances provide openings for investments and
cross border listings (Hughes and Zargar, 2006).

Apart from the benefits demutualized exchanges face
some challenges. Conflict of interest is the biggest
challenge as de linkage of ownership and management
can result in such conflict. Management takes decisions
which are not in conflict with their position in the organi-
ization whereas directors do not want any compromise on
Table 1. Income of demutualized exchanges.

<table>
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<th>Exchange/ demutualization</th>
<th>Operation income</th>
<th>Net income</th>
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<tr>
<td></td>
<td>Before</td>
<td>After</td>
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<td>SGX (1 DEC 1999)</td>
<td>-</td>
<td>S$64.0</td>
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Source: (Akhtar, 2002).

Figure 1. Market capitalization of exchanges. *In US $ trillion, as of March 2006. **Percent of total. Source: World Federation of Exchanges.

compromise on maximum revenue. There is the likelihood that managers may pursue personal goals ahead of corporate goals or the probability that managers may hunt their goals at the expense of the goals of shareholders. Interest of the members is to keep user charges at a minimum whereas interest of a commercial entity is to price at the margin. Ownership structure is another challenge for an exchange. How can ownership be transferred to non-members from members? In most exchanges valuation is done to monetize the position of a
member, but here again value would vary from one stock exchange to another (Akhtar, 2002). It is hard to find the actual value of ownership right. Regulatory framework is another challenge for the demutualized stock exchange (Fleckner, 2006). To run any business smoothly some regulations are required (Elliott, 2002). Exchanges also incur costs to develop and apply regulatory framework. Exchanges may use MOUs to reduce their regulatory cost in an attempt to limit their regulatory duties and obligations. These MOUs could also be used to impose constraints or obligations on regulators.

Demutualization in Pakistan

The demutualization process in Pakistan has been initiated by the Federal Government as part of the capital market reforms package introduced by Asian Development Bank (ADB). Securities and Exchange Commission of Pakistan (SECP) then constituted a committee to submit a detailed report regarding the demutualization of stock exchanges of Pakistan. This committee suggested two models for the process; Fully Integrated and Demutualized Exchange (FIDE) and National Exchange (NE). The authorities regarding demutualization of exchanges have decided to demutualize the exchanges without going into integration. However, the process of demutualization will start when the bill for demutualization and integration of stock exchanges gets the approval of senate. Whenever this bill gets the approval this will become a law after that exchanges will be given time of 3 months to convert into a demutualized exchange. The action plan for this process is already chalked out.

Islamabad and Lahore stock exchanges have hired consulting firm to pursue objective of uniform valuation on the same parameters and terms. Both the exchanges have also developed a Joint Demutualization and Integration Committee (JIDC) to look after the process. Stock exchanges of Pakistan have decided to form three individual demutualized exchanges because KSE is far bigger than the other two exchanges and it wants to stay away from an integrated stock exchange. For an exchange to get demutualized a 5 year business plan would be required. After demutualization following changes will take place according to Stock Exchanges (Corporatization, Demutualization and Integration) Ordinance 2007:

1. Legal status of the stock exchanges shall be changed from company limited by guarantee to a public company limited by shares.
2. The majority ownership shall be segregated from the right to trade on the stock exchange.
3. Shareholdings of the stock exchanges will be as under:
   a) Initial Shareholders: 40%
   b) Strategic Investors/Local financial Institutions 40%
   c) General Public 20%
4. The initial shareholders (the members) will be issued shares for consideration other than cash.
5. The Composition of the Board of Directors shall be:
   Total Number of Directors: 10 (Initial Shareholders Directors 4, Nominee Directors 6)
6. There will be TRE Certificate Holders (trading rights entitlement holders) instead of members.
7. Upon re-registration as company limited by shares, the existing directors of the exchange shall cease to hold the directorship and will be replaced by the first directors.
8. Within 30 days of demutualization the exchange shall hold elections in respect of its nominated directors. The Commission’s nominee directors shall continue to hold their office.
9. The Chairman of the Board shall always be from amongst the directors not representing the TRE certificate holders.
10. Upon change of legal status of the exchange, the liability of every member as guarantor shall stand extinguished.
11. The strategic investors and financial institutions could sell their shares only to other strategic investors and financial institutions with the permission of the Commission.
12. A financial institution could not purchase further shares from the public except from any financial institution with the prior permission of the Commission.
13. The stock exchange shall be listed on itself. However, its listing shall be managed and administered by the Commission.
14. A stock exchange shall not issue new TRE certificates to any person until 30th June 2010 unless 2/3 majority of its TRE certificate holders shall decide otherwise.
15. After July 1, 2010 till December 31, 2019, a stock exchange shall offer 15 TRE certificates each year and after 2019, there will be no restriction on the issuance of further certificates.
16. Exchanges could integrate with each other without the involvement of the court of law.
17. The stock exchange shall not sell its immovable assets at the date of incorporation without prior approval of the Commission.
18. The Commission shall have powers to impose penalties up to Rs.20 million on the stock exchange including its suspension and cancellation of registration, penalty of maximum amount of Rs.1 million on any director, shareholder, TRE holder or committee member in case of any violation of the Ordinance.

