

Privatisation and Demutualisation of MENA Stock Exchanges: TO BE OR NOT TO BE?



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FOREWORD

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. This transformation of exchanges, whether undertaken through demutualisation or privatisation, has initiated an intensive debate on the role of stock exchanges in the regulation and oversight of listed companies and in the role of exchanges as the guardians of “public good” facilitated by capital markets.

Until recently, this debate has had little echo in the Middle East and North Africa (MENA) region, where most stock exchanges are government-owned and some are organised as mutually-owned organisations. The interest in restructuring the ownership and the legal form of Arab exchanges has grown in recent years, as witnessed by the on-going discussions related to the privatisation of the Kuwait Stock Exchange and the demutualisation of the Moroccan Stock Exchange. Others, such as the Lebanese and the Egyptian exchanges, are increasingly interested in exploring similar ownership transitions. The management of a number of exchanges considers that private ownership might afford them greater operational flexibility and ultimately, ability to be more competitive regionally and perhaps internationally.

Responding to this growing interest, this report explores the efforts of MENA stock exchanges to restructure their ownership through regional comparisons and country case studies. It also situates this process within global transformation of the stock exchange industry over the past two decades. In doing so, this report represents the first effort to analyse the ownership and governance practices of Arab stock exchanges with a view to discuss how the ownership transitions might be optimally structured and whether indeed they are desirable in the short or long term.

In answering this question, the report aims neither to support nor to discard demutualisation or privatisation as policy options for restructuring Arab stock markets. Instead, it seeks to provide an overview of the considerations that MENA exchanges interested in ownership transitions might wish to take into account and outline the lessons learned from other Arab and international jurisdictions. In doing so, it questions whether demutualisation and privatisation could be a “quick fix” solution to the challenges experienced by Arab exchanges in terms of listings and liquidity.

The report effectively opens the debate on what the ownership of MENA stock exchanges might look like in a decade. Further research is needed to understand the potential impact of ownership transitions on the competitiveness of Arab exchanges. The available experience, summarised in this report, draws on recent transitions undertaken by some markets such as the recent corporatisation of Borsa İstanbul, which do not yet allow for conclusive recommendations to be drawn. Further research on post-privatisation or demutualisation performance of exchanges is needed but empirically challenging given the lack of data on profitability of government-owned exchanges.

Ultimately, the report underscores that all ownership configurations effectively entail certain conflicts of interest and indeed the “art” of creating sustainable and effective capital markets is in managing these conflicts in a way that ensures that exchanges continue to act in the interest of broader economic development. A number of arrangements related to mitigating conflicts of interests faced by privately owned exchanges are highlighted herein and their applicability to the current institutional frameworks of capital markets regulation and oversight in the region are explored.

Ensuring that exchange ownership transitions do not negatively affect market development, transparency and price discovery is critical at the current stage of development of MENA capital markets. First, exchanges in the region are often seen as being part and parcel of national financial sector infrastructure. Indeed, the report questions to what extent might private ownership of exchanges be beneficial when governments are using exchanges as centrepieces of their financial centres. Secondly, it is not clear whether private ownership might result in pressures on exchanges that might be detrimental to broader financial sector development objectives.

The report is structured in four parts, the first providing the historical context of ownership transitions undertaken by international exchanges, the second discussing the current ownership structure of MENA exchanges, the third presenting the key considerations and possible impact of privatisation or demutualisation of Arab exchanges, and the last analysing whether privatisation or demutualisation will be beneficial to the future development of Arab exchanges. The report includes four case studies of ownership transitions that were recently undertaken or considered by some MENA based markets (Borsa İstanbul, Egyptian Exchange, Palestine Exchange, and Kuwait Stock Exchange). For the purposes of this report, 16 stock exchanges are considered, including all markets in Maghreb, Mashreq, Gulf and Turkey.

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Further information about the Taskforce and OECD work on Corporate Governance in the MENA region is available at www.oecd.org/daf/ca/mena-corporate-governance.htm.

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CHAPTER 1

GLOBAL OWNERSHIP TRANSITIONS OF EXCHANGES

History of stock exchange restructuring

As of December 2012, the total stock market capitalisation of the world's exchanges was almost USD 55 trillion, of 26% of which was from Europe, Africa, and the Middle East, 23% from the Asia-Pacific region, and the rest from the Americas. According to the World Federation of Exchanges¹ Cost and Revenues 2012 Study, listed exchanges represented the majority of members at 41%, including NYSE Euronext, NASDAQ OMX Group, CME Group, and Deutsche Börse.

While privately owned and self-listed exchanges are now widespread across the Americas, Europe, and some parts of Asia, even 15 years ago, this scenario would have been unimaginable. Until early 1990s, the vast majority of exchanges were organised as either mutually owned or state-owned organisations. Today, only 12% of the largest stock markets that are members of the WFE are organised as association or mutual members, dominated by the Shanghai Stock Exchange and Shenzhen Stock Exchange. Even demutualised markets are now a minority: 14% of WFE members are demutualised exchanges, including markets such as the Korea Exchange and the Taiwan Stock Exchange.

The rapid organisational transformation of exchanges from member-owned mutual companies to joint-stock companies has been a key determinant in the structure of capital markets worldwide. As discussed in this report, this process is the manifestation of a deregulation in capital markets and technical innovation - especially in trading - that have put a significant pressure on exchanges to remain competitive. Furthermore, this process of demutualisation and public listing of exchanges has resulted in radical changes in the financial exchange industry, including new management and governance structures, and an increased focus on shareholder value.

Until the early 1990s, most exchanges were organised as non-profit, mutual organisations owned by their members. A membership club with exclusive trading

privileges was a natural organisation form for these markets. In this model, ownership and membership were bundled together, creating trust and ease of contracting among the members.² In the early 1990s, changes to the organisational structure of exchanges started to take place and in 1993, the Stockholm Stock Exchange became the first major exchange to demutualise.

Starting with the demutualisation of the Stockholm Stock Exchange, the number of financial exchanges that have adopted a for-profit, publicly listed organisational form has grown steadily.³ This trend is evident both in different countries and among financial exchanges that trade different types of securities. The largest derivative exchanges in the world, such as the Chicago Mercantile Exchange, the London International Financial Futures and Options Exchange, the Chicago Board of Trade, and NYSE Euronext (acquired by InterContinental Exchange in 2013), are either already publicly listed or operate as subsidiaries of publicly listed parent companies.

Other exchanges soon followed suit and many of them subsequently listed their stock on the exchange (i.e. self-listed). The Australian Stock Exchange, the Toronto Stock Exchange, the London Stock Exchange, the Deutsche Börse, and Euronext have all become public companies. In Asia, the Hong Kong, Singapore, and most recently the Tokyo Stock Exchange are organised as listed companies. Tokyo was the last major stock exchange to self-list, following the merger with the Osaka Stock Exchange, through the listing of shares of its parent company, the Japan Stock Exchange.

Following this initial wave of demutualisation among European and American exchanges, stock exchanges in emerging markets, such as Brazil, India, South Africa, Philippines, Chile and Pakistan, have also demutualised in recent years and some have self-listed. The rationales for these transitions have not necessarily been the same although, competitiveness, ownership reforms and ability to pursue alliances are common factors cited by exchanges (IOSCO, 2005). The following section examines in greater detail the motivations cited by exchanges for pursuing demutualisation and privatisation.

Rationale for restructuring

The last two decades have been marked by increasing deregulation of trading exchanges (e.g. the Big Bang in London, the elimination of fixed commission in the United States), which has made securities trading much more competitive. The continued trend toward deregulation in the early 1990s was concomitant with the new developments in information technology which led to the almost complete replacement of traditional floor-based trading with electronic trading. At the same

time, many of the largest institutional traders have developed capabilities to “internalise” a large volume of trade by matching buy and sell orders without going to the exchange. These developments have strained the traditional organisational structure of financial exchanges.

Why demutualise?

Demutualisation is the process of converting a non-profit, mutually owned organisation to a for-profit, investor-owned corporation. The members of mutually owned exchanges (i.e. broker dealers with “seats” on the exchange) are also its owners with all the voting rights conferred by ownership. In contrast, a demutualised exchange is a limited liability company owned by its shareholders. In this model, trading rights and ownership can be separated and shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange. Although demutualised exchanges continue to provide many if not most of the same services, they have different governance structure in which outside shareholders are represented on the board.

The process of demutualisation takes place in stages and can ultimately take several different forms. In the first phase, members are typically given shares and as a result become legal owners of the organisation. Subsequently, or in some cases even as part of the first phase, the organisation raises additional capital, typically from outside investors as well as members. Having thus become a privately owned corporation, demutualised exchanges have two basic options if they wish to further evolve their ownership arrangements: either broaden their ownership to a set of selected parties, or list (usually self-list) and remove all restrictions on trading.

There are a number of benefits to demutualisation for stock exchanges and indeed this has been explored in the literature extensively. Demutualising or privatising stock exchanges may lead to financial agility and improved decision making compared to mutual or government-owned exchanges. Privatised entities generally have wider access to capital as compared to state-owned or mutually organised markets.⁴ For instance, the governments of Brazil and Pakistan both hoped to attract additional foreign investment through demutualisation of their stock exchanges.

Furthermore, a major weakness witnessed in mutual or government-owned exchanges is that the exchange is ultimately geared to maintaining its owners' interests; however the interests of the members might not necessarily be the same as those of the exchange. As for state-owned exchanges, the government could interfere in the operations and management of the exchange. In a privatised model, the separation of shareholders, management, and users should in principle encourage

the pursuit of business opportunities, flexibility, and better strategic decision-making.

In certain situations, a mutual or cooperative structure could be the most efficient organisational form for an exchange. However, as markets became more sophisticated, the interests of various member groups often diverge, causing strain in the governance and decision making processes. The historical ownership structure of the NYSE underscores these tensions. Of the 1366 NYSE seats, 464 were held by specialists, another 317 by “two-dollar” brokers, and only 575 by the “upstairs brokers” or big Wall Street Firms. This explains the tremendous power that the floor community wielded in decision-making and is frequently cited as one of the reasons for the NYSE’s delayed adoption of electronic trading.

Increasingly, the bulk of the NYSE’s business became driven by institutional investors who wanted the lowest cost and most efficient execution of their trades. However, since the focus on cost and efficiency was viewed as a threat to the floor community, the NYSE found it difficult to implement changes that, although beneficial for the development of the exchange, could be detrimental to some of its member owners. Such conflicts likely contributed to some of NYSE’s decisions in the past, such as its decision not to pursue derivatives trading in 1972 and not allowing IPO firms to be listed until 1984.

While numerous benefits of demutualisation can be cited and have been explored in depth by International Organisation of Securities Commissions (IOSCO), concerns surrounding demutualisation abound. First, demutualisation may provide an incentive for the exchange to hold back on regulation. The costs of regulation are usually immediate and explicit, while the benefits are most often realised in the long term and are difficult to quantify or monetise. As the exchange transitions to a for-profit entity, its owners and management may put less emphasis on regulation in order to increase profits over the short term.

Often, regulation serves to protect the interests of the public and prevent the formation of monopolies. In a sense then, self-regulation may result in conflicts of interest and lack of interest by exchanges to bear regulatory costs. For instance, in order to address self-regulation and conflict of interest issues, Hong Kong has passed demutualisation legislation which “imposes an express duty on the exchange to ensure, so far as reasonably practicable, an orderly and fair market in securities or future contracts traded on or through the exchange. In discharging this obligation, it [the exchange] is required to act in the interests of the public.” (Pearson, 2002).

No less important is the fact that demutualisation raises an agency problem in that management may pursue its own interests rather than the interests of the owners

of the exchange, limiting planning and investment to projects that yield benefits in the short term over the long term. Finally, in the pursuit of profits from listing fees, exchanges may be tempted to lower their listing standards. The costs of such decisions are also borne by the members. However, as highlighted by OECD's earlier work with ten of the largest stock exchanges globally, a factor often mediating these concerns is the reputation of exchanges which the management of considers a key intangible asset (Koldertsova Amico and Christiansen, 2008).

Why privatise?

For many exchanges, demutualisation is just an interim step. Following that, the exchange can either self-list, list on another platform or can become a wholly-owned subsidiary of a publicly-traded company. For example, after demutualising in 1993, the Swedish Stock Exchange became a subsidiary (called the OM Stockholmsbörsen AB) of the OM Group, a publicly traded and listed company. This trend has been facilitated to some extent by the consolidation in the stock exchange industry.

The listing of stock exchanges, perhaps even more than their demutualisation, has transformed their business model. Although demutualisation is claimed to have changed the ownership of stock exchanges, significant ownership stakes were often retained by previous member firms (Steil, 2002). Therefore, the fundamental governance structure of exchanges was not significantly impacted. Self-listing and the subsequent dispersion of ownership of exchanges have finally divorced their interests from those of broker dealers.

Privatisation results in a wider mix of shareholders, including users of the exchange, buy side, listed companies, retail investors, and the public at large. Foreign institutions might become owners of newly privatised exchanges with a given cap. If large and renowned international financial institutions become shareholders of an exchange, this might enhance the visibility and brand name of the exchange. The high profile foreign equity participation in an exchange could indirectly give a boost to the overall attractiveness of the capital market and the investment climate in the country.

By transforming itself into a for-profit investor owned organisation, managers of an exchange can focus on a single mission—maximising the profits and value of the exchange. This “simplification” of the corporate objectives and the governance structure allows for faster decision making, which is increasingly important as the competitive landscape has been transformed by new technology. However, the pressure placed on exchanges to become profitable has arguably come at a high cost

in a sense that the tension between regulatory and profit making functions of stock markets have come under increasing tension.

Given the slump in the listing activity in most global markets in the past few years, exchanges have focused on maximising their revenue from information dissemination and post-trading services. This is also a result of the fact that their revenues from trading have suffered a great decline, as a result of the migration of trading to off exchange venues. This has placed them in direct competition with alternative trading venues, arguably reducing the value of publicly regulated markets to trading execution venues.

Notes

- 1 The WFE is a global association representing the interests of 57 publicly regulated stock, futures, and options exchanges, as well as central clearing houses that many of these exchanges operate as of December 2012. Collectively, WFE members represent the vast majority of the global exchange-traded equities and derivatives markets.
- 2 In fact, NYSE did not have a full-time president or professional staff until 1938.
- 3 For a discussion of the demutualisation process, see Aggarwal (2002) and Aggarwal and Dahiya (2006).
- 4 However, as explored in the following sections, this may not apply to Arab exchanges which benefit from government funding.

CHAPTER 2

OWNERSHIP MODELS OF ARAB EXCHANGES

Government ownership of exchanges

Most exchanges in the region were established and continue to operate as state-owned organisations, either as incorporated government-owned companies or as unincorporated state administrative entities (Amico, 2012a). In this sense, Arab exchanges remain somewhat of an outlier in the world of increasingly privately-owned and self-listed exchanges. As mentioned, the World Federation of Stock Exchanges, which represents the interests of 57 publicly regulated and largest stock, futures, and options exchanges, as well as central clearing houses, is dominated by privately owned exchanges.

In 2012, only 26% of the WFE member exchanges were organised as not-for-profit entities, not privately owned either by members or a larger group of shareholders. Significant contributors to this figure are MENA exchanges, including the Amman Stock Exchange, Borsa İstanbul, the Egypt Stock Exchange, and Saudi Stock Exchange (Tadawul), the largest market in this region. This reflects the history of the emergence of exchanges in the region as governmental bodies, with the exception of the Palestinian stock exchange which emerged out of a private sector initiative, led by a Palestinian holding company (PADICO) and the Palestinian diaspora (refer to case study of the Palestinian stock exchange in Annex A).

For now, only the Dubai Financial Market has moved towards a private ownership model: 20% of its shares are now listed on the market. At the same time, other markets in the region such as Qatar have more recently moved towards greater government ownership. In 2013 the Qatar Exchange has become entirely state-owned, following a recent announcement that Qatar Holding would purchase a 12% stake previously held by NYSE Euronext, already down from a 20% stake held by the latter as part of a strategic partnership deal signed between the two exchanges in 2009.

Nonetheless, the firmly governmental nature of MENA exchanges is starting to change as a number of stock exchanges in the region are considering or actually undertaking ownership transitions. In the past few years, the mutualised exchanges of the region are beginning to manifest their interest in demutualisation and the government owned exchanges are interested to broadening their ownership. The Casablanca Stock Exchange is currently undergoing demutualisation, while the Kuwait Stock Exchange is being privatised. Other exchanges in the region are looking at the results of these experiments to determine whether they may wish to follow the same path.

As a number of Arab exchanges are contemplating restructuring, it is worthwhile to explore their current ownership arrangements and highlight the transitions being considered. The following table is intended to highlight recent changes in ownership/governance of exchanges (i.e. those changes that have been undertaken in the past 5 years or less). These precise nature of these ownership and governance changes will be explored in the case studies in Annex A, which are intended to highlight in greater detail the transitions that are currently underway or recently undertaken.

