RESTRUCTURING ARAB STOCK EXCHANGES: *IMPLICATIONS ON GOVERNANCE* [1]

ARTICLE BY ALISSA AMICO, CORPORATE AFFAIRS MANAGER
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The stock exchange industry has experienced a whirlwind of change in the past two decades, whereby most large international exchanges now operate as private and in some cases listed companies, not unlike the companies listed on them. Today, only 12% of the largest stock markets which are members of the World Federation of Stock Exchanges [2] are organised as associations and even demutualised markets are now a minority, at 14% globally. While privately owned and self-listed exchanges are now widespread across the Americas, Europe, and parts of Asia, even 15 years ago, this scenario would have been unimaginable.

Arab exchanges remain somewhat of an outlier in the world of increasingly privately-owned and self-listed exchanges. This reflects the history of the emergence of exchanges in the region as governmental bodies, with the exception of the Palestine Exchange which emerged out of a private sector initiative. Apart from the Palestinian bourse, the Dubai Financial Market which self-listed 20% of its shares, and four exchanges whose ownership is mutualised [3], all other exchanges in the region are organised as state-owned, incorporated or administrative entities.[4]

Exchange privatisation has not been a hot topic in the Middle East and North Africa (MENA) region until recently, owing to the history of institution building and the structure of capital markets in the region. However, the interest in restructuring the ownership and legal form of Arab exchanges has grown in recent years, as witnessed by the ongoing discussions related to the corporatisation and privatisation of the Kuwait Stock Exchange and the demutualisation of the Moroccan Stock Exchange. Borsa Istanbul was transformed into a corporate entity last year, following significant structural changes that saw the merger of Turkish securities and commodities markets. Tadawul was corporatised even earlier, paving the way to other potential ownership changes and other bourses, such as the Lebanese and Egyptian exchanges, are increasingly interested in exploring similar ownership transitions.

A number of important issues relevant to the future development of Arab capital markets and, more narrowly, for the ongoing development of corporate governance practices in listed companies are raised by these actual and potential ownership transitions of Arab bourses, which remain a centrepiece of national capital markets and financial center development strategies. First, how might the new ownership arrangements affect the role of stock exchanges as "guardians at the gate" of good corporate governance? [5] Secondly, would transition to private ownership help Arab exchanges address some of the market development challenges such as increasing

1 This article is based on report of the OECD released in December in Oman. The full report, including case studies of individual markets, can be accessed at: http://oecd.org/daf/ca/mena-corporate-governance.htm.
2 The World Federation of Stock Exchanges (WFE) is trade association of 62 publicly regulated stock, futures and options exchanges.
3 These include the Casablanca Stock Exchange (Bourse de Casablanca), the Iraq Stock Exchange, the Tunis Stock Exchange (Bourse de Tunis) and the Amman Stock Exchange.
4 Four of the region's markets, including exchanges in Damascus, Beirut, Kuwait and Cairo are currently organised as public entities and have no corporate form.
5 For a more detailed exploration of the role of MENA stock exchanges in corporate governance, please refer to the OECD's earlier report http://www.oecd.org/daf/ca/RoleofMENAstockexchanges.pdf

listing or liquidity that they have been facing in recent years?

To answer these complex questions, this article first examines the motivations of the ownership transitions, the practical considerations to ponder in these transitions, and finally the implications in terms of market and regulatory risks raised by the questions above. First turning to the motivations, it bears to note that the economic context and hence the motivations of Arab exchanges to broaden their ownership, either through demutualisation or privatisation, are different from those that incentivised European and North American stock markets to do so. Competition among exchanges in the region is rather minimal [6] and most exchanges do not require additional capital to finance expansion or technology acquisition.

Rather, a key driver of ownership transitions is the interest of these markets to have a greater flexibility in their operations and less governmental interference (or in the case of mutualised exchanges, broker influence). The perception of executive management of a number of exchanges in the region is that privatisation and demutualisation, by liberating them to pursue more innovative and perhaps aggressive strategies for development, will enable them to address the recent slump in listings and liquidity. [7] Exchanges interested in adopting a private-sector based ownership model appear to be also encouraged by the fact that most of the largest international markets have done and continue to do so. [8]

Demutualisation and privatisation is further seen as a means to put exchanges in the "same outfit" as listed companies, by forcing them to adopt the same governance and listing standards as issuers. For self-listed bourses who are subject to the listing requirements, the adoption of higher governance standards sends a positive message to listed companies. Compliance with regulations for listed companies, and notably with the local corporate governance code, might motivate governance reform within MENA exchanges, for example, by replacing current government appointees on boards with independent directors.[9]

Whether Arab exchanges will be able to achieve their market development or governance objectives through privatisation or demutualisation remains unclear. The impact of stock exchange demutualisation and privatisation has been varied across the world. In Europe and North America, expectations that exchanges become profitable and trade at high price-earnings multiples has put significant short-term profitability pressures on bourses. The competition between regulated exchanges and off-exchange trading venues, which proliferated in North America and Europe, has further exacerbated them. For the first time in a decade, WFE member exchanges reported a significant revenue decline last year.

The conversion of stock exchanges to for-profit entities also raised important issues in terms of their regulatory responsibilities. A key concern expressed by regulators globally is that attempts to maximise profits and shareholder value by demutualised or privatised exchanges might come at the expense of self-regulation and supervision of listed companies by exchanges. The risk of a regulatory race to the bottom, including in corporate governance standards, has been much discussed among regulators and in the literature. To address the potential conflict of interest between their profit-making and regulatory responsibilities,

6 Competition tends to be especially low for listings which are usually local (with the exception of few listings of large Arab companies outside the region). However, competition for regional or domestic capital, especially institutional capital, is quite robust.

