Regulatory Issues Arising from Exchange Evolution

Responses to the Consultation Report

June 2006

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The Advisory Committee of the CNMV-Spain

A. General comments

The IOSCO Technical Committee's Consultation Paper is a review of the 2001 "Issues Paper on Exchange Demutualization". Since then, the trend towards demutualisation and listing of exchange management companies has accelerated, with the result that, by 2005 year-end, 16 exchanges or holding companies operating in SC2 jurisdictions had obtained public listings.

The IOSCO considers that this change in structure, i.e. from a ownership by members to profit-making companies, may raise a number of problems or risks, basically for the exchanges' regulatory role and for supervision by the respective authorities.

The Advisory Committee[1] of the CNMV is concerned at the possible changes in the sector insofar as they may lead to an increase in fees, as a result of shareholder pressure with regard to the market's bottom line, which is not matched by an improvement in this public service. Nevertheless, it welcomes the consultation document, but considers that the fact that it raises just two specific questions is insufficient for such a broad issue.

Since Europe has a number of trading platforms which are not regulated markets, and this document appears to refer solely to the latter, the Advisory Committee considers that the principles governing the markets or which may be established for the markets should apply to all operators.

B. Specific comments

With regard to the two specific questions which are raised:
(i) Do the existing regulatory requirements for exchange licensing / registration and operation continue to be adequate and easily adaptable to the emerging issues or are new tools necessary?

(ii) How should the new business activities of exchanges be considered and included in the regulatory framework?

[1] The Advisory Committee of the CNMV plays an important role within the Spanish securities supervisory system. It was created by the Securities Markets Law and its brief to advise the CNMV Board on any issues that are referred to it. The Advisory Committee comprises representatives of the Spanish securities industry, such as operators of regulated markets, issuers, credit institutions, consumer associations, investment firms, regional governments, clearing and settlement systems, insurance companies and collective investment associations. Moreover, the Board is legally obliged to seek the Committee's advice on the following issues, among others:

a) Legislation issued by the CNMV.
b) Sanctions for serious breaches of law.
c) Authorisation, revocation and mergers/acquisitions of investment firms.
d) Authorisation and revocation of branches of investment firms from third countries.

In addition to its role in providing advice to the National Securities Commission, the Advisory Committee also provides input on draft legislation on the securities markets which is forwarded to the Government or the Ministry of Economy and Finance.

The Advisory Committee considers that the current regulatory framework is still valid and is flexible enough to adapt to the changes that have taken place to date. It also considers that by applying the principles of flexibility (for rapid response to change), consensus (to balance the service provided and the profits derived from it), and competitiveness, the new business activities performed by the markets can be addressed with optimism.

Exchange operators and supervisors evidently share concern about the effects of the aforementioned changes, so it is reasonable that there should be a close relationship of trust between the two sides. The dialogue between supervisors and exchanges should be maintained for such reasons as avoiding regulation arbitrage and systemic and reputational risks that may arise.

Nevertheless, the Advisory Committee wishes to make the following comments on certain issues which it considers to be of particular importance:

1. Corporate governance

This is a relevant aspect since exchanges' regulatory capacity may give rise to conflicts of interest that may be more serious than in other types of listed companies. The added difficulty lies not only in achieving a profile of independent director that defends users' interests but also in having a good definition of the type of conflict of interests in which exchange operators may become involved. Therefore, the corporate governance obligations for companies of this type should not be more onerous than for other companies listed in the same markets, but they should be required to comply with them scrupulously.

2. Equity

The Committee considers that some form of standard should be common to all exchange operators so as to avoid regulation arbitrage and legal arbitrage. Clearly, because of the range of systems, models and risks which exchange operators face, any requirement should consider each market's specific characteristics and risks. Accordingly, an equity requirement should consider all the risks to which these entities are exposed, such as reputational and operating risks.

The CPSS-IOSCO standards address the appropriate management of operating risk for clearing and settlement systems and for central counterparties. Those standards can serve as a basis for analysing future equity requirements.