Table 2.1 Ownership Transitions of Arab Stock Exchanges

Stock Exchange	Abbreviation	Established	Ownership Structure	Changes in Ownership	Changes in Governance
Bourse D'Alger	SGBV	1993	State-owned	None	None
Bahrain Stock Exchange	BSE	1987	State-owned	None	None
Egyptian Exchange	EGX	1883	Public institution	None	Yes
Iraq Stock Exchange	ISX	2004	Mutualised	Yes	Yes
Amman Stock Exchange	ASE	1999	Mutualised	None	None
Kuwait Stock Exchange	KSE	1984	State-owned	On-going	On-going
Beirut Stock Exchange	BSE	1920	Public institution	Anticipated	Anticipated

Stock Exchange	Abbreviation	Established	Ownership Structure	Changes in Ownership	Changes in Governance
Libyan Stock Market	LSM	2007	State-owned	Yes	Yes
Bourse de Casablanca	CSE	1929	Mutualised	On-going	On-going
Muscat Securities Market	MSM	1988	State-owned	None, under discussion	None
Palestine Exchange	PEX	1995	Privately held ²	Yes	Yes
Qatar Exchange	QE	1997	State-owned ³	Yes	Yes
Saudi Stock Exchange Tadawul	SSE	1984	State-owned	Yes	None, under discussion
Damascus Securities Exchange	DSE	2009	Public institution	None	None
Bourse de Tunis	BVMT	1969	Mutualised	No	None
Dubai Financial Market	DFM	2000	State-owned ⁴	None	None
Abu Dhabi Securities Exchange	ADX	2000	State-owned	None	None
Nasdaq Dubai	ND	2005	Mixed	Yes	Yes
Borsa İstanbul	BI	1985	State-owned	No	Yes

Source: OECD Corporate Affairs Division 2013.

Transition to corporatisation

Four of the region's markets which include the DSE, the BSE, the KSE and EGX are currently organised as public entities and have no corporate form. This category of exchanges has in fact witnessed the most active discussion regarding the potential restructuring of their ownership and governance arrangements. Apart from the Damascus Securities Market which was established only a few years ago, all other markets in this category have some point considered a transition to either a state-owned corporate form and/or to private ownership. This underscores that

exchanges organised as state owned administrative entities do not perceive this structure as capable to offer them maximum developmental potential.

As highlighted by the above Table, a number of exchanges in the region have already moved to corporatise. For instance, the Saudi Stock Exchange (Tadawul) has done so in recent years and Borsa İstanbul was transformed into a corporate entity in early 2013, following significant structural changes that saw the merger of Turkish securities and commodities markets. The Egyptian Exchange has for a long time now been considering a similar transition (refer to case study of Borsa İstanbul and the Egyptian Exchange in Annex A). The modalities of their corporatisation were different in each case.

For instance, the Saudi Stock Exchange (Tadawul) was incorporated in 2007 as a for-profit joint stock company and now enjoys an independent legal status and a separate budget. Its particularity is that the company was established for 99 years and its lifetime can be extended by an extraordinary assembly. Currently, capital of the exchange is subscribed entirely by the Public Investment Fund, which is a sovereign investment vehicle under the Ministry of Finance whose mandate is to invest in projects that are "strategically significant for the development of the national economy and cannot be implemented by the private sector alone" (PIF, 2013).

It is worthwhile to mention that the 2007 Articles of Association of Tadawul preview legal arrangements for further restructuring of the exchange. The Articles of Association are structured in such a way as to facilitate the eventual ownership transfer. On the other hand, the current governance arrangements of Tadawul reflect its public sector character, even if the company is now corporatised. The board of the exchange comprises representatives of the Ministry of Finance, Ministry of Commerce and Industry, SAMA (Saudi Central Bank), 4 members representing brokerage companies, and 2 representing listed companies.¹

For other exchanges that have not yet corporatised, the articles of association often allow for the possibility of converting their structure to corporate form. For example, the Beirut Stock Exchange (BSE) – the second oldest market in the region² – has for decades operated as a government entity. Law 160 of 2012, establishing the capital markets regulatory framework, previews the corporatisation of the exchange within one year of the introduction of the securities regulator and the privatisation of the exchange one year thereafter. At the time of the writing of this report, no steps have been undertaken to corporatise or privatise the BSE, for which significant legal changes and feasibility studies would be required.

An interesting point is that 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. The Chairman of the Board is a representative of a national brokerage company, while other members of the board represent the Central Bank of Oman, listed companies and investors. A similar governance model is also in place in Egypt, as illustrated in case study on the Egyptian Exchange.

These governance arrangements, whereby a diversity of interests of market participants are reflected on the board, highlight that while the ownership arrangements in these marketplaces are dramatically different, the governance arrangements are not necessarily fundamentally different than in privately owned exchanges. For instance, the role of Chairman and CEO are separate in most markets including Oman, Saudi Arabia, Morocco, Jordan, and others. Considering this, one important difference between governance of most Arab exchanges and those in Europe and North America is the lack of independent members on the boards.³

At least in principle, broadening the ownership of exchanges in the context of the current governance structure prevailing in most Arab exchanges should present few structural challenges considering that private sector representation is already featured on boards and that governments in the region would likely not seek to entirely divest their ownership stake. Nonetheless, public sector representation on exchange boards would still have to be reduced if ownership is opened up and furthermore, oversight arrangements of the exchange by the securities regulator would have to be clarified.

The start of demutualisation

Currently, four exchanges in the region have mutualised ownership: the Casablanca Stock Exchange (Bourse de Casablanca), the Iraq Stock Exchange, the Tunisian Stock Exchange (Bourse de Tunis) and the Amman Stock Exchange. Their governance arrangements naturally reflect the dominance of market intermediaries as their owners. For instance, the Bourse de Tunis is governed by a 12 member board (all representatives of the 23 market intermediaries who are the owners of the Exchange) elected for a 3 year renewable period. The Chairman of the stock exchange is elected by members of the board, while the Director General of the Exchange⁴ does not represent any of the market intermediaries but must be nominated by the board and approved by the Ministry of Finance. The Ministry of Finance also nominates another observer (Commissaire du Gouvernement) to represent the state on the board.

A similar governance arrangement is in place at the Bourse de Casablanca, which is also governed by a 12 member board representing market intermediaries and chaired by a member elected by the board. It also has a representative of the Ministry of Finance, who also attends all the General Assembly meetings. There is a separation between the roles of the Chairman of the Board and the CEO and the latter is not permitted by internal regulations to have a seat on the board but can participate in its deliberations on invitation. The governance structure of the exchange and internal regulations supporting it are rather advanced and include a Charter for board members and an ethics policy for the exchange staff. There is a high degree of transparency regarding the process of appointment of board members and their remuneration, which is published in the annual reports of the Exchange.⁵

Unlike their government-owned peers, the mutually-owned markets in the region are generally not interested in broadening their ownership beyond market intermediary organisations which naturally have a strong interest in maintaining the current structure. It is understood that discussions are currently on-going to demutualise the Bourse de Casablanca, a process led by the Ministry of Finance. The key participants in this process apart from the exchange itself is the securities regulator and the brokers' association, which was initially reluctant to engage in this process, arguing that the exchange did not require a capital increase to boost its performance.

If implemented, the proposed changes would carry significant implications for the composition of the boards of mutually-owned markets in a sense that they would no longer be dominated by market intermediaries. In this new ownership and governance configuration, independent board members would be introduced, as they would be introduced if the exchanges were to privatise. Some experts argue that such governance changes could call for a possible expansion of the board's responsibilities to include the review and admission of application for listing which is arguably done in a more impartial manner by the securities regulator.⁶

While the exact reason for the current demutualisation of the Casablanca Stock Exchange is debatable, the fact that it has had one listing in 2012 (and 3 in 2011) is definitely a key motivating factor (OECD, 2012). While demutualisation is often resisted by brokers owning the market, the slump in activity has definitely served as a justification for bringing this issue on the agenda. As a counter example, the Tunis Stock Exchange, which is also owned by participating broker dealers, is understood not to be considering any ownership transitions at this time, arguably because the level of activity in the market both in terms of the pipeline of new issuers and liquidity has been improving following the fall of the Ben Ali government.

Some experts believe that the demutualisation of the Bourse de Tunis would be beneficial to its development and the quality of its governance. Proposals have been made in this direction, including the suggestion to suppress the obligation of all brokers should be stockholders in the exchange, in order to open the capital of the exchange to other institutional actors such as banks and insurance companies. Demutualisation is not currently being considered by the Iraqi Stock Exchange, following its transition to the mutualised form after the dismantlement of its predecessor, the Baghdad Stock Exchange which operated during the Saddam Hussein era.

On other hand, the governance arrangements of the Iraq Stock Exchange (ISX) are slightly different, reflecting the fact that it was re-established after its predecessor - the Baghdad Stock Exchange - ceased to exist after the fall of Saddam Hussein regime. The ISX is financially and administratively independent from the Iraqi government including the Ministry of Finance. It is organised as a not-for-profit entity that is owned by its members, the brokers. It is regulated by the Iraq Securities Commission and follows the operational procedures outlined in its by-laws that are compliant with the Iraqi Securities Law.

Likewise, the Amman Stock Exchange, which is also mutually owned, is not currently considering any ownership transitions. It is governed by a 7 member board, all of whose members represent broker dealers as it is the case of the Tunis Stock Exchange and of the Casablanca Stock Exchange. Interestingly, the future vision of the Amman Stock Exchange is to participate in the creation of the Jordan National Financial Center, and the vision of the Casablanca Stock Exchange is also to support the creation of the Casablanca Finance City. The two exchanges are pursuing this goal through different strategies.

Motivations for ownership transitions

As discussed above, a key driver of the ownership transitions that Arab exchanges are undergoing or considering is the international experience, whereby most large exchanges have already gone private. This propels the management of Arab exchanges to believe that they are operating in an ownership environment which is not sufficiently flexible to accommodate the competitive dynamics with other markets in the region and beyond. Indeed, this thinking is not radically different from the traditional factors cited by other emerging markets that have initiated a demutualisation or a privatisation process. In an IOSCO survey of emerging markets, competition for global listings and order flow were most commonly cited by respondents (IOSCO, 2005).

This thinking is reinforced by recent developments in Arab capital markets many of which have seen lackluster levels of liquidity and listings in recent years (refer to Table below). Contrary to the years when the privatisation processes in countries such as Egypt and Morocco have acted as a key driver of an active IPO environment and foreign investor interest, the current geopolitical climate in the region and its impact on capital markets in the region indeed fosters the belief that change is needed to overcome this period of placid activity.

Table 2.2 MENA IPO activity by market, 2010-2012 (in million USD)

Country	Stock Exchange	2010		2011		2012	
		Number	Value	Number	Value	Number	Value
Saudi Arabia	Tadawul	9	1,019	4	416	7	1,419
Morocco	Bourse de Casablanca	2	166	3	49	1	3
Syria	Damascus Stock Exchange	3	7	1	3	–	–
Oman	Muscat Securities Market	1	474	1	63	2	264
Tunisia	Bourse de Tunis	1	5	1	8	2	7
UAE	Abu Dhabi Securities Exchange	–	–	3	269	–	–
Egypt	Egyptian Exchange	2	376	–	–	–	–
Algeria	Bourse d'Algiers	1	20	–	–	–	–
Jordan	Amman Stock Exchange	–	–	1	3	–	–
Bahrain	Bahrain Bourse	1	389	–	–	–	–
Qatar	Doha Securities Market	1	144	–	–	–	–
Palestinian Authority	Palestine Securities Exchange	1	50	–	–	–	–

Source: Ernst and Young, MEED, 2012.

The following Table provides a more detailed breakdown of IPO activity last year. The data highlights that that outside Tadawul, few markets have seen any listings and most of them were quite small even by regional standards. Notably, it excludes the IPO of Amira Foods, a UAE based foodstuffs company which listed on NYSE with a USD 90 million capitalisation as well as the IPO of NMC Healthcare, another UAE based company which chose to list on the London Stock Exchange (LSE) in a USD 206 million deal. These deals follow a DP World listing on the LSE

in 2011. Taken together, these moves demonstrate that while the LSE's overall listings of locally domiciled firms have significantly fallen over the past decade, the listings of Arab firms on the LSE are in fact growing.⁷

Table 2.3 IPOs in the MENA region, 2012

Company	Sector	Stock market	Capital raised (million USD)
Afric Industries	Abrasives manufacturing	Casablanca	3
Hexabyte	Internet services provider	Tunis	1
Takween Advanced Industries Company	Packaging	Tadawul	62
Tokio Marine Saudi Arabia	Insurance	Tadawul	16
Najran Cement Company	Cement production	Tadawul	227
Bank Nizwa	Islamic banking	Muscat	158
Al-Tayyar Travel Group	Travel and tourism	Tadawul	365
Ateliers Mecaniques du Sahel	Stainless steel products	Tunis	6
Saudi Airlines Catering Company	Catering	Tadawul	354
City Cement Company	Cement production	Tadawul	252
Alizz Islamic Bank	Banking	Muscat	106
Dallah Healthcare Holding Company	Healthcare	Tadawul	143

Source: Ernst and Young, MEED, 2012.

Perhaps more importantly for Arab exchanges, this Table highlights one of the key motivations for Arab exchanges to restructure their ownership. Domestic issuers are indeed increasingly offered access to multiple markets and no longer have to list domestically. While it is still relatively rare for Arab companies to list in a market other than the domestic market, cross listing is starting to be encouraged and it may be a sign of an emerging competition for listings among Arab exchanges. For instance, in 2012 Tadawul issued regulations allowing foreign firms to cross list on

the condition that applicants fulfil requirements of another market with equivalent listing requirements and processes.

Indeed, reforms recently introduced by MENA exchanges such as secondary listing tiers (i.e. Qatar) and review of listing standards (i.e. Dubai), in addition to other legal and regulatory changes that affect exchanges such as review of company laws (i.e. Kuwait) and governance codes (i.e. Qatar and Saudi Arabia) were already intended to add dynamism to local markets. Some of these regulatory changes such as the recent measure allowing foreign companies that meet an equivalency standard in terms to cross list on Tadawul, were quite unexpected. Others, such as the reclassification of Qatar and the UAE to the emerging market status, have long been discussed and anticipated.⁸

Geopolitical instability in the region over the past three years, coupled with the recent nature of the adopted changes, make it difficult to gauge the long term impact of these measures and whether liquidity and listings, which remain the two key priorities for MENA investors, will return to the region. This uncertain climate for regional exchanges is certainly a factor defining the context in which they are operating, prompting the management of these markets to consider structural changes to their ownership model.

The grounds on which these structural changes are sought often have much to do with enabling the management of exchanges to make adaptations to their strategy and to react more rapidly to market developments than their public (and in some cases, mutualised) ownership would allow. In a number of instances, boards of Arab exchanges feature representatives of other Ministries and other government bodies and might be relatively slow to make strategic decisions and set the strategy for the exchange as would be required in a competitive capital markets context.

A related motivation for ownership transitions is to address conflicts of interest, especially in mutualised exchanges where exchanges are run in the interest of brokers and not, as some would argue, for public good. Similar arguments were made during the wave that set off the process of demutualisation of exchanges worldwide. However, as will be explored in further detail below, each exchange ownership model has its own conflicts of interest vis-à-vis listed companies, investors and other actors in the market.

Exchanges also view ownership transitions as a means of eventually collaborating with strategic shareholders. Already, there is some cross ownership among exchanges: the DFM has a 21% stake in the LSE and 17% stake in NASDAQ OMX. Also, NYSE Euronext held a stake in the Qatar Exchange for four years until divesting entirely in early 2013. None of the regional exchanges have

cross- holdings, which reinforces the view that exchanges are seen as part of national financial infrastructure.

Whereas partial ownership of an Arab stock exchange by an international exchange might not be seen as sensitive and might indeed be seen as reinforcing its image, it is at this point difficult to imagine that one of the regional exchanges would allow another regional competitor to acquire a stake in it. While Arab exchanges all collaborate with NYSE Euronext and NASDAQ OMX since their technical solutions are used to facilitate a range of activities⁹, collaboration among Arab exchanges remains rather minimal.

Discussions with industry participants reveal that the collaboration between exchanges that is necessary to forge a common Arab capital market are impeded by the fact that stock exchanges continue to be seen as part of the national financial infrastructure. Some heads of Arab exchanges go as far as claim that consolidation of exchanges in whichever form is not politically tenable. Their claim is perhaps best illustrated by the long discussed merger between the Dubai Financial Market and the Abu Dhabi Securities Exchange. Finally, the political will appears to exist and serious merger talks are underway.

In part as a response to this reality, focus has shifted from facilitating structural linkages between exchanges to creating technical linkages to facilitate trading by investors in one Arab country of securities listed in another Arab country. The Arab Federation of Exchanges is for instance increasingly looking at mechanisms to facilitate trading across Arab exchanges which remains cumbersome and expensive. Another area of increasing interest to foster linkages between markets has been cross-listing. While in principle cross-listing between Arab exchanges is possible, in practice few companies resort to dual listings, with a few exceptions of companies listed on large international exchanges and cross listed locally.

