Demutualization and International Trends in the Stock Exchange Market

Nora Rachman
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Summary

✓ Trends since the 90’s and their Consequences
✓ An Overview of the Capital Market in the World
✓ The Demutualization Process
✓ Perspectives for the Capital Market in Latam
Trends since the 90’s and their Consequences
Trends since the 90’s

GLOBALIZATION

Overseas competition for listing and trading

CLIENTS’ DEMANDS

Liquidity, trading efficiency, new products and lower costs

STOCK EXCHANGES

TECHNOLOGICAL ADVANCES

Algorithms and Program Trading
Outcome: commissions reduction

ALTERNATIVE TRADING SYSTEMS

Trading through ECNs and internalization of orders
Consequences

**CONVERGENCE**
Cash Market and Derivatives in the same stock exchange

**ELECTRONIC TRADING PLATFORMS**
Total replacement of the Open-Outcry trading scheme

**STOCK EXCHANGES**

**DEMUTUALIZATION**
Transparency and Strategic flexibility

**CONSOLIDATION**
Challenges: valuation expectation and anti-trust issues

**REGULATION**
Conflicts: jurisdiction and self-regulation
An Overview of the Capital Market in the World
### North-American Landscape

**Mergers, Demutualization and IPOs**

<table>
<thead>
<tr>
<th>Year</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>Demutualization</td>
</tr>
<tr>
<td>2002</td>
<td>IPOs: NYMEX, CME, TSX, Archipelago</td>
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<td>2004</td>
<td>IPO: Archipelago</td>
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<tr>
<td>2005</td>
<td>IPOs: ISE, ICE</td>
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<tr>
<td>2006</td>
<td>IPO: NYSE Group</td>
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<tr>
<td>2007</td>
<td>Mergers: NASDAQ, NYSE Group, Euronext</td>
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<tr>
<td></td>
<td>Acquisitions: CBOE, NASDAQ, Instinet</td>
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<td></td>
<td>Demutualization: Chicago Board of Trade</td>
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<tr>
<td></td>
<td>Acquisition: NASDAQ, 19.9% of DIFX</td>
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<td></td>
<td>25% ownership of London Stock Exchange</td>
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*Legend:*
- NYMEX: New York Mercantile Exchange
- CME: Chicago Mercantile Exchange
- TSX: Toronto Stock Exchange
- Archipelago
- ISE: International Securities Exchange
- ICE: Intercontinental Exchange
- Chicago Board of Trade
- NYSE: New York Stock Exchange
- NASDAQ: National Association of Securities Dealers Automated Quotations
- Instinet
- CBOE: Chicago Board Options Exchange
- NASDAQ: National Association of Securities Dealers Automated Quotations
- DIFX: Dubai International Financial Exchange
- London Stock Exchange
- MX: Mexican Stock Exchange
Probable Listings on the way...

North America
- ✔ NYMEX
- ✔ CBOE
- ✔ New York Board of Trade

Asia
- ✔ Bombay Stock Exchange
- ✔ Korea Exchange
- ✔ Tokyo Stock Exchange
Period: From the IPO day to November/22/2007 – (USD)

Source: Bloomberg

*Nyse and Nasdaq 11/21/2007
*Euronext 7/11/2007
Market Capitalization

**Listed Exchanges**

- NYSE
- Nasdaq
- LSE
- HKONG
- TSX
- Deutsche Börse
- BMES
- ASX
- BOVESPA
- OMX
- USE
- SGX
- Malaysia
- Athens
- Santiago SE
- Osaka
- Philippine
- Colombia SE
- Lima
- New Zealand
- Tokyo
- Bombay
- NSE
- Korea
- Borsa Italiana
- Taiwan
- Mexican
- Oslo Bors
- Wiener
- Budapest
- Ljubljana
- Bermuda

**Demutualized**

- Shanghai SE
- Swiss
- Shenzhen
- Istanbul SE
- American
- Tel Aviv
- Warsaw
- Luxembourg
- Thailand
- Jakarta
- Irish
- Cairo & Alexandria
- Buenos Aires
- Tehran
- Cyprus
- Colombo
- Mauritius
- Malta

Source: WFE
The Demutualization Process
The Reasons to Demutualization

- Strengthening before the international competition and adjusting to an integrated markets dynamic
- Higher flexibility and response velocity to the changes in the domestic and international scenario
- Capital raising to new investments
- Liquidity and valorization of the brokerage houses’ (members) investments
- Strengthening the commercial focus
Demutualization Stages

- 1st. stage: Mutual Structure → Non-Mutual Structure
- 2nd. stage: Corporation → Public Corporation (optional)
- 3rd. stage: Listing in the Stock Exchange (optional)