3. Record-keeping, clearing and settlement

The CNMV Advisory Committee notes that this Consultation Paper does not analyse the record-keeping, clearing and settlement functions; these fundamental aspects are not even minimally harmonised as yet.

Australian Stock Exchange

Public Comment on "Regulatory Issues arising from Exchange evolution"

Thank you for the opportunity to comment on the IOSCO consultation on Regulatory Issues arising from Exchange Evolution.

ASX supports IOSCO Principle 26 which states that jurisdictions should have appropriate arrangements to ensure that exchanges are properly run. However, although there are some common challenges facing 'for-profit' exchanges around the world there are no "one size fits all" solutions. Each jurisdiction makes different arrangements to deal with the challenges of exchange demutualisation and listing. ASX believes the arrangements in Australia are working well. Therefore, ASX considers it inappropriate to make recommendations that apply equally to all jurisdictions.

The IOSCO paper warns of the regulatory risks of 'for-profit' exchanges but we have seen no evidence of a "race to the bottom" since exchanges began demutualising and, on the contrary, the evidence seems to point to increasing levels of regulation in financial services generally, including in areas of exchange regulation. Set out below are specific comments against various sections of IOSCO's consultation paper.

B Implications of changing environment for exchanges' regulatory role

The IOSCO report mentioned the risk that "the for-profit exchange may be tempted to lower standards to try to generate additional revenue" (p.8)

ASX strongly disagrees with this statement. ASX's commercial success depends on adequate fulfilment of its regulatory functions and it has continued to devote significant resources to supervision since demutualisation and listing in 1998. On 15 December 2005 ASX announced the results of a review of its supervisory role, structure and processes and noted that "providing a market that is fair, orderly and transparent through vigorous supervision is central to ASX's business and a core value in everything it does". ASX is obliged by law to provide such supervision and "as a business entity, its reputation and attractiveness to customers and investors depend upon it."

The IOSCO report also mentioned the possible risk that for-profit exchanges might reduce the resources devoted to regulation or place insufficient value on the regulatory process.

This is not borne out by the ASX experience. In its 15 December 2005 announcement, ASX said it would commit significant additional resources to further strengthen market integrity, including creating a dedicated insider trading team providing additional resources to promote corporate governance disclosure and committing additional technological and training resources to improve

supervision of listed entities and participants. In quantitative terms, ASX has increased its budget for Market Supervision by more than 13% for 2006-07.

Misuse of Regulatory powers

In Australia, ASX has addressed the perception of possible misuse of regulatory powers for commercial benefit at a number of levels:

- it put in place extensive policies and procedures governing the separation of supervisory and commercial operations and the management of conflicts including a specific policy on handling 'Commercial and Supervisory Conflict of Interest';
- it established an internal unit (Group Compliance) to review supervisory decision-making processes, spot-check supervisory decisions and report its findings to the Audit and Risk Committee of the ASX Board;
- it established ASX Supervisory Review Pty Ltd (ASXSR) - a wholly owned subsidiary of ASX, which operates independently of the ASX Group's board and management - ASXSR reviews and reports to the ASX board on whether ASX adequately complies with its obligations as a market and clearing house operator, is conducting its supervisory activities ethically and responsibly, funding them adequately and maintaining appropriate controls concerning employee and commercial conflicts of interest; and
- it has announced that it will increase the separation of the regulatory functions from the commercial operations through establishment of a supervision subsidiary on 1 July 2006, ASX Markets Supervision Pty Ltd.

In addition to the abovementioned areas of internal oversight, independent external oversight of ASX's use of regulatory powers is provided by the securities regulator, the Australian Securities and Investments Commission (ASIC).

Regulation of competitors

With respect to regulation of competitors, ASXSR also provides an independent layer of scrutiny of the actions of ASX where an identified commercial conflict exists between ASX and a listed entity or a trading or clearing participant. ASXSR reviews ASX supervisory decisions regarding those entities and participants with a commercial conflict, who elect to come within these review procedures. The review procedures help ensure that ASX deals with competitors fairly when making regulatory decisions.