It is important to also mention that some considerations that would *prima facie* seem as important motivations for demutualisation or privatisation have not been brought up as crucial by industry representatives. More specifically, for most stock exchanges of the region, demutualisation and privatisation is not seen as enabling markets to compete with other markets in the region. This is indeed a relatively low priority since Arab companies do not tend to list on exchanges other their national exchange (except outside the region). MENA exchanges also do not face competition from alternative trading platforms such as electronic trading networks (ETNs) in the US or multilateral trading facilities (MTFs) in Europe.

Likewise, raising capital is not cited as one of the key considerations for broadening the ownership for either mutualised or state-owned Arab exchanges.

None of the exchanges that have recently undertaken or considered ownership transitions, with the possible exceptions of the Palestine Securities Exchange (PSE) and the Beirut Stock Exchange, are motivated by raising capital as a fundamental reason for the ownership transition. This is in fact consistent with the responses to a survey of emerging markets on demutualisation conducted by IOSCO in 2005.

Exchanges that are currently considering transitions such as the Kuwait Stock Exchange (KSE) are not constrained financially. The KSE, much like other state-owned exchanges, can resort to government support in case of any revenue shortfalls. Indeed, the privatisation strategy originally developed for the KSE envisioned that half of its capital would be sold to retail investors (for more details, refer to KSE privatisation case study in Annex A). This followed the spirit of earlier privatisation attempts in the GCC, many of which were a mechanism of wealth distribution to the local population, perhaps even more than a source of revenue for the state. The evidence of this was the very common share oversubscriptions in a number of Gulf privatisations.

However, most MENA exchanges are not candidates for government support since unlike their European and North American counterparts they retain complete monopoly on all trading activity. In principle, the capital market laws of a number of MENA countries refer to the possibility of the securities regulator licensing multiple exchanges (e.g. Saudi Arabia, Lebanon, etc.), but the reality is that national stock exchanges are the place where all trading occurs in listed securities since over the counter trading is very limited and alternative trading platforms do not exist.

Hence, while revenues from listing have naturally declined in recent years with the fall of listings and secondary issues in most markets, trading revenues in most Arab markets have not suffered, especially considering that most markets are dominated by retail investors who act as short term, “impatient” actors. According to the latest available figures, retail investors represent for over 80% of trading in Saudi Arabia, and close to that in the neighbouring Qatar and Dubai. The level of institutional investment in Arab capital markets is relatively low, reflecting the low level of development of local pension, insurance and mutual funds. Likewise, foreign institutional capital is low in most markets of the region and especially in Saudi Arabia and Qatar due to investment restrictions.

Figures on the profitability of Arab Exchanges are generally not available, particularly for exchanges that are state-owned. This is indeed reflective of the disclosure practices of other state-owned enterprises in the region, which are not subject to the same requirements as listed companies are (Amico, 2012b). Often, state-owned enterprises in the region disclose little on their financial performance and strategy and state-owned exchanges act in a similar manner. Further clarity in

the profitability and sources of revenue of Arab exchanges would be necessary going forward to analyse the impact of ownership transitions and other strategies that might affect their development.

Notes

- 1 Until the company's capital is offered for sale, the board of directors acts as a general assembly, whereas the board of the PIF acts as the Extraordinary General Assembly. That said, all key decisions such as increases or decreases in company capital are subject to CMA approval.
- 2 The decree establishing the Beirut Stock Exchange was promulgated in 1920s by the French Commissioner.
- 3 In the case of the Palestine Exchange, the privatisation and in particular the self-listing of exchange has prompted its compliance with the local corporate governance code, which recommends a certain number of independent members on the board.
- 4 These two functions were separated in 2002.
- 5 This is not a trivial point considering that this practice remains rather rare in the region.
- 6 Currently, the securities regulator (CDVM) approves the prospectus for listing but it is the board of the exchange that decides whether to admit a security for trading.
- 7 In the aftermath of the financial crisis, IPOs by UK companies have almost come to a halt. And while they still totally dominate the LSE, public offerings by non-UK corporations have not been large enough to match the IPO activity on the LSE in 1990s (Isaksson and Celik, 2013).
- 8 The discussion regarding the exclusion of Egypt from MSCI emerging markets index was relatively sudden and related to the ability of foreign investors to repatriate funds in view of potential foreign exchange shortage.
- 9 Most Arab exchanges operate on NASDAQ's technology platform and a few on NYSE Euronext technology solutions.

CHAPTER 3

IMPACT OF EXCHANGE OWNERSHIP TRANSITIONS

International experience

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 the same short-term pressures on exchanges that other listed companies experience. The conversion of stock exchanges to for-profit entities has in particular raised several questions about capital markets regulation. The key question debated in this process is what role governments should play in regulating private stock exchanges. If stock exchanges are to facilitate the raising of equity finance for growing companies, the consequences of their failure could be also significant for future economic growth of a country.

A number of complexities arise in terms of government oversight of privately owned, listed exchanges. On the one hand, exchanges could be subjected to the same arrangements as other listed companies, thereby potentially improving their transparency. On the other hand, the legal basis of government regulation is much less clear for privately owned exchanges than if exchanges are organised state-owned. In addition, government regulation of international exchange groups is certainly more complicated and entails the risk of regulatory spill over. In several international mergers such as between NYSE and Euronext or NASDAQ and OMX, specific provisions have been negotiated to eliminate such risk.¹

Competitive challenges

With the growth of competition between exchanges and off-exchange trading platforms, the impact of these transitions has become more uncertain. While stock exchange demutualisation or privatisation does not automatically imply that trading fragmentation will occur, in Europe and North America exchange demutualisation and privatisation have indeed been accompanied by deregulation of trading and the multiplication of trading venues², raising questions about the ability of stock exchanges to perform their price discovery function and regulatory responsibilities.

In the last decade, the growing threat from alternative trading systems has put pressure on exchanges to adopt more efficient trading systems and to migrate to electronic trading. The electronic trading systems have separated the physical location of trading from the act of executing a trade. This has had a profound impact on main regulated exchanges which have become increasingly marginalised as the liquidity and trading have gravitated towards off exchange venues and more recently, dark pools.

It bears to mention that the rise of dark pools and off-exchange trading venues more generally was in large part a response to the demands of institutional investors who wished to pass larger orders at a lower price but also without passing them through regulated markets which would affect market prices. While recognising the usefulness of dark pools for executing large trade orders, both IOSCO and the European Commission noted a number of regulatory concerns related to them, as they may ultimately affect the quality of price discovery. This point is also relevant for MENA exchanges considering their interest to attract greater institutional investment in the region.

As the trading volumes have grown, exchanges have invested significant capital in deploying cutting edge technology in their trading platforms, both to meet the demands of sophisticated institutional investors (e.g. hedge funds) and to respond to threats of liquidity migration to off-exchange platforms. Thus, the business model of exchanges in the new ownership environment is marked by fairly high upfront costs. However, once the trading platform is deployed, the marginal cost of adding more trades is close to zero, which provides strong incentives for different exchanges to merge and then combine their trading systems.

As the volumes of trading on regulated markets have declined and the volume of listings significantly decreased, many argue that capital markets in some jurisdictions are no longer serving their role of providing equity financing to growing companies. In the US for instance, the annual average number of companies that made an initial public offering has fallen to 116 in 2001-2012, from 525 in 1993-2000. The amount of capital raised also fell quite dramatically between the two periods, from an annual average of USD 65 billion to USD 30 billion (Isaksson and Celik, 2013).

Exchanges and regulation

Many experts also argue that some markets no longer fulfil their function in terms of providing a transparent price discovery process. With the tremendous fragmentation of trading, the rise of dark pools³, and the lack of a consolidated tape in some markets, exchanges are no longer able to guarantee a transparent price

discovery process. Instead, many markets have shifted strategies in order to compensate for lost revenue from trading by providing co-location services that enable other platforms or internalised networks to execute their orders at ever faster rates.

This new strategy for generating revenue from what would be previously seen as non-core activities highlight the tremendous pressure on profitability of exchanges in the new ownership context. As a result, regulators may need to closely monitor the financial condition of demutualised or privatised exchanges. For example, in Australia, a reserve fund was created to provide a capital cushion and potentially mitigate any financial hardships or failings. The Toronto Stock Exchange provides an early-warning reporting system whereby the exchange is required to maintain certain financial ratios and to notify regulators when not in compliance.

A related argument often made in the context exchange ownership transitions concerns the regulatory function of exchanges which operate as for profit entities and do not gain any direct revenues as a result of their regulatory activities. Historically, most exchanges globally have historically operated as self-regulatory organisations (SROs).⁴ The self-regulatory functions of exchanges typically consist of setting and enforcing rules for trading, conducting surveillance, overseeing the trading system to prevent abuses, and establishing rules to govern the conduct of members.

A concern expressed by regulators is that attempts to maximise profits and shareholder value by demutualised or privatised exchanges will come at the expense of self-regulation and supervision. Although conflicts of interest arise in both non-profit and for-profit exchanges, concerns have been raised about whether a demutualised exchange will take enforcement actions and impose penalties on those who are major providers of revenue.

Exchanges have over the years resisted such arguments, claiming that regulation and supervision as key assets protecting their reputational capital. The NYSE, for example, has argued that the regulatory function is an integral part of the exchange's reputation; and it has backed away from demutualisation because of the SEC's insistence that the NYSE first set up an independent regulatory body.

For-profit exchanges can establish a separate entity to conduct regulatory functions, thereby avoiding some of the conflict-of-interest issues. For instance, when NASDAQ started to demutualise in April 2000, the National Association of Securities Dealers created NASD Regulation Inc. (NASDR) as a separate subsidiary to regulate the Nasdaq Stock Market, which was established with a separate legal

form. The Chinese walls between NASDR and NASDAQ have continued to become stronger leading up to NASDAQ's public offering in 2008.

An exchange can also outsource its regulatory functions to a completely independent third party. This approach may help avoid the perception of conflict of interest. However, there must be some way to ensure that the third-party regulator is accountable and will perform its functions effectively to avoid harm to the reputation and brand name of the exchange. In North America, certain regulatory functions of exchanges have been delegated or contracted to third party non-governmental regulators (FINRA)⁵ in the United States and IIROC⁶ in Canada), while others, notably in the area of listing, have been retained by exchanges themselves. In the U.S. futures market, the National Futures Association performs this function for several exchanges. The relevance of these models to MENA exchanges is discussed later in this report.

With the rise of competitive pressures, for-profit exchanges are likely to have even stronger incentives to self-regulate to protect their reputational capital. Global competition in securities markets will continue to make the regulatory question even more pertinent and challenging as cross-border mergers and alliances between exchanges take place. Several exchanges that had first changed their ownership structures by virtue of demutualisation or privatisation have later engaged in takeover or merger with other exchanges (e.g. NYSE and Euronext, London Stock Exchange and Borsa Italiana, etc.). In Latin America and Asia, exchanges have opted for mergers with their clearing houses or derivative exchanges (e. g. Malaysia, Tokyo, Singapore, Australia, etc.).

Regulatory developments have had to keep up with this consolidation of stock markets. For instance, since the NYSE-Archipelago merger, the common stock of the new NYSE Group has been listed on the New York Stock Exchange. To avoid conflicts of interest, the Group has created a not-for-profit corporation, NYSE Regulation, with the New York Stock Exchange as the sole equity member of NYSE Regulation. This new corporation performs all the regulatory responsibilities previously conducted by the NYSE and is funded by the NYSE Group.

As explored in the following section, some of the concerns arising from the international experience with privatisation and demutualisation are relevant, while others less so. Arab exchanges do not for the moment compete with off exchange platforms. On the other hand, broader regulatory challenges in terms of division of responsibilities between securities regulators and exchanges in the new ownership landscape are most certainly applicable. The following section will explore concerns that are specific to Arab exchanges as they contemplate ownership transitions.

Concerns specific to Arab exchanges

New owners: Who are they?

In considering the demutualisation process in the region, a key question that arises is who to transition the ownership to. In other words, who might have an interest to become an owner in one of the MENA-based exchanges? As described in the case studies of Annex A of this report, different solutions have been proposed, including strategic investors, retail investors, financial institutions and even listed companies. The choice of these new investors has been dictated by different national circumstances and outcomes of the restructuring process envisioned by policymakers.

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 and the timelines set out for these reforms. As discussed elsewhere in this paper, a number of exchange ownership transitions in the region were prescribed by laws which often established deadlines for privatisation (e.g. Beirut Stock Exchange). These legally binding deadlines have in some cases proven difficult to meet for a variety of reasons, one of them being the lack of interest from investors.

From the experiences highlighted in case studies in Annex A of this report, the decision to restructure the ownership of the exchange should factor in at a very early stage the choice of investors because it is this choice that might drive the timelines. 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. Identification of potential buyers may be time consuming, especially in environments where markets are not sufficiently liberalised (i.e. vis-a-vis capital account or foreign portfolio investment restrictions) to attract sufficient interest from investors, for example where a strategic buyer is sought.

For instance, though a clear deadline for the privatisation of the Beirut Stock Exchange was fixed, it is not being met because there is no clear buyer(s) and even the categories of institutions that might be eligible to purchase a stake in the BSE have not been identified. The BSE example highlights another dilemma in stock exchange privatisation in the MENA region. 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 the obvious investors in exchange privatisations, bank ownership of exchanges in the MENA region poses multiple concerns, not least the emergence of banks as too “big to fail” actors.

Banks in the region are already a key source of corporate lending, accounting for half of total financing to the private sector and in as much as 70% in the GCC countries in particular (World Bank, 2011). Development of capital markets, while important for banks with investment banking divisions or other sources of income from the capital markets (i.e. mutual funds owned by banks), may actually run contrary to the interest of banks, whose assets in the region are estimated at 130% of the GDP (ibid). In countries such as Lebanon and the UAE where the banking sector is a backbone of the national economy, this might be particularly the case. The development of deep bond markets in particular would theoretically run contrary to the interest of many banks, as that would allow firms to access debt other than through bank borrowing.

Another important conflict of interest as far as bank ownership of exchanges is concerned is that the banking sector in the region accounts for a high proportion of listed companies. Listed financial institutions, most of which are banks, account for 58% of market capitalisation, twice the level in other regions (World Bank, 2011). The sale of stakes in exchanges to banks - especially listed banks - thus raises a number of important conflicts of interest. It may indeed reduce the power of broker dealers or governments in the exchanges, but might create a situation where listed companies become owners of the market where they are listed.

As a result, being the owners of exchanges, banks would effectively be supervising their own listing, unless all bank supervision powers are transferred to the central bank and/or to the securities regulator. Such transfer of oversight responsibilities would require a serious departure from arrangements currently prevailing in all countries (except for Bahrain⁷), where bank supervision for listed banks is carried out jointly by the Central Bank (for capital adequacy and related requirements) and by the securities regulator (for prospectus requirements and on-going trading rules).

While an unorthodox model internationally, exchange ownership by listed companies in the region was being considered by the Kuwait Stock Exchange whose planned privatisation envisioned the sale of a 50% stake in the exchange to listed companies. This type of ownership configuration would effectively present the same range of quite serious conflicts, notably concerning the oversight of listed companies which are at the same time exchange owners. In addition, ownership of exchanges by listed companies 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.

While in most countries of the region, and most notably in the GCC, main responsibilities for oversight of listed companies have been transferred to the

securities regulators, exchanges often collaborate with the latter on a range of oversight issues such as for instance on insider dealing. Exchange ownership by listed companies hence continues to pose concerns. The example of the Palestine Securities Exchange is particular in that it was established by a large private holding company since the government at the time was not in position to do so. As discussed in the PSE case study in Annex A of the report, PADICO, the main owner of the PSE, has committed to further reducing its ownership.

If financial intermediaries, banks and listed companies are not necessarily suitable as sizeable owners of exchanges, other options for ownership of demutualised or privatised exchanges are necessary to consider. A sale to a strategic buyer might be interesting from the perspective of the development of domestic markets, especially when the former has expertise or technology that might be difficult or expensive to acquire otherwise. However, as discussed elsewhere in this paper, such divestments are difficult politically because they are often perceived as a risk to national identity.

Privatisation of exchanges to the wider public has also been considered in some instances. Notably in Kuwait, half of the capital of the exchange was originally allocated for retail investors, bringing the model of exchange privatisation closer to how any other state-owned firm would be restructured through a market exit. Privatisation to the wider public also requires that the possibility of foreign ownership be considered and addressed, which is especially important for some GCC based markets where foreign ownership in some sectors is limited, even for portfolio investors.

Whether exchange ownership is opened to retail investors or companies, ownership thresholds need to be considered. In most jurisdictions where exchanges were privatised, limits have been set at 5% for individual market participants or firms and indeed in the case of the planned privatisation of the Kuwait Stock Exchange a similar limit was set. An important point in establishing such limitations is to avoid control by related parties. For instance, if a holding company and one of its subsidiaries acquire a 5% stake each, their consolidated ownership would be 10%.

Hence, the terms of the privatisation must be clear about actors who are considered as related parties.⁸ More generally, investors wishing to take a sizeable stake of the exchange (for example in excess of 5 or 10%) could also be made subject to a variant of “fit and proper” test review to ensure that they are not conflicted. This review could be carried out by the securities regulator and/or the Ministry of Finance, as those two entities are typically responsible for organising the privatisation process.