After reviewing the demutualization process of Pakistan, here are few potential benefits and challenges.
Potential benefits of demutualization

In the case of Pakistan, the demutualization of stock exchanges can yield benefits as shown in Figure 2. Review of the demutualization process in Pakistan clearly supports the benefits seen in Figure 2. After demutualization the stock exchanges can improve in corporate governance. The de linkage between the ownership and management will channelize the efforts for the betterment of the exchanges. Management will do their best to improve the policies and matter of the exchange in order to show the progress. Better policies and enhanced benefits will attract the prospective people to apply. On the other hand owners will hire such efficient group of people who can perform well as part of their management team. Demutualization can facilitate access to better economic and human capital. The process will help them to raise capital from sources other than ones which were previously available like they can get money from institutional and individual investors. Demutualization will also increase pressure for growth and development. When a stock exchange demutualizes it becomes a company limited by shares which has to earn profit. Now the stock exchange has to compete with all the other companies to develop a reputation in the market. Moreover, its shares will be listed along with the other companies and to increase the value of the shares, exchanges have to be vigilant and efficient to grab the upcoming opportunities. As far as KSE is considered it has the positive repo which can help to improve the position of the exchange when it will demutualize. Whereas the other two exchanges, ISE and LSE have to really work hard to cope with the fierce competition in market. There is a possibility of going for an international alliance since stock exchanges in Pakistan (Especially KSE) has performed well in last decade or so. Merger is another option as it will increase and improve the creditability and enhance the domain of operations. Overall income of the demutualized exchanges will increase as evident from Table 1.

Implications of demutualization

Demutualization is a complex process and the biggest challenge is the development of an appropriate regulatory framework which not only looks after the demutualization process but also post demutualization developments. Although stock exchanges have decided to make two separate departments that is regulatory and commercial to reduce issues but that would be after demutualization process. Conflict of interest can be another problem which demutualized exchanges of Pakistan can face because after demutualization ownership will be transferred to non members from members (SECP, 2004). In the present scenario members are the owners and they take decisions in their own best interest. In a demutualized exchange management takes the decision and in this situation an agency problem can arise between management and the owners or shareholders. Delegation of authority to the management which is separate from the owners is another issue. There is a possibility that
management pursues personal goals rather than corporate goals. Stock exchanges have to bear agency cost as a result of demutualization. Risk could be another challenge for demutualized exchanges. Investors may be reluctant to invest in a for profit exchange because of the economic conditions of the country. Lenders may not lend the capital sufficient enough to run the business properly. Share prices of stock exchange can be undervalued. These factors can haunt the investors or the authorities. Another problem can be the selection of an appropriate bench mark for pre and post demutualization process.

CONCLUSION AND RECOMMENDATIONS

Demutualization is an intricate process, which can result in increased efficiency, capitalization, governance, if done effectively. Apart from stated benefits there are few challenges faced by the demutualized exchanges like regulatory problems, ownership issues and conflict of interest etc. Exchanges can be demutualized either by integration or mergers but in Pakistan authorities have decided to keep the three exchanges apart. KSE has the ability to stand alone as it has the reputation which can help to improve the position of the exchange after demutualization. Since performing well for last decade or so KSE is a major prospect of going for an international alliance and it has the potential to go global. The other two exchanges ISE and LSE have to really work hard to cope with the fierce competition in market. It would be better for them to merge and form integrated exchanges that will enhance their domain of operations. This would also reduce their operating cost by eliminating duplication of management and other operations. At least merger with Central Depository Committee (CDC) would definitely reduce IT and communication cost. Better management, de linkage of ownership from managers, better policies, and improved corporate governance will encourage the companies to list themselves.

It is recommended that one committee should watch over the whole process both pre and post demutualization to make it a success. A regulatory framework will help to reduce conflict of interest, unethical practices, and would help to make rules for the primary and secondary market, investors’ protection and transparency in stock exchanges. Agency problem can be tackled by better understanding between the two groups. Better salary and benefits to management can increase their job satisfaction level. Price of shares of stock exchange can be undervalued. These factors can haunt the investors or the authorities. Five year plan of the stock exchanges can help the owners to build the confidence of the investors. This five year plan is the legal requirement from every exchange before it gets demutualized.

REFERENCES