Under the Corporations Act, competitors can also apply to be supervised by ASIC instead of ASX if they are concerned.

Uses of Regulatory Income

The IOSCO report also stated that for-profit exchanges could use "its powers to generate regulatory income to finance its commercial operations" and one of the mechanisms for misuse may be implicit in the fee structure.

ASX continues to be responsible for funding the costs of supervision and is transparent about where the funds are drawn from.

IOSCO also stated that although securities regulators "generally do not regulate fee structures, it is important that fees are fair and are not operating as a barrier to access".

ASX would be wary about any barrier being put on exchange freedom to set commercial policy. Fee-setting is a commercial matter for exchanges, subject to the Trade Practices Act and oversight by the Australian Competition and Consumer Commission. Market and competitive forces also act as a discipline on commercial policy.

Financial risk and exchange viability

IOSCO notes that the ongoing financial health of an exchange is generally considered important to a jurisdiction's capital markets. IOSCO also notes that for-profit exchanges may be more inclined to take greater commercial risks than mutuals, enhance returns to shareholders by returning cash and thus reducing the capital base and find it more difficult than a mutual to raise emergency funding.

ASX's Audit and Risk committee is tasked with considering ASX Group's financial statements for the half and full year and the adequacy and effectiveness of its risk management, internal compliance and control systems. These measures are designed expressly to manage financial and other types of risk and ensure ongoing exchange viability.

C. Regulatory responses to exchange evolution

Transfer/removal of regulatory functions

The IOSCO report states that:

> *"jurisdictions might choose to remove a regulatory responsibility from an exchange either because they perceive an unacceptable conflict of interest in a for-profit exchange retaining that responsibility, or because they consider that granting an exchange an exclusive regulatory franchise might impede competition."* (p.21)

In Australia, experience has shown that business, government and ASIC have confidence in the way ASX carries out its supervisory activities and have no desire for ASX to move out of any of its regulatory roles. The Parliamentary Secretary to the Treasurer, Mr Chris Pearce, has said that the system is working well. More recently in its February 2006 annual assessment of ASX's market licence, ASIC confirmed that ASX was meeting all its legislative obligations to supervise the market.

Moving regulatory functions from the exchange to the regulator also has the potential to diminish the responsiveness to changing market practices. Given the greater flexibility of exchange rules and the proximity of exchanges to the market, exchanges are often able to amend rules quickly to respond to market evolution, and certainly well in advance of any change to the legislative framework made by the regulator. This responsiveness could be lost if regulatory responsibilities were removed from exchanges.

Efficiency and effectiveness in regulation is the overriding goal and managing conflict of interest is a significant but nonetheless small part of achieving this. The benefits of exchange regulation of trading and listing are considerable and should be carefully weighed against the risks of removing these functions to another regulator before any action is taken.

D. Broader regulatory issues arising from the new business models

Competitive behaviour

There is no doubt that competition regulators should consult with securities regulators when considering competition issues within the exchange industry. But ASX considers that it would place an unnecessary burden (and potentially conflicting requirements) on exchanges if both the

competition and exchange regulators were to try and regulate the behaviour of exchanges. Competition and securities regulation are two very different types of regulation and competition regulators need only become involved where competition issues are at stake.

The recent assessment (of 24 May 2006) by the Australian Competition and Consumer Commission, that there would be no lessening of competition by the proposed merger of ASX and the Sydney Futures Exchange, is an example of an instance where it is appropriate and necessary for a competition regulator to become involved in exchange industry developments.

Recommendations

Recommendation 1 *– Regulators should have arrangements to keep the changing market environment under review and identify emerging issues in a timely fashion*

ASX agrees with this recommendation. A Memorandum of Understanding (dated 1 July 2004) governs the relationship between ASIC and ASX. The MOU aims to minimise duplication of activity and promote co-operation, effective communication and mutual assistance between ASIC and ASX.