Opening exchange ownership to companies that are not listed also carries its risks since some of the largest companies in the region are organised as family-owned, unlisted conglomerates and giving them ownership may give them sizable power to influence the regulatory framework, unless all regulatory and supervisory activities are transferred to the securities regulator. Furthermore, to the extent that stock exchanges and securities regulators are promoting IPOs among family-owned firms, putting ownership in their hands might also create some conflicts of interest. On the other hand, it is plausible to suggest that private ownership of exchanges might encourage some firms to list, on the condition that the exchange is not owned by a competing firm.

It is at this point unclear what impact might private ownership of Arab exchanges have on listings of equity or debt by state-owned enterprises. The Palestinian Authority does not have state-owned companies to list and the only other jurisdiction with a partially privately owned exchange is Dubai. The limited experience demonstrates that the ownership structure of the exchange has not impeded listing by SOEs. NASDAQ Dubai has a number of SOEs listed, including for example, Emirates NBD. Governments can list stakes in SOEs and can set the price through a book building process or by selecting a price, on the condition that at least 25% of the stock is listed (NASDAQ Dubai, 2013).

Finally, self-listing is one policy option for broadening exchange ownership that also merits further consideration. A number of the world's largest markets have decided to self-list, with the result that today approximately 40% of WFE member exchanges are self-listed. In the region, the Palestine Exchange, and to a lesser extent the Dubai Financial Market, have self-listed.⁹ In principle, self-listing would imply that the exchange would have to undergo the listing process as any other firm wishing to go public.

In particular, it would have been overseen by a separate entity as it has been done in other jurisdictions. For example, the Australian Securities and Investments Commission (ASIC) held the listing authority related to ASX's listing. In addition, the process for managing conflicts of interest arising out of ASX's self-listing was subject to a separate MOU between the exchange and ASIC. In Canada, the Ontario Securities Commission not only exercised the listing authority over TSX listing but has required the exchange to provide additional disclosures.

In some markets, additional arrangements were introduced to further reduce any conflicts of interest that may arise in the context of listed exchanges. For instance, the Securities and Exchange Board of India (SEBI) has in 2012 allowed exchanges to list, on the condition that it is not a self-listing. Furthermore, a

Conflicts Resolution Committee is formed by SEBI with a majority of external and independent members to deal with any potential conflicts of interest.

Similar arrangements could theoretically be introduced in the MENA region, where many exchanges have some self-regulatory powers but where the recent establishment of capital market regulators has resulted to a transfer for most regulatory and listing powers to them, especially in GCC countries. For some of the newly established regulators in the region (e.g. Kuwait, Lebanon, Syria), these arrangements might call for the acquisition of additional expertise and consideration of experience of other countries that have undergone similar transitions.

Reshaping regulatory responsibilities

As discussed elsewhere in this report, perhaps the most fundamental issue in stock exchange ownership transitions is the review of regulatory responsibilities to ensure that newly private exchanges have mechanisms to deal with conflicts of interest inherent in the exercise of their profit making (i.e. listing) and non-profit making (i.e. oversight and regulatory) functions. Globally, various models have been adopted to separate these two functions with a view to ensure that there are no conflicts of interest faced by exchanges ran as for profit entities and some of these have already been discussed above.

For instance, the OMX Nordic Exchanges have also established a separate structure responsible for monitoring issues related to self-listing and market surveillance. This structural separation of income generating from regulatory activities has not put to rest all debate on this subject (OECD, 2008). Some sceptics have pointed to the fact that the regulatory department of the exchange can still be financed through the budget of a for profit entity, and unless the budget of the regulatory arm is independent and sufficient, this separation might not be actually effective.

Although it is not the objective of this report to contribute to the debate regarding how exchange regulatory responsibilities must be structured post-privatisation, it is important to situate this debate in the context of the MENA region. In other words, given the current configurations of capital market supervision models, how will private ownership of exchanges affect current structures and practices? What transfer of regulatory and oversight responsibilities might be necessary if Arab exchanges were to become privately owned?

The answers to these questions naturally depend on the nature of the new ownership of exchanges. For mutually-owned exchanges such as Casablanca and Tunis, extending ownership to other financial market actors might not call for a

radical transformation of the regulatory framework, especially if the company was already operating on the basis of a for-profit model. On the other hand, privatising the exchange through self-listing might imply that the exchange would be run as a public, limited liability, for profit company, that might face pressure from shareholders to attain certain PE multiples.

This may require a more careful examination of the regulatory framework and a further transfer of stock exchange's supervisory responsibilities to the securities regulator. As a result, certain technical skills and knowledge in Arab capital market authorities such as on monitoring of insider trading might need to be further strengthened. The exact nature of the regulatory collaboration between the exchange and the securities regulator might also need to be further specified in the form of an MOU for instance. In some countries of the region such as Saudi Arabia, an MOU between the stock exchange and the securities regulator has already been signed to clarify respective roles and co-operation protocols.

The OECD's 2008 report on the role of OECD exchanges in corporate governance, which was based on a review of literature and interviews with industry executives, highlighted that exchanges consider their reputation as one of their most important intangible assets and hence do not feel that their for-profit nature has negatively affected the exercise of their regulatory and supervisory responsibilities (Koldertsova Amico and Christiansen, 2008). Nonetheless, as mentioned, almost all exchanges have seen some regulatory authorities transferred to another entity following their privatisation or demutualisation.

The actual or planned transitions of Arab stock exchanges to full or partial private sector ownership may actually complicate the regulatory coordination that exists in these markets. Exchanges that are 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. 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 are privately-owned.

Competition and consolidation?

The securities laws of most MENA countries in principle enable capital market regulators to licence multiple exchanges. So far, with the exception of the UAE and to a lesser extent Bahrain¹⁰, all other Arab stock exchanges hold monopoly on trading public securities. In the UAE, discussions regarding the unification of national exchanges have been on-going for a while. In the current configuration, the level of competition among exchanges in the region is minimal.

As highlighted by the results of the survey to MENA exchanges conducted by the OECD in 2011, most markets in the region are not under extreme pressure as far as listings and trading are concerned. One possible source of competition for them is the London Stock Exchange. There are currently 33 companies from the MENA region listed on London's main market, 25 of which are dual listings. That said, it would be difficult to make the case that Arab exchanges are in competition with foreign markets because few Arab companies list abroad and Arab exchanges are not, at least at the current juncture, in intense competition with international marketplaces as far as foreign listings are concerned.

It is plausible to argue that this competition will develop in the longer term as more large Arab companies are tempted to list abroad. Even if they do decide to list abroad, it is at this point far from clear whether London will remain an international value of choice, or if Hong Kong or one of the other growing marketplaces (that also operates in English) might interest Arab companies. It is also not clear if one or more exchanges in the region might become the "center of gravity" in the region. In principle, Tadawul, and most liquid market in the region, may be well positioned to do so. The Casablanca Stock Exchange has also made efforts to attract listings from the African continent, trying to position itself as a choice of listing venue.

This stands in stark contrast with the United States and Europe, where competition among exchanges and between exchanges and off-exchange platforms (for trading revenues in particular) has been intense. This was highlighted in particular in the WFE 2012 survey which noted that for the first time since 2001, total revenues of its member exchanges have decreased by 10%. This phenomenon can be explained by the very low level of listings and even de-listings in many markets, as well as the fact that in many jurisdictions, exchanges are no longer the dominant venue for trading activity.

The extreme fragmentation of markets in Europe (following the adoption of MIFID in 2007¹¹) and the United States (following multiple regulatory developments¹²) and its impact on price discovery and market transparency more generally has been extensively debated in recent years. This debate has not reached the MENA region considering that exchanges hold monopoly on trading and listing activity. This status quo has arguably been beneficial for the development of MENA exchanges, but may be challenged if the move of exchanges to a private ownership model occurs in parallel with the "liberalisation" of rules governing the licencing of other trading venues.

Under these conditions, a number of scenarios for the development of Arab stock exchanges could be envisioned. While the introduction of competition in the stock exchange industry might be beneficial in reducing costs for actors in the

capital markets, they might also have less desirable secondary effects of trading fragmentation as we have seen in Europe and in the United States. For the moment, this is not a source of significant pressure for Arab markets.

Another dimension of this greater competition that needs to be considered is what would happen to a privately owned exchange that nonetheless plays a key role in the development of a domestic financial center. For a number of jurisdictions, not least Saudi Arabia (King Abdullah Financial City), Dubai (DIFC), Turkey (Istanbul Financial Center), Morocco (Casablanca Finance City), Qatar (Qatar Financial Center) and others, that are vying to establish their financial center dominance in the region, private ownership of the exchange might be more difficult to manage. Privately owned exchanges might have objectives other than those promoted by the government as part of the broader financial sector development strategy.

On the other hand, private sector ownership of exchanges might 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. Discussions with large institutional investors and asset managers reveal that MENA markets are still not getting as much attention in their portfolios as Asian or Latin American markets. In this sense therefore, the potential ownership transitions of Arab exchanges might be positive towards real industry consolidation and the search of synergies and complementarities. This was highlighted in particular by the case study of the reform of Borsa İstanbul, undertaken in early 2013.

Notes

- 1 For instance, under the terms of the NYSE-Euronext combination, both groups remain distinct corporate entities owned by a single holding company, with the result that Euronext does not register as a “US Securities Market” and therefore its issuers are not subject to the U.S. securities legislation (Aggarwal et al., 2007). In the UK, the government has introduced the *Investment Exchanges and Clearing Houses Bill* which ensures that the UK's regulatory approach cannot be threatened by any takeover of UK exchanges or clearing companies (Balls, 2007).
- 2 In the United States alone, there are currently 13 stock exchanges, about 40 dark pools or private trading platforms, and many options to internalise orders.
- 3 For instance, a study by IOSCO shows that during the last week of 2010, no less than 9.2% of total trade by value in Japan was executed in dark pools (IOSCO, 2011).
- 4 As explored in OECD's earlier study on MENA stock exchanges, this is not the case in most markets of the region.
- 5 FINRA was created in 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration functions of NYSE. It performs market regulation under contract from the NASDAQ market, AMEX, the International Securities Exchange (ISE) and the Chicago Climate Exchange (CCX). FINRA registers and educates industry participants; examines securities firms; writes rules governing its members; enforces those rules and the federal securities laws; informs and educates the investing public; provides trade reporting and other industry utilities; and administers a dispute resolution forum for investors and member firms.
- 6 IIROC is the national self-regulatory organisation that oversees investment dealers and trading activity on debt and equity marketplaces in Canada. Created in 2008 through the consolidation of the Investment Dealers Association of Canada and Market Regulation Services Inc., IIROC's functions include setting regulatory and investment industry standards, protecting investors and strengthening market integrity.
- 7 Unlike other countries of the region, Bahrain has a single regulator for banks and capital markets.
- 8 Domestic regulations on related party transactions can be used as a starting point. However, in a number of jurisdictions these regulations remain imprecise, leaving a number of relationships unregulated. In the context of stock exchange

restructuring, these must be clearly spelled out and a process of review by the securities regulator must be put in place to ensure that the thresholds are respected.

- 9 Unlike the PSE, the DFM has listed only 20% of its equity. The remaining 80% remains in the hands of Dubai government. NASDAQ Dubai also trades shares of NASDAQ OMX, one of its shareholders.
- 10 The UAE currently has five licenced exchanges. The Bahrain Stock Exchange competes with the Bahrain Financial Exchange, wholly owned by Financial Technologies Group, operating a network of 9 exchanges in Africa, Middle East, India and South East Asia.
- 11 By ending "concentration rules" and encouraging competition between traditional exchanges and off exchange platforms, the Directive has prompted rapid development of MTF platforms, which similarly to ECNs in the United States also aim at minimising trading costs for broker dealers.
- 12 In the U.S., alternative trading systems are considered as exchanges, which are provided an exemption from registration, subject to specific conditions. ATS must be registered a broker-dealer with FINRA and SEC. In 1996, SEC has decided to give ECNs access to NASDAQ, with the aim of integrating ECN markets with broader public markets to ensure fair and efficient treatment of all orders.

CHAPTER 4

WILL PRIVATISATION AND DEMUTUALISATION PAY?

Different economic context

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 and most exchanges do not require additional capital to finance expansion or technology acquisition. Rather, the key drivers of the ownership transitions undertaken and contemplated by the region's exchanges are rooted in the interest of these markets to have greater flexibility in their operations and less governmental interference (or in the case of mutualised exchanges, broker influence).

Exchanges interested in adopting a private-sector based ownership model appear to be also encouraged to move towards privatisation and demutualisation by the fact that most of the largest international markets have done and continue to do so. The Japan Stock Exchange was the last large stock exchange to privatise in 2013. The perception in the MENA stock exchange community is that privatisation and demutualisation, by liberating the management of exchanges to pursue more innovative and perhaps aggressive strategies for market development, will enable these markets to address the slump in listings and liquidity that has characterised most markets in the region in recent years.

Demutualisation and privatisation are also 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 other listed companies. Indeed, the adoption of higher governance standards by exchanges would send a positive message to the listed companies. For some markets, compliance with regulations for listed companies, and notably a corporate governance code, might motivate governance reform by, for example, replacing current appointees of Ministries by independent directors on exchange boards. This was indeed corroborated by the case study of the Palestinian stock exchange.

The corporatisation of exchanges and the introduction of private ownership in Arab exchanges might effectively insulate them from political influence and enable them to undertake development strategies that might be unfeasible in the current configuration where stock exchanges are seen as part of the national financial infrastructure and where they sometimes behave as a “subsidiary” of the securities regulator (despite being their key funding source). This was highlighted in case studies of Borsa İstanbul and the Kuwait Stock Exchange included in this report.

It might, for instance, enable them to create greater linkages either through outright consolidation, cross-ownership or more tempered measures. An example of such a measure, adopted by the ASEAN exchanges – also uninterested in further consolidation – was the creation of a methodology for a region-wide corporate governance index. If introduced in the MENA region, such a measure would effectively respond to the concern of large international investors that the opportunities for investment in blue chip stocks in the individual MENA markets are limited.

Practical considerations

Beyond these theoretical and perhaps polemic arguments, this paper sought to present and analyse a number of practical considerations that need to be considered in ownership transitions. The first and most obvious of these considerations is who might be the new owners of exchanges? As discussed in this report, the proposals to broaden ownership to other financial sector institutions, notably to banks, might be problematic on a number of accounts, not least because banks are the largest category of listed firms in the region and making them owners of exchanges would likely result in even greater conflicts of interest than in most current ownership and governance configurations.

Reflections on who might be the potential investors in a stock exchange should in fact begin before a decision about privatisation or demutualisation is taken. As highlighted in this report, ownership by banks or listed companies would be problematic and the sale to a strategic investor might be sensitive in light of the fact that Arab stock markets continue to be seen as integral to national financial infrastructure. In most jurisdictions, it would appear that self-listing might carry the least conflicts of interest, but would subject the exchange to pressure from shareholders and market expectations that might be quite different to the current environment in which these markets operate.

The risk of exchanges transitioning from public to private monopolies also ought to be considered. Currently, only two jurisdictions in the region have more than one national stock exchange and arguably, there is currently no scope for such

competition to develop given the level of development of capital markets in the region. Therefore, privatisation and demutualisation, if not accompanied by measures to stimulate greater competition in the securities trading industry, might result in the creation of private monopolies which might or might not have broader “public good” interests at heart.

Experience demonstrates that setting deadlines for corporatisation or privatisation by law may place an unnecessary and perhaps an unrealistic pressure on the exchange and other parties involved in the process. The deadline set by the legislation mandating the privatisation of the Beirut Stock Exchange two years after the establishment of the securities regulator will likely not be met. Ownership transitions, by their nature being irreversible, require careful planning by way of feasibility studies and plans for regulatory coordination between the exchange and the securities regulator. This is indeed the reason that for a number of markets, such as Borsa İstanbul and the Egypt Stock Exchange, discussions regarding whether and how to change their ownership structure have taken years.

More generally, considering that demutualisation and privatisation each involves multiple stakeholders and political sensitivities, it is debatable whether incorporating it as one of the items in the capital markets law as was done in Lebanon, but also in other emerging markets such as India, is indeed desirable. While stock exchange restructuring often goes hand in hand with broader capital market development objectives and is thus sometimes addressed in general capital markets legislation, the deadlines created by such legislation have on occasion proven unrealistic. Other alternatives that may not require a legislative route could be considered. For instance, the Hong Kong Futures Exchange and the Stock Exchange of Hong Kong were demutualised through a court application, without an introduction of any new law.

The long term planning inherent in stock exchange transitions is also necessary in order to sequence the reform process. The examples of reform of both Kuwaiti and Lebanese stock exchanges highlight that the introduction of a securities regulator and the restructuring of the stock exchange concomitantly introduces additional challenges. It appears difficult to proceed with the privatisation of the stock exchange in the context when the regulatory framework for supervision of listed companies has not been soundly established. The presence of an effective securities regulator is also necessary in order for the exchange to be able to transfer some of its regulatory and supervisory responsibilities.