Some Stock Exchanges carry out the 3 stages, others just do the 1st or the 1st and 2nd stages

- Examples:
  - Demutualization: Bolsa da Colômbia, Bombay Stock Exchange
  - Demutualization and IPO: NYSE, Euronext, LSE, BME
Changes and Needs

Resulting from the Demutualization and Merges

✔ Separation between the “trading access” and the “decision making power”
  • The trading access and the others services provided by the Stock Exchange are, generally, separated from the ownership of shares
  • The decision-making power now belongs to the shareholders (that will not be, necessarily, the former brokerage houses or the former members)

✔ Corporate governance reinforcement and strategy
  • For-profit corporation, the management will be more competitive
  • Adoption of a “Business Model”

✔ Regulation
  • Changes in the self-regulation model after the demutualization
  • Jurisdiction conflicts in the merger process
Trading Access
Some adopted models

✓ **Issue of trading access licenses**
  - Automatically granted to the former owners of the membership certificates
  - Entrance possibility to the new intermediaries, since they are properly qualified for that
  
  *Ex. NYSE*

✓ **Issue of shares with different classes**
  - Voting right Class
  - Trading access right Class

*Ex. CME e NYMEX*
Regulation

Issues in discussion at IOSCO

✓ Jurisdictional Conflicts

Anti-trust issues and difficulties to conciliate the regulators’ requirements in the regional e international mergers

✓ Self-Regulation Function of the Stock Exchange

As a commercial entity, for profit organization, can a Stock Exchange keeps satisfactorily its self-regulatory function?

Profits maximization

X

Fair market operating
Self-Regulation

3 Alternatives

✓ The Stock Exchange keeps the self-regulatory activities
  • If the stock exchange acts in a relapse way regarding its regulatory activities, it can cause damage to its commercial image
  • The stock exchange has a better display to perform the trading supervision as well as the compliance of the public companies. It is its task providing a regulated market

✓ Dissociation between the commercial activities and the regulatory activities inside the demutualized stock exchange
  • Launch of a non-for-profit entity to take care of the regulation activities, under the same holding, but constituted by an independent board and an independent management

✓ Outsourcing of the regulatory activities
  • Launch of a non-for-profit entity, fully disentailed and constituted by members that do not have entails with it or interest in the stock exchange activities
  • Regulatory activities fully attributed to a governmental body.
Perspectives for the Capital Market in Latam
Some Possibilities...

✓ Demutualization and IPO

*Currently, the Stock Exchanges from São Paulo, Santiago, Lima, El Salvador, Colombia and Panama are listed, while the Stock Exchanges from Mexico, Bolivia and Caracas are demutualized*

✓ Mergers and acquisitions by North-American and European Stock Exchanges

✓ Market integration

*Ex. Pilot Project BOVESPA-BMV*
Demutualization in Brazil

BOVESPA e CBLC announced studies to the demutualization and IPO in June 2006.

The whole process, which culminated in BOVESPA’s IPO, was concluded in 16 months:

- Demutualization: August 2007
- IPO: October 2007
Demutualization in Brazil

Steps taken

- Approval by the regulatory bodies
  - Securities and Exchange Commission and the Central Bank
- Corporate Restructuring
  - Approval by the members for the creation of a for-profit organization
  - Bylaws and contracts review
- Trading Access
  - Rules definition, licenses etc
- Self-Regulation
  - Restructuring of the supervision activity
- Social Responsibility
  - Future of the current projects
- Preparation to IPO
  - Adjustment to the financial statements standards and corporate governance improvements
Corporate Structure

Current Shareholders (Financial Institutions / Others)

- Exchange

BVSP

- Market Surveillance & Monitoring

BSM

New Shareholders

- Clearing & Settlement
- Central Securities Depository

CBLC

- Exchange & Monitoring

Clearing & Settlement
Vertically Integrated Model

- Bovespa offers a complete array of services for trading, settlement and custody of securities

- CBLC
  - Trading
  - Central Securities Depository
  - Index Licensing
  - Securities Lending
  - Listing
  - Clearing
  - Product Development
  - Settlement
  - Market Data
  - Risk Management
  - Front, Middle and Back Office Software Licensing
  - Custody Services for Clubs and Funds
Experienced Management Team and High Standards of Corporate Governance

- All common shares with equal voting rights
- Full tag-along rights
- Majority of board of directors composed of independent members. Very strict definition of independence including:
  - No commercial relationship with Bovespa
  - Cannot be a controlling shareholder of any company listed on the Bovespa
  - If a board member of any listed company, must be an independent director of that entity
- All board members are non-executives
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