Meetings on the operation of the MOU take place quarterly between ASX and ASIC. In addition, there are monthly meetings between senior supervision staff at ASX and enforcement and compliance staff at ASIC to discuss operational and strategic supervisory matters common to both organisations. There is additional, frequent contact between ASX and ASIC relating to day-to-day operational matters. Regular contact between ASX and ASIC is important and sufficient to ensure the regulator is informed of significant commercial initiatives and market developments.

Recommendation 2 *– Regulators should assess whether changes made by exchanges require adjustments to the regulatory framework for an individual exchange or exchange generally and address any such changes promptly*

There is no "one size fits all" solution to the challenges of exchange evolution and the situation is constantly evolving. Existing arrangements between ASX and ASIC are, we believe, working well.

Recommendation 3 *– Regulators should assess the impact on resources of any changes to the regulatory model for exchanges, and ensure the core regulatory obligations and functions of exchanges are appropriately organised and resourced.*

It is a license requirement under the Corporations Act that a market operator must have "sufficient resources (including financial, technological and human resources) to operate the market properly and for the required supervisory arrangements to be provided" (S.792A (d)). ASX monitors the resources it devotes to supervision to ensure it complies with this legislative obligation. ASXSR also reports to the ASX Board whether ASX is meeting its licence obligations, including the adequacy of resources to supervise the market. ASIC also assesses whether ASX has adequate resources as part of its annual assessment process. ASX is committed to consistently providing adequate resources to ensure market integrity is maintained and, as mentioned earlier, has increased its budget for Market Supervision by more than 13% for 2006-07.

Commercial imperatives and brand protection are also strong drivers of adequate resourcing for market supervision and there is no need for additional regulation in this area.

Recommendation 4 *– Regulators should be prepared to share relevant information concerning cross-border activity.*

We agree that effective cross-border cooperation between securities regulators is important. Sharing information on cross-border activity is vital to ensuring market integrity in an increasingly globalised trading environment.

ASX also shares information with other exchanges on cross-border activity. ASX has an MOU with the Sydney Futures Exchange concerning the provision of information for the purpose of regulation and enforcement where both futures contracts and the underlying securities are involved. In addition, ASX is very active in communicating with and supporting other markets in the Asia Pacific region. ASX has established Memoranda of Understanding with 8 exchanges in the Region and regularly hosts delegations from other exchanges.

We also note that regulators should also be prepared to share relevant information with the exchanges they regulate, especially where regulators are referring possible disciplinary cases to the exchanges. This two-way information flow is necessary to ensure appropriate regulatory outcomes are achieved in an effective and efficient manner.

Recommendation 5 *– Regulators should consider competition issues that may arise in connection with the evolution of exchanges where such evolution impacts on market integrity, efficiency or investor protection*

Competition between exchanges is welcome and should be overseen by competition regulators where necessary. Any impact competition may have on market integrity or market supervision should be monitored by the securities regulator – not the competition regulator.

In response to the two main questions posed by IOSCO, ASX has the following comments:

Do existing regulatory requirements for exchanges licensing/registration and operation continue to be adequate and easily adaptable to the emerging issues or are new tools necessary?

The existing Corporations Act licensing requirements for market operators are more than adequate and broad enough to be adaptable to emerging market issues. The requirements contain general obligations to ensure a market is fair, orderly and transparent, there are adequate arrangements for handling conflicts between commercial and supervisory interests and there are sufficient resources to operate the market properly (S792A).

How should the new business activities of exchanges be considered and included in the regulatory framework?

In the ways described under Recommendation 1, they should be identified and considered during the regular and robust two-way meetings between regulators and exchanges.

ASX agrees with IOSCO's conclusion that most securities regulators have taken a customised and pragmatic approach, based on the particular circumstances in a jurisdiction, to ensure demutualised exchanges continue to perform regulatory functions in the proper manner. We support a continuation of this approach.

Please feel free to contact me if you would like to discuss any of these comments in more detail.