Sequencing of reforms is also essential in order to address other legal issues that might arise in the privatisation process such as employee rights. As highlighted in the case study of the Kuwait Stock Exchange, exchanges that are state-owned -

whether organised either as government entities or as state-owned joint stock companies – must address issues dealing with employee rights quite early in the process. This is especially the case in countries where employees of the exchange enjoy employment benefits superior to those found in the private sector. These types of concerns are similar to the challenges that would have to be addressed in the context of a privatisation of any state-owned entity in the region.

Likewise, the demutualisation or privatisation process, usually driven either by the securities regulator (e.g. Kuwait) or by the Ministry of Finance (e.g. Morocco), needs to consider the interests of other stakeholders other than employees. For mutualised exchanges, overcoming any potential resistance from broker dealers is evidently essential. Successful international experience demonstrates that wider consultation processes including the investor community can be beneficial to foretell sources of potential tensions and to devise solutions to address them. For instance, in Malaysia, a working group chaired by the regulator, comprising members of the exchange, the association of stockbrokers and the Capital Market Advisory Council was put in place to facilitate the on-going discussions on demutualisation (IOSCO, 2005).

The impact of demutualisation and privatisation on the governance of exchanges 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 legal structure will certainly impact on board composition. For exchanges that might be interested in a self-listing, the impact on their governance will likely be greater and appropriate mechanisms would have to be introduced to supervise the exchange's listing and the creation of required reporting to shareholders following its listing. 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.

That said, experience would seem to suggest that demutualisation/privatisation and listing decisions should be considered separately. While some markets such as Australia have undertaken them concurrently, the benefits of each need to be considered carefully. Self-listing may allow a further broadening of ownership and capital and may offer benefits in terms of transparency of the exchange, but as mentioned above, requires further changes to the regulatory framework to address any potential conflict of interest. Listing of the exchange would also relinquish the control that the state (in case of state-owned exchanges) or brokers (in case of mutualised exchanges) might have in terms of selection of suitable buyers, and might be more appropriate in situations where the concentration of ownership is particularly undesirable or where governments wish to distribute windfall revenues to the public (as in the case of other privatisations in GCC countries).

Lessons learned

Assuming that these considerations are taken into account, will privatisation or demutualisation of Arab exchanges will be positive their development? While it might be tempting to answer this question positively, as some exchanges in the region already have, a number of consequences of these transitions need to be taken into account before doing so. In this regard, lessons learned in other jurisdictions are critical to examine both for success factors and for concerns that might have rendered the process less than optimal. Regional experience in this regard is so far limited. Only the Palestine Exchange has self-listed and given the recent nature of this transition, it is too early to gauge its impact on exchange performance.

Looking outside of the region, empirical evidence remains ambiguous as to how ownership transitions affect exchange performance and wider financial markets development. For listed exchanges for example, should performance be gauged by share price and if so, what should it be compared to? These questions appear straightforward but the empirical answers to them are far from simple, which is why so few academic studies have attempted to address them. Stock price performance is not the only factor that needs to be examined when looking at post-transition performance of an exchange.¹ Yet, few studies have sought to isolate variables key to the longer term success and sustainability of demutualised and privatised exchanges.

It would also be important to consider how new ownership of exchanges would affect investment levels and liquidity. As discussed elsewhere in this report, it is unclear how broadening of stock exchange ownership would affect the listing pipeline of MENA exchanges. It would also be important to consider how changing ownership would affect levels of investment in the regional exchanges, now that regional SWFs are allocating a greater proportion of their investments to domestic capital markets. GCC SWFs are already estimated to hold stakes in a wide range of domestic companies and their on-going interest in local stock markets might be dictated by considerations that might no longer hold in the context of privately owned exchanges.

While ownership changes are unlikely to affect the interest of retail investors, which in most markets are the biggest source of liquidity, they may affect institutional investors. Foreign institutional investors may be encouraged by developments in capital markets in the region (for instance if a large international exchange becomes an investor in one of the Arab exchanges). Local pension and social security funds, which are marginal investors in local markets, are in principle positioned to grow and may become more active investors in capital markets. Under this scenario, an exchange, which is seen as part of the national financial

infrastructure, may attract a greater portion of their investment. On the other hand, if foreign institutional investors take a greater interest in Arab capital markets, they might wish to see order internalisation and the development of dark pools to process large orders.

The ways in which exchange ownership transitions may affect wider financial sector development and stability are also far from clear. In Europe and North America, exchange demutualisation and privatisation was accompanied by fragmentation of trading, which arguably had many negative consequences, as highlighted by recent technical glitches in the American market. In this regard, the position of Arab exchanges is quite “protected” since their development has occurred in the vacuum from this competition. It could be argued that this has allowed a structured development of MENA markets without management of these exchanges being “distracted” by competitive challenges. While ownership transitions do not necessarily need to be accompanied by growing competition, global industry developments highlight that they are often concomitant.

Towards private MENA exchanges?

Further consideration of local circumstances and the suitability of privately run exchanges to local economies at this juncture of their development are necessary. For instance, the current ownership arrangements of exchanges, most of which are closely overseen by the securities regulators (e.g. Oman, UAE, Saudi Arabia) allow capital market authorities to create regulations in a manner that is synchronised with the speed of product development (i.e. derivatives, ETFs, etc.). Close collaboration between exchanges, securities regulators and other market actors is arguably fostered by their common goals, set by their respective governments. These common goals have allowed some markets to position themselves globally through strategic partnerships and mergers (i.e. Dubai Exchange’s investment in NASDAQ or Qatar’s investment in the London Stock Exchange).

In a wider sense, Arab exchanges currently act as centerpieces of state-driven financial sector development strategies that typically aim to consolidate capital markets and banking expertise under the umbrella of a national financial center. Given that exchanges are often seen as part and parcel of national financial sector development strategies, ownership transitions will need to be considered in any future plans to develop financial centers and related infrastructure. For instance, stock exchanges in the region are often members of national corporate governance commissions and other initiatives to promote transparency in markets as part of their “public good” mandate. Whether or not this close collaboration and “public good” nature of exchanges can be maintained in the post-privatisation environment is open to debate.

Ultimately, conflicts of interest are present in all models of exchange ownership, and the “art” of developing stable and attractive capital markets is in managing these conflicts so that capital markets fulfill their fundamental objective: providing equity or debt capital to growing companies. Hence, instead of pronouncing itself on the ownership model that might be best suitable to individual Arab exchanges, this report has focused on the process that needs to precede these ownership transitions and the factors that need to be taken into account as they are pursued. A number of considerations raised in this report in terms of sequencing of reforms and the relationship between exchanges and securities regulators, merit further discussion. The timing of the privatisation also needs to be considered to ensure that maximum value could be obtained.

Other options that aim to achieve the results sought by these ownership transitions maybe worthwhile to consider. Discussions with heads of exchanges highlight that most of them are interested in demutualisation or privatisation in order to engender profound governance changes. The Stock Exchange of Thailand was able to implement some reforms to its governance structure such as appointing non-member “public interest” directors to its board without undergoing demutualisation. Such examples highlight that structural and governance-related objectives may be achieved without fundamentally altering the ownership of the exchange, unless other goals such as raising capital need to be addressed in parallel.

Finally, demutualisation or privatisation “may pay” for some exchanges in the region but these transitions should not be seen as an automatic solution to the listings and liquidity crisis that many of the region’s exchanges are experiencing. These latter problems are serious and merit further analysis and reflection, in particular to examine whether the incentives (i.e. tax incentives) or other measures (i.e. secondary listing tiers) have been effective in mobilising greater interest from issuers and investors.

Whether and how to demutualise and privatise exchanges in the region is a separate question that requires - as demonstrated in the report - careful sequencing of reforms, a strategy for opening up ownership and an established securities regulator as key prerequisites. Experiences from other emerging and developed markets suggest useful lessons learned as well as challenges to avoid in restructuring exchange ownership. The pitfalls to avoid in order for stock exchanges to continue fulfilling their role in the broader financial development roadmap of Arab countries are important to consider going forward.

Note

- 1 There is research documenting significant positive first-day returns. These are frequently referred to as IPO “under-pricing” and are calculated as the per cent difference between the closing price on the first trading day and the IPO offer price. For further information on post-IPO returns refer to Annex B.

ANNEX A.

CASE STUDIES

CASE STUDY I. KUWAIT STOCK EXCHANGE: NEW OWNERS?

History of the Kuwait Stock Exchange

Kuwait has one of the oldest stock markets in the Persian Gulf region. Kuwaiti investors were introduced to trading in stocks with the creation of the National Bank of Kuwait in 1952 as the first Kuwaiti shareholding company. In the following decades, the Government of Kuwait issued a number of laws and rules to regulate stock market activity, culminating in August 1983 with the issuance of an Amiri Decree establishing the Kuwait Stock Exchange (KSE). At the time, the exchange was mandated to both organise trading activities and to regulate them since at the time no securities regulator or the equivalent existed in Kuwait.

Unlike its counterparts in the region, the KSE continued to act as a self-regulatory organisation for decades after until the promulgation of the Capital Markets Law in February 2010 which saw the formal establishment of the Capital Markets Authority in Kuwait. Following the adoption of this Law, the Kuwaiti CMA became the regulator of the Kuwaiti market, with wide responsibilities both for establishing standards for listing companies and for admitting applications for listing, as well as for licensing of market intermediaries and other activities previously undertaken by the KSE. Today, the CMA has similar functions and powers as do securities regulators in the Gulf and other MENA countries.

The establishment of a capital markets regulator in Kuwait was overdue not only vis-a-vis the development of its peers in the region but also as a needed force to improve the transparency and orderliness in Kuwait's capital markets which have been impacted by serious crises in its long history. The first such crisis was the Souk Al Manakh incident in 1982, which destroyed the confidence of local and foreign

investors in Kuwait's market. Souk Al Manakh was established almost in parallel with Kuwait's official market as an over the counter exchange which traded securities of 45 companies listed in other Gulf markets.

The main purpose of this market was to trade shares of foreign companies not listed of the Kuwait Stock Exchange, mostly those listed in other Gulf countries. Many Kuwaitis borrowed from banks to finance trading on the Souk Al Manakh and settled trades through post-dated checks, hoping that the value of purchased shares would rise before the checks fell due. The post-dated checks were then traded in a secondary market at interest rates as high as 100 per cent. These trading practices helped push the value of securities to prices not justified by market fundamentals to the point that by the early 1980s, Souk Al Manakh was the third-largest market globally, while the official exchange was not close to its size.

In 1982, the bubble created in trading on Souk Al Manakh bust, set off by a bounced cheque that touched off a cascade of margin calls and losses. In the course of this crisis, most of Kuwait's banks became insolvent, having lent heavily to traders who could no longer afford to repay loans. Following this crisis, government investigators discovered that there were close to 30 000 cheques outstanding, with a total value exceeding USD 90 billion. The government responded by bailing out the banks and establishing the Kuwait Clearing and Financial Settlement Company, with a capitalisation at USD 2 billion.

The fallout from the crisis prompted a re-examination of the capital markets development strategy in Kuwait and in the neighbouring countries. A reorganised Kuwait Securities Exchange began trading stocks in 1984, this time with restrictions of margin trading and short selling but its size no longer compared with the Souk Al Manakh. Despite the crisis of confidence that followed this period, the exchange remained a self-regulated entity.

The exchange was once again negatively affected by the crisis that affected other GCC exchanges in 2006, which generated significant losses for hundreds of thousands of local retail investors drawn into the stock market frenzy in early 2000. Two years later, the onset of the global financial crisis has once again negatively affected the exchange. By then, most of the investment companies (organised under the umbrella of the Union of Investment Companies), which engaged in much proprietary trading in listed companies in early 2000, were already out of business.

Planned privatisation of the KSE

The privatisation of the Kuwait Stock Exchange became imminent following the passage of the Capital Market Law 7 in 2010. The Law previewed the

establishment of a Capital Market Authority to regulate capital markets since Kuwait was one of the last countries in the region not to have a securities regulator. At the same time, the Law quite concretely outlined the conditions for the restructuring of the Kuwait Stock Exchange. The Law envisaged that 50% of the equity of the Kuwait's Stock Exchange would be sold through an IPO to Kuwaiti citizens, with the remaining 50% to be sold to the companies listed on the stock exchange. These changes were due to be implemented by March 2012.

Under the Law, new governance arrangements reflecting the public-private nature of the exchange ownership were previewed, although they did not necessarily reflect emerging good practice of stock exchange governance. The Board of the KSE proposed by the Law was to be composed of a Chairman and a Deputy Chairman, as well as 6 members of the general assembly, all approved by the CMA. According to the Law, the CMA's management retained the right to reject any proposed candidate without this fact being known to the General Assembly. The role of the Chairman and the Executive Director were combined.

The privatisation of the Exchange has stalled since the passage of the Law for multiple reasons, including a debate regarding the method of privatisation set out in the Law. More specifically, the transfer of ownership to listed companies was deemed by many experts to constitute a significant conflict of interest considering that it is not in the interest of listed companies to maintain or raise standards for listing. This issue was not specifically addressed in the Law and mechanisms to mitigate this conflict of interest arising from the rather unconventional ownership model proposed by the Law were not previewed. In part, this is due to the fact that few exchanges so far (with the exception of the Stockholm exchange) have allowed listed companies to become owners of the stock market.

Traditionally, the privatisation of exchanges globally was done through either a strategic sale or a self-listing. The ownership of the exchange by the companies listed on it is extremely rare and in the MENA region, only the Palestinian stock exchange is majority owned by one of the largest companies listed on it. This is due to circumstances particular to the Palestinian economy and the fact that the exchange was never owned by the government. It is unclear what underlined the selected method of privatisation of the Exchange in the Kuwaiti case.

The planned privatisation of the KSE was met with intense opposition from the Exchange employees. The latter have long regarded themselves as public servants and were not keen to surrender their privileges in terms of remuneration and generous vacation in the course of the ownership transfer. The position of KSE employees reflects a deep seated rejection of privatisation in Kuwait that has affected government plans for restructuring other public sector institutions. The

threat of strikes was looming over the Exchange as discussions on privatisation advanced, while the CMA gained the authority to restructure the conditions of employment of KSA employees.

The privatisation plan was also affected by the introduction of the CMA which happened in parallel. Effectively, as soon as the Capital Markets Law came into effect, the regulator became the legal owner of all assets of the exchange and in 2012 it appointed HSBC to advise on the transition process as well as to find suitable investors (from the pre-defined universe). However, it is reported that in addition to other concerns outlined above, the process was further stalled when it was discovered that a clause in legislation establishing the CMA prevented the agency from conducting commercial activities. To avoid any conflict, a parliamentary vote was needed to amend to the act governing the CMA.

In the meantime, the activity of the KSE is developing and the Exchange is pursuing a number of technological upgrades as well as strategic alliances. In 2009, the KSE signed a partnership contract with NASDAQ OMX, under which it is introducing new trading and surveillance systems, benefitting from a transfer of knowledge and experience from NASDAQ OMX experts. Last year, the KSE introduced major changes for brokers who previously relied on workstations provided by the Exchange, and who can now build their own order management systems with more sophisticated back offices.

Currently, the exchange and the market participants are preparing for a number of other changes such as the introduction of ETFs, futures, options and indices. Some of the new technological improvements are intended to underpin the strategic orientations of the exchange. For instance, in June 2013, the KSE agreed with the Dubai Financial Market (DFM) to facilitate the transfer of securities between the two exchanges. The DFM has already started to implement this arrangement, enabling shareholders of Kuwaiti companies to easily transfer their shares to and from the DFM.

Current situation and lessons learned

Kuwait's stock market is the second-most liquid exchange in the Arabian Gulf after Saudi Arabia with an average volume of USD 72 million (Dh264.47m) last year (KSE, 2013). Trading is driven almost entirely by local investors - while institutional investors are estimated to hold about a third of Kuwait's market, foreign investors account for less than 10% of total investment (World Bank, 2011). As in other markets of the region, trading has been concentrated in the 30 largest most liquid stocks, but unlike other markets of the region, they are not the largest listed

companies. It is reported that 21 of these stocks represented only 3% of the market but captured nearly half of the trading value (Oxford Business Group, 2013).

KSE's market capitalisation has consistently been one of the largest of Arab markets of USD 100 billion, with over 200 listed companies (even after the significant delisting of non-compliant companies). With a market capitalisation to GDP ratio of approximately 100%, KSE is one of the deeper markets of the region. Its on-going development and, in particular, its competitive position vis-à-vis its regional peers will be determined by a number of factors, not least its ability to assure the transparency and integrity of listed companies and the trading infrastructure more generally which was in the past perceived as somewhat deficient, resulting in some observers referring to the KSE as a regulated insider market.

The on-going development of the KSE is also conditioned on the effectiveness of improvements to the securities regulatory framework introduced by the Capital Market Authority. A number of new regulations for listed companies and licensing requirements for market intermediaries have been introduced by the CMA in the past two years and a corporate governance code is understood to be under development, bringing the regulatory framework of Kuwait closer to the regional standard.