7 Already, exchanges in the region have introduced a number of substantial regulatory and structural changes such as introducing secondary listing tiers to attract SMEs (i.e. Qatar), entering into emerging market indices (i.e. UAE and Qatar) and introducing a dual listing regime (i.e. Saudi Arabia) to address related challenges.

8 Almost all of the largest exchanges globally are privately owned. The Tokyo Stock Exchange was the last large stock exchange to privatise in 2013.

9 That said, many of the region's state-owned markets, even those which are unincorporated, have governance arrangements that reflect strong private sector presence. For instance, the Muscat Securities Market, which is a government-owned exchange, has a board of directors representing a variety of interests.

for-profit exchanges worldwide have moved to establish separate entities to conduct regulatory functions or outsourced their regulatory functions to an independent third party.

While such arrangements might be plausible in the region, and especially in the GCC where exchanges have limited self-regulatory and market oversight functions, the transitions of Arab stock exchanges to full or partial private sector ownership may actually complicate regulatory coordination between exchanges and securities regulators. Exchanges organised as governmental organisations often operate under direct oversight of securities regulators and this relationship might become more complicated to manage if they were organised as for profit entities and/or if there were multiple exchange operators.

For a number of jurisdictions - not least Saudi Arabia, the UAE, Turkey and Qatar - which are vying to establish their financial center dominance in the region, private ownership of the exchange might be more difficult to manage. After all, privately-owned exchanges might have objectives other than those promoted by governments as part of their broader financial sector development strategies. In addition, regional policy coordination (e.g. a single set of listing rules being discussed in the GCC), might be more challenging to achieve if exchanges were privately-owned.

In addition to such regulatory concerns, a number of practical modalities need to be carefully considered before Arab exchanges decide whether private ownership might be suitable as a model. The first and perhaps the most obvious question that arises in this regard is who to transition the ownership to. The choice of potential investors in the restructuring process is crucial to consider from the outset of the restructuring process as it affects the sequencing of reforms. If a sale to a strategic investor such as another international exchange operator is feasible and desirable, the ownership transition may be accomplished much faster than if no clear buyer is available.

In a number of instances, opening capital to financial institutions, notably banks, is one of the key options being considered for exchange restructuring. While banks might be obvious investors in exchange privatisations, bank ownership of exchanges in the MENA region poses multiple concerns, not least the emergence of banks as systemically “too big to fail” actors. An important conflict of interest as far as bank ownership of exchanges is concerned is that banks in the region account for a high proportion of listed companies, which would result in banks effectively be supervising their own listing, unless all bank supervision powers are transferred to the central bank and/or to the securities regulator. Self-listing, while removing some of these conflicts of interest, might be difficult to orchestrate and would introduce immediate market pressures that exchanges in the region are not used to dealing with.

The timing of privatisation or demutualisation is also important to consider. For instance, the Kuwait Stock Exchange saw its restructuring process commence in parallel with the establishment of the Capital Market Authority, which complicated the corporatisation and its envisioned sale. The Beirut Stock Exchange currently finds itself in a similar predicament. These experiences clearly demonstrate that the capital markets oversight infrastructure must be firmly in place before exchange ownership transitions are put into place to allow for an orderly transition of regulatory responsibilities. In this region, where corporate governance codes are relatively young and their enforcement is at early stages, it is important that the regulatory bodies are clear about where lines of responsibility lie.

Last but not least, the impact of demutualisation and privatisation on the governance of exchanges themselves must also not be underestimated. Although the governance arrangements of most state-owned and mutualised markets in the region demonstrate the participation of a diverse range of stakeholders on the board, the changing ownership structure would certainly impact on board composition. In a self-listing context, the impact on exchanges’ governance will likely be greater and appropriate mechanisms would have to be introduced to supervise the exchange’s own listing and the creation of required reporting to shareholders following it. This might require serious culture shifts for some exchanges that have historically not been subject to disclosure on their profitability, board meetings, shareholder requests and related matters.

Ultimately, the question is whether demutualisation or privatisation “will pay” in terms of capital market development, by helping markets attract greater listings or portfolio investment. Looking at the issuer side, the answer appears far from clear. Ownership of exchanges by listed companies for instance, an option which was contemplated by the Kuwait Stock Exchange, can create situations where some companies maybe even more reluctant to list their shares in a marketplace which may be, for instance, partially-owned by a competitor. On the other hand, it is plausible to suggest that exchanges may develop a greater institutional investor base and hence attract more issuers if they were privately-owned and more flexible in their strategic decisions.

While exchange ownership structure is unlikely to affect the interest of retail investors, which in most markets of the region are the biggest source of turnover, it would likely affect institutional investors. Foreign institutional investors may be encouraged by developments in capital markets in the region if, for instance, a large international exchange became an investor in one of the Arab exchanges. Private sector ownership of exchanges would likely allow exchanges to deal with the political sensitivities surrounding consolidation that many observers see as a prerequisite for Arab capital markets to appear more prominently on the radar screen of large international investors.

Further consideration of the suitability of privately run exchanges to local economies at this juncture of their development is warranted. Demutualisation or privatisation “may pay” for some exchanges in the region but ownership transitions should not been seen as an automatic solution to the listings and liquidity challenges that many of the region’s exchanges are facing. These latter problems are serious and merit reflection, in particular to examine whether the existing listing regimes and regulatory incentives are effective in mobilising greater interest from issuers and investors. The OECD’s Capital Markets and Corporate Governance Taskforce, composed of heads of stock exchanges and securities regulators, serves as a forum to address this and other issues related to capital markets development and corporate governance.