Yours sincerely,
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Chicago Mercantile Exchange

The Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to comment upon the Commodity Futures Trading Commission's ("CFTC" or "Commission") ongoing review of self-regulatory organizations ("SROs"). CME invented financial futures contracts more than 30 years ago and is currently the largest and most diverse financial exchange in the United States and the largest derivatives clearing organization in the world. CME is also the largest demutualized and publicly-traded futures exchange in the United States.[2]

CME has a long history and strong track record in self-regulation. As one of the leading exchanges in the world, we believe that our market surveillance and financial supervision regulatory capabilities are part of the brand identity that we have created. In serving the marketplace, CME has stressed the quality and strength of its regulatory capabilities as an attraction to our products, markets and services. Market participants use our markets, in part, because they know we operate with high standards for market integrity and for supervision of trading activity and financial activity on the part of our member intermediaries.

As the Commission has requested, we have addressed each enumerated question individually, in the order that they appear in the release.

1. Is the present system of self-regulation an effective regulatory model for the futures industry?

CME Response: CME believes that its model of self-regulation, in which a demutualized market center and regulatory function exist within the same entity, is effective and time-tested. Such a model represents the best model for the following reasons:

A. CME's Public Company Model Creates an Incentive to Regulate

CME's transition from a member owned exchange to a public company has created substantial additional incentives to operate a fair, financially sound and competitive

2 All of CME's outstanding shares are held by Chicago Mercantile Exchange Holdings Inc. ("CME Holdings"), a Delaware for-profit corporation. CME Holdings completed its initial public offering in December 2002 and its Class A common stock is listed on the New York Stock Exchange (the "NYSE") and The NASDAQ National Stock Market, Inc. ("NASDAQ"). The Board of Directors of CME Holdings and CME are comprised of the same individuals.

marketplace. Reputation and competition are powerful motivating forces for ensuring proper behavior, especially in today's global environment where market participants have virtually immediate, around-the-clock access to a broad range of competing markets and products.

Moreover, publicly owned exchanges have a unique incentive to properly discharge their statutory self-regulatory responsibilities. Such exchanges operate in a transparent environment in which research analysts and institutional shareholders scrutinize management's business decisions and monitor the company's performance. Any failure to maintain and effectively implement prudential regulatory programs could cause analysts and shareholders to adopt a negative view of performance and stock prices would likely be adversely impacted. Indeed, the results of any materially adverse agency action involving the market would require disclosure to shareholders.

Ultimately, CME believes that our regulatory capabilities are part of the brand identity that we have created. The quality and strength of our regulatory capabilities provide market participants with the confidence to use our products, markets and services.

B. Commission Oversight Ensures Compliance

The Commodity Exchange Act (the "Act") and Commission regulations currently impose strict self-regulatory responsibilities on all SROs, which include the requirement that SROs enforce all of their rules and maintain continuing programs to ensure compliance with the Act, the Commission's regulations and the SRO's rules. The CFTC helps to ensure that exchanges satisfy their self-regulatory responsibilities through, among other things, periodic rule enforcement reviews that ferret out lax or deficient enforcement. In the event that an SRO fails to satisfy its obligations, the Commission is empowered to compel the SRO to fulfill its responsibilities, and may suspend or revoke the SRO's designation. We believe that these measures are appropriate and adequate to supervise and enforce an exchange's self-regulatory responsibilities.

C. Funding of the Self-Regulatory Function Is Not Diminished

CME has a strong incentive to adequately fund and ensure the integrity of its markets. CME has, in fact, continued to devote significant resources to self-regulation since going public.

Any notion that an established for-profit entity might attempt to attract order flow or increase its profits through lax self-regulation would be misplaced. In this respect, we note that Professor Craig Pirrong of the University of Houston has found that a for-profit SRO, as opposed to a not-for-profit SRO, would generally not have an incentive to attract volume or increase its profits through lax self-regulation.[3] According to Professor Pirrong, because "most of the attributes of exchange self-regulatory efforts have observable and often quantifiable impacts," the for-profit form creates a strong incentive to regulate intensely, while the not-for profit form "is likely to have little impact on the intensity of exchange self-regulatory efforts."[4]

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[3] *See* Craig Pirrong, A Theory of Financial Exchange Organization, 43 J. of Law & Econ. (2000); Craig Pirrong, Electronic Exchanges are Inevitable and Beneficial, 22 Regulation (1999).