A significant contribution to the quality of the regulatory framework for listed but also for unlisted companies was the introduction of a new Companies Law 25 of 2012, which replaces the Commercial Companies Law of 1960 and for which the Ministry of Industry is expected to issue secondary regulations within a year. In particular, the Law addresses a number of important aspects of the corporate governance framework in Kuwait, hitherto unregulated. For instance, the Law introduces joint liability for board members and managers for the failure to properly register its articles of association and requires companies to keep these at their headquarters and on their website for shareholders to examine. It also introduces a number of important and new governance provisions, such as the separating the CEO and board duties, increasing the minimum number of directors from 3 to 5 and requiring that boards meet at least 6 times annually.

The Law also specifies that the CMA is the relevant authority for approving prospectuses of issuers for primary and secondary issues, which is an important provision if the stock exchange is to be privatised. As highlighted in other case studies and elsewhere in this report, the separation of regulatory powers prior to or following the privatisation of the exchange is important to remove any potential conflicts of interest from the management of the exchange. The creation of the CMA is timely to assure this regulatory transition. However, the timing of the privatisation

and the creation of the securities regulator appears to have introduced confusion as well as conflicting interests in this process.

For the time being, no timeframe has been formally announced in respect of the KSE's privatisation. Additionally, the extent to which there would be any revision to the distribution of ownership, as prescribed in the Capital Markets Law, remains unknown. That being said, efforts are currently underway to transition the KSE into a commercial entity, likely positioning it for a future privatisation. The CMA and the 11 member KSE Market Committee (headed by the Kuwait Minister of Commerce and Industry) approved the creation of a Transformation Committee to steer such a transition or prospective corporatisation phase. The 5 member Committee, established in the middle of 2013, comprises three non-executive members, including an independent Chairman.

One of the reasons that the Transformation Committee is expected to be productive is that there is an agreement from the CMA board of commissioners as to its mandate, unlike in past arrangements. The Chairman of the Transformation Committee is an influential and respected change management expert, with a strong track record in the financial services industry locally. Other members of the Committee include the Director General of the KSE and a foreign representative with expertise in exchange restructuring issues. At the time of the preparation of this report, they continued efforts to restructure the stock market in line with the previous decision to transfer its ownership ultimately to private hands.

The first step in this journey, addressing the legal impediments to incorporate the KSE, appears to have paved the way for the exchange to embark upon a genuine transformation phase; one which is hoped will prepare the KSE well for an eventual successful privatisation. It appears that for the moment, the lack of visibility into KSE's reform has not impacted its performance, although it is impossible to estimate how the exchange would have performed in terms of listings or investment attraction if the restructuring process has not been delayed. KSE performance in 2013 has been positive and the index has reached its peak in May, spurred by local but also foreign investment. It is debatable to what extent this investment is stable or speculative (i.e. in anticipation of the expected conversion of the exchange in a private company).

In terms of the sequencing of reforms, it seems that in Kuwait, the earlier stock exchange restructuring process was negatively affected by the fact that the Law establishing the securities regulator was adopted in parallel with the exchange privatisation framework and that the ownership and oversight of the exchange were transferred to the regulator in the course of this process. By the same token, the establishment of the securities regulator at the same time as the privatisation of the stock exchange might also be difficult as highlighted by the example of Lebanon. In

Lebanon, Law 160 of 2012 established the regulator, at the same time requiring the conversion of the Beirut Stock Exchange to a joint stock company within a year of the establishment of the CMA, and further specifying that the capital of this joint stock company is to be sold to private investors a year later.

In both cases, it appears that the sequencing of reforms has not been optimal in a sense that the securities regulatory framework and the institutional framework for capital markets oversight were not well established when the stock exchange restructuring process commenced. An additional complication in the case of Kuwait is that exchange privatisation is resisted by stakeholder groups such as employees, which makes the transition to a private ownership model more challenging. In countries where the privatisation of public entities is often contested, it might be prudent to build this consideration in the process either through mechanisms for early retirement or other compensation of employees who risk forfeiting some of their privileges in the transition.

CASE STUDY II. THE PALESTINIAN STOCK EXCHANGE: A PRIVATE SECTOR-DRIVEN MARKET

Establishment of the stock exchange

The Palestine Exchange was a late bloomer on the stock exchange scene in the Middle East and North Africa, having been established in mid-1990s. Its relatively late establishment owes to the fact that the Palestinian Authority at the time exercised oversight over a limited number of institutions, mostly in the education and health sectors and did not consider establishing a stock market a priority. The institutional foundation of the exchange is intricately tied to the creation of the Palestine Development and Investment Company (PADICO).

PADICO was established by Palestinian diaspora and local leading banks to become the largest holding company working in the Palestinian territories, with a paid up capital of USD 250 million. Over the years, it established subsidiaries in several industrial sectors and saw an opportunity in setting up a national stock exchange, in large part to attract local and international capital in order to provide long-term finance for major infrastructure projects.

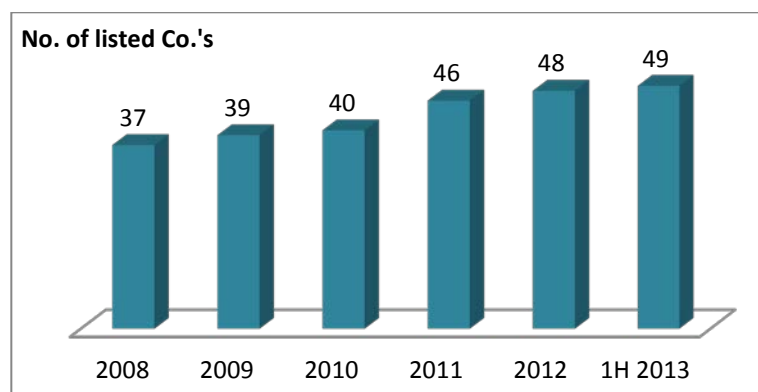
When PADICO presented the government with a plan to establish a securities exchange led by the private sector, it welcomed the initiative. As a result, a private shareholding company, majority-owned by PADICO Holding with smaller contributions from the public and private sectors, was established in 1995. Initially called Palestine Securities Exchange (PSE), the company began its operations as a self-regulated private shareholding company, with exclusive rights to engage in trading and settlement operations, stock transfer, as well as central depository activities.

The PSE signed an operating agreement with the Ministry of Finance in 1996, which included the Exchange's objectives, authorities, rights and obligations, legal and managerial structure and relations with the Ministry, then the securities sector's supervising body. The agreement called for the Exchange to be overseen by an 8 member board of directors, 5 nominated by the main shareholder, 1 by the Minister of Finance, and 1 to be an elected representative of the brokerage firms, as well as the general manager.

Following a period of organisation and technical preparations for the launch of the exchange, trading began in February 1997, with ten listed companies, predominantly in real estate, banks and insurance sectors. A few of these companies were subsidiaries of PADICO which made the listing process easier. The remaining companies were convinced to list since they actually needed to raise capital to finance expansion plans. Some members of the management/boards of these companies have previously worked abroad and understood the merits of a public listing. By the end of 1997, the total number of listed companies has doubled.

The exchange started to operate with a very modest capital of USD 3 million, but as highlighted in the Figure below, it was successful in convincing additional companies list and hence grew rapidly. The PSE's trading system was purchased from a Canadian company, EFA (today owned by NASDAQ OMX), which made PSE the first Arab exchange fully automated in both trading and CDS. As a result of these advancements, by 2005, the PSE was the best performing stock exchange in the world with the Al Quds index rising by 300% that year. The main components of the exchange by way of listed companies remained in banking, insurance, investment, industry and services sectors.

Figure A.1 Number of listed companies (2008-2013)



Source: Palestine Exchange, 2013.

Restructuring of the capital market

The enactment of the Securities Law No. 12 at the end of 2004, which saw the creation of an independent market regulator, the Palestinian Capital Market Authority (CMA), meant a substantial change in the legal structure of the capital market. The Law forced the stock exchange to relinquish many of its self-regulatory

powers and the Capital Market Law No. 13 issued in 2005 transferred all legal and supervisory duties from the Ministry of Finance to the CMA, but it was not until 2010 that the CMA became enforcing Law 12. Based on the Securities Law No. 12, the CMA and the PEX responsibilities were divided as follows:

Table A.1 Division of responsibilities between the PEX and the CMA

CMA	The PEX
<p>Issue instructions to PSE regarding: Trading and the underlying securities; data dissemination to brokerage firms and the public; applying PSE rules, instructions and procedures; other issues related to securities law.</p> <p>Review the decisions and instructions issued by PSE to insure its compatibility with the related laws & rules.</p> <p>The CMA can request PSE to:</p> <ul style="list-style-type: none"> Hold the membership of a brokerage firm; Cancel the authorisation of any brokerage firm; Hold trading, if the CMA is convinced of a “force majeure” condition that prevents trading. Hold or cancel any security paper or any authorisation. 	<p>Organise, control and supervise the member firms’ (brokerage firms), securities issuers’ and listed companies’ activities in terms of their securities.</p> <p>Organise the dealing on securities to protect the securities owners, investors and the public from any fraud and unfair practices.</p> <p>PSE can impose fees on listed and member companies for using its services and appliances.</p> <p>Set the practicing and supervising rules and establish control procedures to ensure the exchange performance, subject to CMA approval.</p> <p>Conduct investigations on members and listed companies and impose penalties (subject to CMA approval).</p> <p>PSE can ask the CMA to suspend trading in any traded security paper or to stop any member company for any period of time.</p>

Source: Palestine Exchange, 2013.

In addition to changing the self-regulatory status of the exchange, after the establishment of the CMA, calls grew to amend the ownership structure of the exchange. After the establishment of the CMA, a representative of the Ministry of Finance on the board of the exchange was no longer needed, and representation of brokerage firms on the board was also eliminated to reduce conflicts of interest. In addition, the CEO and Chairman roles were separated.

At the same time, it was decided that better governance and transparency could be promoted by transforming the Palestine Securities Exchange into a public shareholding company and self-listing it. This was motivated by the interest of the CMA that the exchange comply with its corporate governance principles, which

apply to listed companies. Officially, this transformation was initiated by the board of the exchange making a recommendation to the AGM. Subsequently, the application was presented to the Companies Comptroller (in the Ministry of Economy) and was approved. A new Memorandum of Association and Articles of Incorporation were drafted.

These efforts were ultimately crowned in 2010 when the exchange converted itself into a public shareholding company with a new corporate identity - Palestine Exchange (PEX). The shareholding company, Palestine Securities Exchange (PSE), listed its shares on the exchange in the first half of 2012. Upon listing, PSE did not issue new securities since the main intention was to focus on restructuring the shareholder base through the entry of new individual, institutional and strategic investors.

For the purpose of listing PSE on PEX, the CMA organised and supervised the listing process. The PSE had to submit the listing application and all related documents to the CMA which studied the application and ensured its compliance with all listing conditions and with the Securities Law and regulations. The PSE went even beyond that by proposing to the CMA the creation of a committee made up of both governmental and non-governmental entities to discuss the listing application. However, the CMA preferred to study the application and take the decision alone.

After approval of the listing application by the CMA, a listing agreement was signed by a representative of PEX and the principal owners of the PSE under the supervision of the CMA. At the same time, the CMA was transferred all the authority that previously lied with the exchange such as the ability to halt or suspend trading. The CMA also assumed the responsibility of overseeing the disclosure of the exchange as a now listed company. The PSE had to comply with all the applicable disclosure regulations and the related CMA instructions, as would other listed companies.

It also adopted measures to comply with the Palestinian Corporate Governance Code, which was and remains voluntary. For example, its Chief Executive Officer withdrew from the board, a board secretary was appointed, and board member terms were limited to 3 (as per the Corporate Governance Code). At the same time, the representative of brokerage companies was removed from the board to avoid any conflicts of interest. Currently, the board is comprised of 7 members (of which 6, including the Chair, are nominated by PADICO and the remaining member represents Al-Sanabel Trading and Investment Company Ltd.). They are nominated for a four-year term. In addition, amendments to the PSE's articles of association

were introduced that resulted in the board issuing a conflict of interest policy and a code of ethics.

Outcomes of the restructuring

The reform of the organisational structure of the stock exchange is seen by its management as having been positive. Nonetheless, it is difficult to gauge the impact of the exchange restructuring on the overall capitalisation or liquidity, in part due to the difficult economic climate that has prevailed over the past few years. Listings have increased but at a slower pace. Liquidity has been improving but also unequally. Paltel has dominated the PSE with over 50% of the market value and is by far the most liquid stock on the market.

The management of the exchange is of the opinion that private ownership of the exchange from the outset was a key success factor, allowing the market to quickly react to international developments, at the same time being shielded from government bureaucracy and political developments that could have adversely affected its growth. The PSE was indeed the first exchange in the region to self-list and while the benefits of this decision could be debated, the fact remains that government-owned exchanges have been constrained to undertake similar a decision.

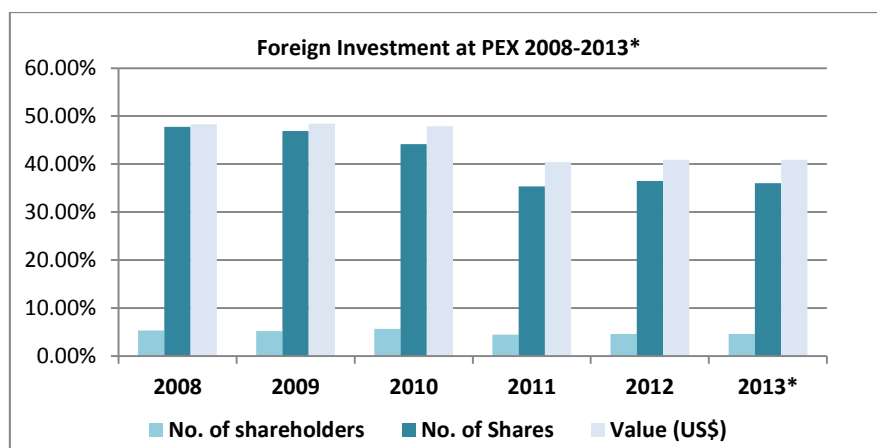
The management of the exchange believes that the privately owned and self-listed nature of the exchange has allowed it to be "closer" to the listed companies by understanding their regulatory constraints by their development needs. It has also allowed the exchange to act as a "role model" for listed companies. At the same time, this ownership structure has given the necessary flexibility to the exchange management to address technological and organisational challenges. For instance, the exchange is not subject to public sector salary scales, which would make attraction and retention of talent difficult.

The ownership and the organisation structure of the market are understood to have facilitated transparency and helped the exchange attract not only local but also international investment. The issuance of investor numbers to shareholders in 2009 has further improved the visibility of Palestinian Authority stocks to international investors. In 2012, international investment in the stock exchange amounted to 41% of the total market capitalisation, 78% of which was institutional capital.

As per the Figure below, this high level of foreign investment in the Palestinian Authority capital market is due to the absence of any restrictions on foreign investors but also to strong investor protection mechanisms. In addition, the exchange management is working intensively on marking the exchange

internationally (via roadshows, inclusion in frontier market indices and strong relationships with regional and international bodies).

Figure A.2 Number of listed companies (2008-2013)



Source: Palestine Exchange, 2013.

PADICO remains one of the main investors in the PSE, in addition to being listed on the PSE and being one of its owners. Although there are some conflicts of interest inherent in this configuration, it is an improvement on an earlier situation. While PADICO remains a dominant owner of the exchange, there is another significant blockholder, Al Sanabel Trading and Investment Company (with a stake of 17%), other investors own 5% or less (refer to Table the below).

At the same time, a number of drawbacks of this ownership model have been pointed out by sceptics, most notably the hesitation of some owners of private companies to undertake an IPO on an exchange that is controlled by a rival investment company. To be sure, PADICO has controlled the exchange prior to the listing, which could therefore raise similar concerns. It could be argued that such concerns could be addressed by a powerful and independent securities market regulator which could ensure that all listed companies are overseen in an equitable fashion.

Table A.2 Evolving shareholding structures of the Palestine Exchange

Shareholding structure upon launching PEX			Shareholding structure Today	
#	Shareholder Name	Ownership %	Shareholder Name	Ownership %
1	Palestine Development and Investment (PADICO-Liberia) Ltd.	68%	Palestine Development and Investment (PADICO) Ltd.	67.69%
2	Palestine Development and Investment, Ltd	5%	Palestine Development and Investment Company Ltd.	5%
3	Palestine Industrial Investment, Plc.	5%	Al-Sanabel Trading and Investment Company Ltd.	17%
4	Palestine for General Trade, Ltd	0.5%	EuroMena Limited Partnership Co.	5%
5	Palestine for Packing and Packaging, Ltd.	0.5%	Other	5.3%
6	Palestine for Technology Transfer, Ltd.	0.5%	Palestine for Technology Transfer, Ltd.	0%
7	Palestine for Basic Chemical Products, Ltd.	0.5%	Palestine for Basic Chemical Products, Ltd.	0%
8	Samed Investment & development Co. Ltd.	20%	Samed Investment & development Co. Ltd.	0%
	Total	100%		100%

Source: Palestine Exchange, 2013.

Another concern often raised in the literature and raised elsewhere in this paper with regard to the self-listed exchange model is that being a listed company, the exchange might be tempted to focus on the business side (i.e. attracting listings) at the expense of its regulatory responsibilities, thereby engaging in a race to the bottom in terms of listing quality and trading standards. The owners of the PEX are aware that credibility and trust play a critical role in attracting listings and trading (and therefore revenue).

Political economy considerations

While it is debatable whether stock exchanges should be publicly or privately owned, the unique circumstances of private sector and institutional development in Palestinian Authority militated for the creation of a privately owned stock market.

While the private sector saw capital market development as a mechanism of further private sector development, nascent public sector institutions had other political, social and economic priorities. On the other hand, the establishment of a securities regulator was crucial to establishing proper public oversight of the securities market.

While there is no magic formula for an ideal ownership structure of an exchange - it might be a private, mutual or a public entity - the quality of its governance structure and the quality of the securities sector regulatory body are key ingredients to consider. According to the exchange management, the legal structure of the exchange becomes less relevant when these two conditions are fulfilled. Private ownership of securities markets may be especially advisable in countries beset with complex public sector structures and reform obstacles.

Perceptions of privatisation need be addressed considering that it is not currently associated with positive economic outcomes in many countries of the region, notably in post-transition economies. On the other hand, in jurisdictions where public sector institutions are perceived as being inefficient, private ownership of the exchange might be subject to less resistance. At a time of significant public scepticism toward public sector institutions, private ownership of the Palestinian exchange has facilitated its eventual success and proved a foundation for a Palestinian capital market.

The exchange management believes that a private sector approach to establishing the exchange has avoided many of challenges that could have arisen if a public sector entity had first been created and then privatised. A clear vision of the exchange management and the critical assistance of Palestinian finance and trading professionals working in the Middle East region were also important to the ultimate success of the institution. Last but not least, the positive collaboration and a solid relationship between the CMA and the exchange had a positive impact on the development and the credibility of the securities sector in Palestinian Authority.

CASE STUDY III. CORPORATISATION OF THE ISTANBUL STOCK EXCHANGE: TOWARDS THE ISTANBUL FINANCIAL CENTER

History of the Turkish capital market

A key phase in the development of Turkish capital markets dates back to 1980s, which saw the enactment of the Capital Market Law in 1981 and the establishment of the Capital Markets Board the following year. A new decree was issued in October 1983 foreseeing the establishment of securities exchanges in the country. In October 1984, the Regulations for the Establishment and Functions of Securities Exchanges was published and the Istanbul Stock Exchange (İMKB) was established in 1985. In Turkey, the establishment of the securities regulator preceded the establishment of the stock market, which is a unique pattern of capital markets development in the MENA region where most exchanges were self-regulated for a number of years before a securities watchdog would be established.

Since the establishment of İMKB, Turkish capital markets have developed to offer advanced intermediary services such as research, investment consultancy and portfolio management; clearing and settlement in accordance with international standards; and online, real-time data dissemination of market data. The legal structure of the Turkish capital markets is in line with the European capital markets regulations. As a result, the stock exchange has been successful to gaining a mutual recognition status with a number of large international partners.

For instance, İMKB was recognized as a “designated offshore securities market” by the Securities and Exchange Commission in 1993 and was designated as an “appropriate foreign investment market for private and institutional Japanese investors” by the Japan Securities Dealers Association in 1995. Likewise, İMKB was acknowledged by the Austrian Ministry of Finance as a “regulated market” in accordance with the regulations of the Austrian Investment Fund Act in 2000.

Recent developments in capital markets

While Turkey has a 1.5% weight in the total global gross domestic product, its contribution to global capital markets stands at 0.5%. These figures and observations prompted the Turkish government to examine options for restructuring

local stock market, in particular to support its consolidation and increase its competitiveness globally. The Capital Markets Board Law No. 6362 went into force after being published in the Official Gazette in December 2012.

Pursuant to article 138 of the Law, Borsa İstanbul (formerly İMKB) was founded on the same date, for the purpose of serving as a securities exchange. Borsa İstanbul brings together all exchanges operating in Turkish capital markets under a single roof. Its Articles of Association were prepared by the Capital Markets Board, and following their approval by the Minister in charge, the Exchange was legally registered in April 2013 as a private legal and self-regulatory entity.

The Law defines the new shareholder structure of Borsa İstanbul. Accordingly, 49% of all shares of Borsa İstanbul are registered in the name of Treasury and all transactions related to such ownership will be executed by Treasury. The remaining 51% of the shares are registered in the name of Borsa İstanbul, of which 4% of the capital is transferred to members of İMKB, 4% per cent to the shareholders of Turkish Derivatives Exchange, 1% is transferred to Turkish Capital Markets Association, and some relatively minor capital to the members of İstanbul Gold Exchange.

The privatisation of İMKB has been discussed as an idea for a long time. The process was formulated in multiple stages including demutualisation, integration and privatisation. The first stage is to transform into a profit-aiming structure through demutualisation. The demutualisation is exceptionally significant in terms of the flexibility in the investment decisions to be taken for organizational dynamism and infrastructure. Second stage is the integration of cash, commodity and derivatives markets under one roof.

Before the transformation in 2012, the stock exchange was organised as a government-owned, not-for-profit organisation. In an effort to harmonise the Turkish capital markets regulations with the EU framework and improve the integration of the Turkish capital markets in global markets, Turkish law makers have enacted the CML No. 6362 as a reform making law bringing about not only the liberalisation in the domestic exchange market but also the re-structuring and re-branding of İMKB as Borsa İstanbul which was converted by the same law to a joint-stock company (i.e. corporatised).

Indeed, the stock exchange in its current configuration is a good example of a horizontally-integrated market. Borsa İstanbul currently owns 44.63% of İstanbul Settlement and Custody Bank, 100% of the Turkish Derivatives Exchange, 30% of the Central Registry Agency, 10% of the Capital Market Licensing and Training Agency of Turkey. On the international level, Borsa İstanbul has holdings in the

Kyrgyz Stock Exchange, Baku Stock Exchange and Sarajevo Stock Exchange with stakes of 24%, 5% and 5% respectively. This local consolidation and the creation of international linkages positions exchange more competitive internationally and aims to fulfil the new mission of the exchange.

For the moment, 49% of the new entity is owned by the government, represented by the Turkish Treasury. Currently, Borsa İstanbul provides markets for stocks, exchange traded funds, warrants, government bonds, Treasury bills, corporate bonds, money market instruments (repo/reverse repo), derivatives and foreign securities. At the end of 2012, the market capitalization of 406 companies listed and traded on the İMKB reached to a level of USD 311 billion. In 2012, 26 companies offered their stocks for the first time to public, and the amount raised through these IPOs was USD 352 million.

Borsa İstanbul's official mission is to establish, operate and develop transparent, efficient, reliable and accessible markets in facilitating trading, liquidity and price discovery for capital markets instruments. Following its transformation, the exchange aims to become one of the largest exchanges globally in terms of capitalisation and number of listed companies, reflecting Turkey's current economic potential. The exchange management would also like to see local and foreign investor participation increase. Borsa İstanbul also envisions a world-class in-house exchange technology that enables, among other things, linkages with other markets. This vision will add value to the drive of making Istanbul an international financial center.

New financial contracts and instruments are planned to be included in the system. Single stock futures and options have already been introduced in 2012. Index options, foreign currency options and futures will be introduced in near future. Turkish foreign exchange market will be an element of global foreign exchange market as well. Commodity and energy contracts are planned to be traded in Turkish Capital Markets.

In terms of regulatory responsibilities in this new configuration, the Law endows the CMB with important regulatory responsibilities, not only in terms of oversight of the operation of stock exchanges in Turkey, but also in terms of direct supervision of listing and trading on public securities markets. For instance, the Board reserves authority to suspend or delist any given traded instrument. At the same time, a number of provisions were adopted to strengthen investor protections and rights and the transparency of local capital markets.

The future of Borsa İstanbul

Following the enactment of new Capital Markets Law, Borsa İstanbul completed its demutualisation. Horizontal integration has also been completed after the acquisition of derivatives and gold exchanges. Vertical integration is in progress through gradual increase of shares in Takasbank and Central Registry Agency. Borsa İstanbul's Futures and Options Market (FOM) has merged with Turkdex and Borsa İstanbul has been integrated with Istanbul Gold Exchange. After FOM merger with Turkdex, more than 80 000 accounts and relevant positions were migrated to the FOM system. FOM currently has more than 70 members and a total traded value of USD 80 billion.

These changes are undertaken with the view to bolster international competitiveness of the exchange but also to prepare it for potential domestic competition. The Capital Markets Law adopted in 2012 envisages restructuring of stock exchanges and uses the term "stock exchange operators" which implies that Borsa İstanbul could be subject to competition in the long term. The Law indicates that securities exchanges established in Turkey must operate as joint stock companies and that the establishment of exchanges and market operators must be authorised by the Council of Ministers upon a recommendation of the Capital Markets Board. While in principle the establishment of competitive exchanges is previewed by the Law, in practice it is subject to a rigorous approval process and an approval by the CMB. Likewise, the establishment of alternative trading platforms, multilateral trading facilities and other organised marketplaces is subject to CMB oversight.

In the long term, further changes to the ownership structure of the exchange are envisioned through an IPO to be conducted by 2016. The public offer of the shares of Borsa İstanbul belonging to the state or their sale through other means shall be realised within the framework approved by the Council of Ministers upon a proposal to the Minister to whom the Undersecretariat of the Treasury is affiliated. In the meantime, the Capital Markets Law provides that shares in Borsa İstanbul may be transferred to related parties in order to cement strategic partnerships and/or to obtain access to technology, technical knowledge or other exchange related competence upon consent of Capital Market Board.

The Istanbul Financial Center

A key pillar of Borsa İstanbul's strategy is to make İstanbul, already the heart of Turkish markets and a natural hub in Eurasia, a regional and eventually global financial center through cooperation with the financial institutions in the region and in internationally. Borsa İstanbul is considered to be the heart of İstanbul

International Financial Center (IFC-Istanbul) Project, which provides a roadmap for the development of the financial services sector in Turkey. The overall roadmap is comprised of several components, including building a legal infrastructure that operates according to international standards, improving the physical and technological infrastructure, along with improving the regulatory and supervisory framework and increasing the diversity of financial products and services.

The underlying idea of this project is to bring together the strength of the Turkish banking sector and the capital markets which will together help expose the potential of trading commodities. At the same time, the authorities envision the creation of a network of exchanges in Eurasia, with Istanbul as its hub. Several steps have already been undertaken by Borsa İstanbul to facilitate the integration and cooperation among Eurasian exchanges. In addition to its position to act as a capital markets hub for the Eurasia region, Borsa İstanbul has also signed several MOUs with exchanges in the MENA region in order to foster operational and strategic alliances.

In parallel, international cooperation efforts have accelerated. A number of initiatives are underway to establish connectivity and cross listing of products with other stock exchanges. Borsa İstanbul has signed a partnership agreement with NASDAQ OMX that aims to expand the exchange's weight in global markets and strengthen its position as a regional hub for capital markets. Borsa İstanbul will integrate and operate NASDAQ OMX's suite of world-class market technologies for trading, clearing, market surveillance and risk management, covering all asset classes including energy contracts.

To enable this strategic alliance and facilitate the technology transfer that it would result in, there are discussions that the NASDAQ OMX Group would take a stake in Borsa İstanbul, but these are so far not confirmed. That said, this alliance would respond to one of the priorities of Borsa İstanbul to improve its technological infrastructure. The developing strategic partnership between the two exchanges points to a long-term commitment that is intended to benefit member firms and customers of both exchanges.

With its USD 311 billion market capitalisation and over 400 listed companies (as of end 2012), Borsa İstanbul aims at improving the depth of the market further and to augment the amount of funds channelled to economy. It is expected that recent demutualisation and privatisation shall provide Borsa İstanbul with greater flexibility and ability to develop its international alliances and competitiveness. The potential of the exchange is significant. Turkey's current GDP, approximately USD 770 billion, is expected to double by 2023 and Borsa İstanbul aims to be a key engine of financing future economic growth in Turkey.

CASE STUDY IV. THE EGYPTIAN EXCHANGE: DEALING WITH STATE LEGACY

The history of the Egyptian Exchange

Established in 1903 and 1883 respectively, the Cairo and Alexandria Exchanges were one of the oldest in the world. By the 1940s, the Egyptian capital market was the fifth largest globally in terms of activity. Its development was negatively affected by the wave of nationalisation in 1950s, where almost a hundred of most active listed companies had their stock transferred to government bonds. As a result, market capitalisation declined to approximately 1% of the GDP in 1974, from 13% in 1958 and the number of listed companies dropped to 55 from 275 companies in the same period.

Following this decline, the Egyptian capital market was relatively inactive until the passage of the Capital Markets Law 95 of 1992 that introduced a number of changes into primary and secondary markets, including encouraging private investment, improving investor protection, and enhancing the role of banks in capital markets. Following the enactment of the Law, the Cairo and Alexandria Exchanges started growing rapidly, encouraged by changes in the regulatory environment and privatisation heralded by the Asset Management Programme, which was administered by the Ministry of Investment.

This privatisation programme which utilised IPOs as one of its preferred methods of divestment was key to reactivating the Egyptian Exchange not only by increasing listings and attracting foreign investment, but also by encouraging other private firms to raise capital through the stock market. Listed companies were provided with a tax exemption equivalent to three months deposit rate paid by the Central bank on the paid up capital. This resulted in an influx of companies to the public markets and by end of 2001, 1100 companies were listed with a combined market capitalisation of USD 24 billion.

The vast majority of these companies were subsequently discovered to be illiquid and of little interest to investors. At the time of their listing, a key condition to listing was that there must have been at least one trade every 6 months. This requirement was relatively easily to circumvent since trading could be done by any

company insider. Very little trading in the stock of these companies occurred. Instead, the top 100 companies accounted for more than 85% of the volume traded. In order to bring liquidity and "clean up" the market, over 800 companies were delisted from the exchange by 2005 for failing to meet the liquidity and transparency requirements. This occurred after new Listing Rules were adopted in August 2002, which the companies were given one year to comply with.

Since then, the market has been experiencing a revival both in terms of the market capitalisation, which rose to 85% of the GDP in 2005 from 35% in 2003, despite this mass delisting. In the same year, foreign ownership reached 35%, up from 16% in 2001. The overall market performance was fairly robust in this period, despite mass delisting of firms initially attracted to list through tax incentives, the halt of the privatisation programme in 2008, and the slowdown of privatisation activity overseen by the Ministry of Investment since the onset of the financial crisis.

In parallel, the EGX had embarked on a re-organisation program, putting in place a new state of art trading system in 1997 and linking it to the CSD of the clearing company, introducing new listing, disclosure, membership and trading rules, investing in the long term capital or human resources of the Exchange via continuous training. The underlying technology of the exchange has evolved significantly from an open outcry system in place until 1992 to an automatic order driven system. The signing of the contract with the Canadian Software Company, EFA, in 1998 provided the Exchange with a new trading, clearing and settlement system. In addition, the development of a surveillance system that avails the exchange with the functionality to monitor transactions on a real time basis was completed in 2000.¹

In 2005, the EGX was the first Arab Exchange to be a member of the World Federation of Exchanges since 2005. The executive Chairman of EGX is a member of executive committee of African Securities Exchanges Association (ASEA), the Vice Chairman of Federation of Euro Asian Exchanges (FEAS) and a founding member of the Union of Arab Stock Exchanges. In 2008, the Cairo and Alexandria exchanges were merged into a single entity, the Egyptian Exchange (EGX). This consolidation marked a new chapter in the development of the Egyptian capital market.

The EGX today

Since 2004, daily trading volumes have increased fifteen fold and now the daily trading volumes average USD 90 million (as of August 2013). The trading activity and the market size have been affected by the events of the Arab Spring. Market

capitalisation stood at USD 50 billion USD in August 2013. Currently, over 230 companies are listed on the EGX, which makes it the largest market in the region in terms of the number of listings but no longer in terms of capitalisation as it has been surpassed by a few Gulf based markets.

Recent events in Egypt have had a notable impact on the volatility of the EGX and the level of foreign investment, which has rebounded in 2013. The management of the exchange has explored a number of mechanisms for increasing the capitalisation and liquidity in the market, including by encouraging large family companies to list and it is understood that these efforts have borne some fruit. To stimulate capital to the market, the EGX is in the process of introducing the first ETF on EGX 30 index with a local investment firm. In addition, the management intends to conduct road shows in the Arab world to increase their investment in the Egyptian capital market.

Attracting investment to the EGX is a priority not only to address some capital flight that has occurred as a result of political instability in Egypt, but also to reduce ownership concentration. The market, as its competitors in the Arab world, is still characterised by high concentration of ownership due to the fact that companies are only required 10% of their equity but also the dominance of a few large firms in the overall market capitalisation. The five largest listed firms represent over half of the total value traded of the main index, the EGX 30. The EGX has launched other indices to attract investment such a CSR index, developed by Standard and Poor's. It is unclear to which extent these efforts have been successful.

Beyond regularly updating its listing requirements, the Exchange has been relatively active in striving to improve the quality of the regulatory framework and address international financial developments. Recently, new rules have been issued on GDRs, OTC trading, disclosure of material events. The management of the exchange is continuing to introduce practices to align the EGX with international standards.

Ownership and governance structure

The EGX is the only registered stock exchange in Egypt, operating as a quasi-self-regulatory, fully government owned and unincorporated entity. The exchange is overseen by the Egyptian Financial Supervisory Authority (EFSA), established in 2009 as a result of the merger of the CMA with other financial regulators. The exchange is not very integrated horizontally but has a small stake in Misr for Central Clearing, Depository and Registry, which acts as a central depository and registry system in Egypt. The Egypt Information Dissemination company is a joint venture

between the EGX and NASDAQ OMX established in 1999 with the purpose of making available real time data and information on Egyptian listed companies.

The Presidential Decree 51 adopted in 1997 had outlined the new statutes governing the Egyptian Exchange (EGX), in particular covering the composition of its Board of Directors, its mission, appointment procedures, and its rules and regulations. According to this Decree, the Prime Minister appoints the Chairman of EGX for a period of three years. 6 board members are elected from market participants and others represent the Central Bank, the banking sector. The securities regulator is no longer represented on the board of the exchange.

Presidential Decree 91 issued in 2009 sought to ameliorate corporate governance arrangements of the EGX, especially in terms of board composition. It stipulated that both the Chairman and the Vice-Chairman of EGX are to be appointed by the Prime Minister, a representative to be appointed by the Central Bank of Egypt, whereas the remaining board members to be elected; 3 from securities companies; 1 from the custodian banks and 2 from the listed companies, provided that one of them represents the SMEs sector. The board member representing the securities regulator is no longer required.

Accordingly, the board of directors of the EGX became much more diverse and now represents various stakeholders from securities firms, banks, and listed companies, which brings governance arrangements of the EGX closer to those of privately owned exchanges. The fact that the majority of the board represents the private sector and that the Chairman of the exchange is an independent professional has served the exchange well over the past fifteen years.

In 2004, the EGX management prepared a strategic paper outlining how the exchange could transition to the privately-owned exchange model. The paper recommended that the EGX first corporatises (i.e. converts to a joint stock company fully owned by the government) and then considers converting the ownership of the exchange. At the time, the paper was circulated to senior government officials, but no action was taken since the government was at the time focused on restructuring its ailing SOEs. Considering that the Egyptian Exchange was both professionally managed and profitable, its restructuring did not constitute any priority for the government.

The management of the exchange believes that corporatisation and subsequently the privatisation of the EGX should enable it to raise capital from a broader base of shareholders, provide it with the ability to adapt to a fast-changing marketplace, compete better on the technology level and finally leverage the value of the EGX itself as a brand and as a business entity in ways other than trading. The

restructuring could also allow the EGX to form strategic alliances with other regional or non-regional exchanges thereby fostering its competitiveness in the region.

For instance, if the EGX becomes privatised, it would access the necessary funds and expertise to invest more in technology as well as to introduce new services and products such as derivatives or commodities. The EGX has a successful experience of establishing a joint stock company, in collaboration with NASDAQ/OMX that handles its information dissemination business. The same is envisaged if EGX establishes a separate company for trading and clearing derivatives that would also be a privately-owned and managed.

The exchange management believes that eventually the government should divest its ownership entirely. The 2004 paper on restructuring of exchange recommended that the government place some restrictions on the transfer of ownership; a 5% limit was proposed to avoid control by any specific entity. As discussed elsewhere in this report, the limit was inspired by examples of other countries (e.g. Australia, Canada, Singapore and Hong Kong).

The EGX's current governance structure, which already features a broad mix of stakeholders including brokerage firms, mutual funds, custodian banks and listed companies, should facilitate the eventual transition. It is expected that this same diverse group of board members will be maintained; not as managers but as shareholders of the Exchange.

The management of the Exchange considers that further restructuring of the stock exchange will lead to improved decision making. Moreover, privatisation would result in a wider mix of shareholders including users of the exchange, buy side, listed companies, retail investors and the public at large. Foreign institutions might become owners of the new privatised exchange with a cap. If large and renowned international financial institutions become shareholders of the Exchange; this would enhance its brand and improve the attractiveness of the capital market in the country. In addition, and unlike in other case studies developed here, access to additional capital that would allow the Exchange to invest in technology is considered important.

Political economy considerations

The same considerations that apply to the potential privatisation of public assets apply to stock exchanges. First, the transition from public to private monopolies should be avoided. Competition can be fostered through the introduction of alternative trading platforms and even in the absence of the former, competition

will arise naturally if one of the exchanges in the region positions itself attractively vis-a-vis others as a platform for listings.

Related to this concern is the nature of potential shareholders of the Exchange. As mentioned above, limits on ownership in the exchange can be placed and the securities regulator or another competent entity may be required to assess whether potential shareholders are "fit and proper". The risk is that some entities may be ill suited to act as shareholders of the exchange. A particular risk in Egypt and indeed in the wider MENA region is that exchanges could end up being owned by banks which are already economically powerful actors and, in many markets, constitute the bulk of the listed sector. As discussed above, this might be of a particular concern if listed banks become exchange owners.

An additional complication may arise in cases where banks also own brokerage firms. In Egypt, banks are not permitted to provide brokerage services directly; instead they must establish a separate legal entity. There are 10 Egyptian banks that have brokerage firms indirectly own the top brokerage firms in terms of volume traded (out of the total 140 brokerage firms in Egypt). Therefore, if a decision is taken to privatise the Exchange, one should take care of related party issues that will arise if a given bank and its brokerage firm intended to be owners of the Exchange. It is suggested that a limit should be set on related parties' ownership of the privatised exchange in order to avoid unintended control of the exchange by a few shareholders.

Another risk is that exchanges could end up being owned by the largest listed companies. Considering that these listed companies are often held tightly by controlling shareholders and there is no wide ownership or free float of their shares, their ownership of a national exchange might put the latter in the hands of a few powerful families. The Egyptian capital market could be an exception with an average free float of 31% for its 231 listed companies as of September 2013 so this might not be a major concern.

However, considering that one of the fundamental allegations made during the course of the successive revolutions in Egypt was the concentration of economic power in the hands of a few family groups, this type of ownership arrangements of the national stock exchange might not be tenable. In the view of exchange management, it is preferable to have a well-diversified group of owners from various constituents (not just one entity such as banks or brokers or listed companies). In choosing the new owners of the exchange, one should consider their value in promoting business opportunities and enhancing revenues for the Exchange post-privatisation.

Market regulators or equivalent entities should have a final veto on the potential ownership of the exchange and should be able to screen potential shareholders. The regulator could play a key role in deciding how to allocate exchange ownership in case of any contentions on the shareholder structure. This is in line with international developments whereby market regulators and competition authorities have recently vetoed a number of transactions implying the transfer of exchange ownership. This was witnessed in three famous failed exchange mergers in the past few years; namely, LSE Group proposed merger with TMX Group, Singapore merger with Australian Exchange and finally Deutsche Borse merger with NYSE Euronext.

Another precondition to the successful demutualisation or privatisation is the presence of a robust regulatory framework as well as a professional and well equipped securities market regulator which could oversee the process and provide most of the regulatory oversight that a capital market requires. For instance, the securities regulator should be responsible for developing or approving the fee structure of the Exchange to ensure that it does not abuse its end customers, especially in instances where the Exchange is not subject to competitive pressure from its foreign competitors or domestic alternatives venues.

It is the role of the securities regulator to ensure that the Exchange maintains its role as a market place for fair and efficient price discovery. Most fundamentally, the securities regulator must be ready for the review and transfer the regulatory functions previously exercised by the stock exchange. For instance, the listing authority is currently in the hands of the EGX (subject to prospectus approval by the EFSA). The listing decision is currently taken by the Listing Committee composed of the Chairman of the Exchange, 2 employees chosen by the Board, a member representing a securities firm sitting on the board of the Exchange and one member of the Egyptian Society of Accountants and Auditors.

Mergers and strategic alliances between Arab exchanges is a theme that has been given consideration for a number of years and it would be important to consider it in the eventuality that EGX ownership base is broadened. The securities regulator or the competition authority should retain a veto as far as the mergers of the EGX with other markets are concerned. For example, a pan-European exchange organized to include 8 exchanges that was planned in 2002 had failed. As a result, few exchanges in Europe started bilateral discussions and some succeeded in their drive to consolidate forces (e.g. Euronext and Eurex).

A merger between two Arab exchanges would be politically sensitive since a number of exchanges in the region are vying for the regional leadership position. In addition, nationalistic and legal obstacles (i.e. differences in corporate law, listing

requirements, etc.) can also pose a challenge. Finally, each Arab market has its separate infrastructure for clearing and settlement and therefore any mergers would need to consider whether the merger would create synergies beyond the listing and trading functions. In the short term, it might be more pragmatic for exchanges to get connection via a network solution, thereby keeping their brand but facilitating trading across markets. The issue to consider here is that in this configuration, larger, more liquid markets might draw all trading.

A final consideration relates to the timing of the proposed demutualisation or privatisation. Though the privatisation of the Egyptian Exchange is currently viable from a technical view, the timing does not appear to be suitable due to the current economic and political conjuncture and the generally negative attitude of the public towards privatisation. Examples of other markets that have attempted to broaden their ownership have highlighted the importance of the timing of the restructuring and having all players on board as critical success factors.

Note

- 1 It was replaced by the Millennium Surveillance System in 2012.

ANNEX B.

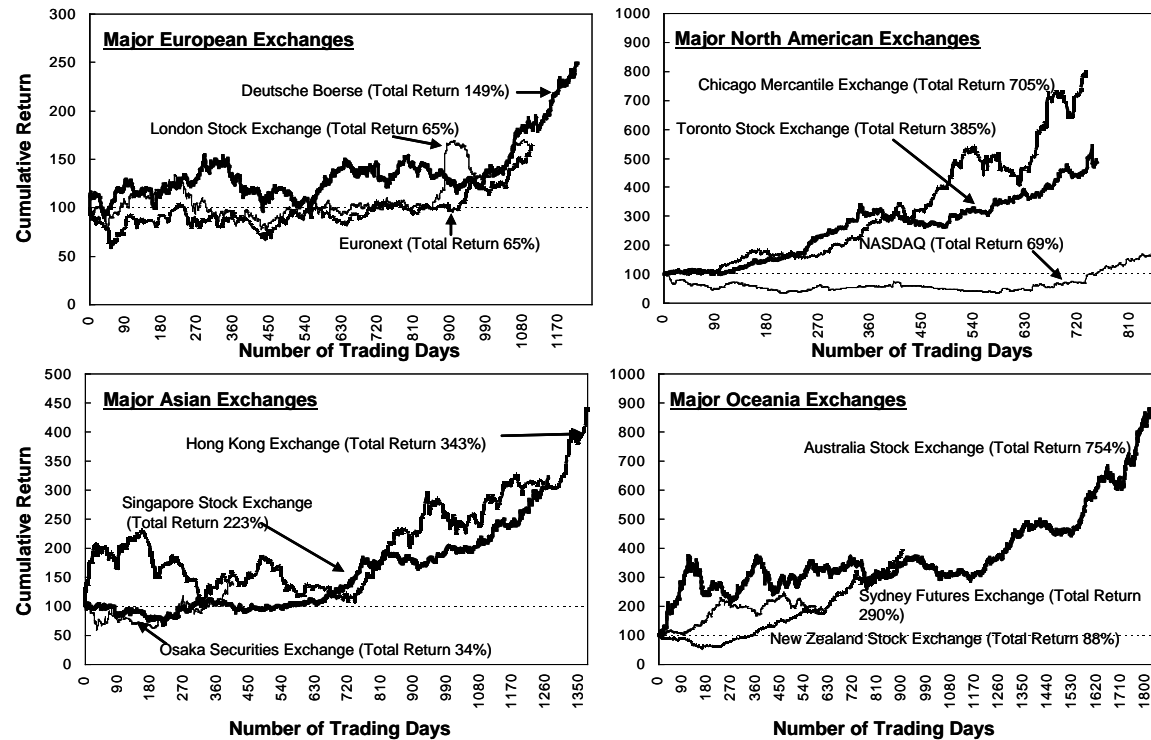
HISTORY OF DEMUTUALISATION OF MAJOR EXCHANGES

Table B.1 History of demutualisation of major exchanges

	Year of Demutualisation	IPO/Listing Date	First Day Return (Offer to Close)
<u>Major European Exchanges</u>			
London Stock Exchange	2000	20-Jul-01	-5.20%
Euronext	2000	10-Jul-01	-8.40%
Deutsche Borse	2000	5-Feb-01	11.40%
BME Spanish Exchanges	2001	14-July-06	-4.03%
Swiss Exchange	2002	N/A	N/A
OMX Group	1993	1-Jan-93	N/A
Borsa Italiana	1997	N/A	N/A
Oslo Exchange	2001	28-May-01	25.26%
Hellenic Stock Exchange	1999	28-Jul-00	-6.40%
<u>Major North American Exchanges</u>			
NYSE	2006	7-Mar-2006	19.4%
Nasdaq (including AMEX)	2001	1-Jul-02	0.00%
Toronto Stock Exchange	2000	12-Nov-02	13.10%
Chicago Mercantile Exchange	2002	6-Dec-02	22.57%
CBOT	2005	19-Oct-05	48.70%
CBOE	2010	15-June-10	12.03%
International Securities Exchange	2002	8-Mar-05	68.89%
<u>Major Asian/Oceania Exchanges</u>			
Tokyo Stock Exchange	2001	2013	N/A
Osaka Stock Exchange	2001	2-Apr-04	154.12%
Hong Kong Stock Exchange	2000	27-Jun-00	17.90%
Australia Stock Exchange	1998	14-Oct-98	3.70%
Taiwan SE Corp.	N/A	N/A	N/A
Korea Exchange	2005	N/A	N/A
Singapore Stock Exchange	1999	16-Nov-00	21.80%
Bursa Malaysia	2004	18-Mar-05	23.33%
Philippines Stock Exchange	2001	15-Dec-03	120.18%
New Zealand Stock Exchange	2003	4-Jun-03	16.67%
Sydney Futures Exchange	2000	16-Apr-02	-3.02%

Source: Aggarwal, 2013.

Figure B.1 Share price performance of select listed exchanges



Source: Aggarwal, 2013.

ANNEX C.

CONSOLIDATION IN THE STOCK EXCHANGE INDUSTRY

Table C.1 Consolidation in the stock exchange industry

Year	Acquirer	Target
<u>2012</u>	Tokyo Stock Exchange	Osaka Securities Exchange
	Hong Kong Exchanges and Clearing	London Metal Exchange
<u>2011</u>	London Stock Exchange	TMX Group
<u>2008</u>	Nasdaq	OMX
	CME Group	Nymex Holdings
<u>2007</u>	NYSE	Euronext
	Nasdaq	Boston Stock Exchange, Philadelphia Stock Exchange
	TSX Group	Montreal Stock Exchange
<u>2006</u>	Australian Stock Exchange	SFE Corporation
<u>2005</u>	NYSE	Archipelago
	Nasdaq	Instinet
<u>2004</u>	TSX (Toronto)	Natural Gas Exchange
	OMX	Copenhagen Exchange
	Nasdaq	BRUT ECN
<u>2003</u>	OMX	Helsinki Exchange
<u>2002</u>	Euronext	LIFFE
	Euronext	Portuguese Exchange
<u>2001</u>	TSX (Toronto)	CDNX (Canadian Venture Exchange)
	BME Spanish Exchanges	Madrid Stock Exchange
		Valencia Stock Exchange
		Barcelona Stock Exchange

Year	Acquirer	Target
		Bilboa Stock Exchange
<u>2000</u>	CDNX (Canadian Venture Exchange)	Winnipeg Stock Exchange
	Euronext	Paris Stock Exchange
		Amsterdam Stock Exchange
		Brussels Stock Exchange
	Hellenic Stock Exchange	Athens Stock Exchange
		Thessaloniki Stock Exchange
		Athens Derivative Exchange
	Hong Kong Exchanges & Clearing	Stock Exchange of Hong Kong
		Hong Kong Futures Exchange
		Hong Kong Securities Clearing Company
<u>1999</u>	Singapore Exchange	Stock Exchange of Singapore
		Singapore Intl Monetary Exchange (SIMEX)
	CDNX (Canadian Venture Exchange)	Vancouver Stock Exchange
		Alberta Stock Exchange
	Nasdaq	American Stock Exchange

Source: Aggarwal, 2013.

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Privatisation and Demutualisation of MENA Stock Exchanges: TO BE OR NOT TO BE?

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- Rationale for restructuring

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- Transition to corporatisation
- The start of demutualisation
- Motivations for ownership transitions

Chapter 3. Impact of exchange ownership transitions

- International experience
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Annex C. Consolidation in the stock exchange industry

www.oecd.org/daf/ca/mena-corporate-governance.htm