[4] Letter of Craig Pirrong, Professor of Finance and Director of the Global Energy Management Institute, Bauer College of Business of the University of Houston, to Jean A Webb, Secretary, Commodity Futures Trading Commission (Sep. 13, 2004).

Operating as a for-profit company thus impels CME to further strengthen its brand through effective self-regulation.

D. Combined Knowledge of Market and Regulation Creates Benefits

CME, as well as other exchanges, have built extensive and sophisticated regulatory systems and programs to ensure market integrity and financial safeguards for market users. CME has assembled some of the most talented regulatory, risk management and financial supervision experts in the world of trading. These employees oversee our market regulation department, financial audit area, risk management and clearing house departments and trading floor personnel. Importantly, our Market Regulation Department employees have an average of approximately eight years of departmental experience and 17 years of industry experience. Our Audit Department includes 17 employees who have Certified Public Accountant designations, and a management group whose employees average 13.5 years of departmental experience. The quality of our overall regulatory system depends heavily on the integration of these separate functions and on the manner in which these staff members are able to coordinate closely their activities and information sharing. Unbundling any part of this extensive and intertwined system will damage the protections afforded to the industry and market participants.

In times of a market crisis, these staff members work together as a tightly knit team that is responsive to CME's needs to ensure market integrity and financial safeguards. Emergency situations demand the highest level of coordination.

A prime example of an emergency situation involves the recent bankruptcy filing by Refco, Inc., the parent company of Refco, LLC ("Refco"), a large clearing member of CME. As a result of the alleged fraudulent activities of its chief executive officer, Refco Inc. was forced to seek bankruptcy court protection through a Chapter 11 filing. While Refco Inc. was in bankruptcy, its Refco subsidiary continued to operate as a clearing member in good standing at CME.

During the several weeks that Refco continued to operate after its parent company was in bankruptcy, CME, as the designated SRO for Refco, brought together in-house experts from various CME departments to work with the industry and the CFTC in an effort to monitor the trading activity of Refco and to analyze and discuss the future of Refco. In addition, in the event that a worst case scenario arose involving Refco, CME explored, discussed and developed a comprehensive contingency plan for a large clearing member default if a sale to another party did not occur and Refco was forced into bankruptcy.

According to many sources within the industry, CME and its staff were instrumental in managing the Refco situation to a positive result. CME auditors, who have worked with Refco for years and were intimately familiar with Refco's operations, were on-site at Refco the day after Refco, Inc.'s financial problems were made public. The on-site auditors coordinated with the CME audit staff in Chicago as well as the CME clearing house staff and market regulation, membership and legal staff to monitor and assess the ever-changing Refco situation. Information was provided immediately by CME staff to the entire industry, allowing money flows to and from Refco to continue and allowing the clearing member to stay in business while its parent was in bankruptcy. If the information had not been provided by CME staff to the rest of the industry, daily movement of funds to and from Refco would likely have stopped and many of the approximately 24,000 customers would have had their trading accounts and funds placed in jeopardy.

CME's long-standing familiarity with Refco, the trust and personal relationships that have been built over the years between CME staff and Refco staff, and the ability to have Audit, Clearing

House, Market Regulation and Surveillance, Membership and Legal staff all in close proximity and on-hand immediately sharing the same information, allowed a potential crisis to be resolved in a positive manner for Refco's customers and the futures industry. CME's development of sophisticated regulatory, margining and auditing systems over the years came into play during the Refco situation. CME's ability to use its systems and analyze the resulting data in an immediate response to Refco, assisted in information flowing to the industry and the clearing member staying in business until a sale to a third-party could be arranged.

As the Refco matter demonstrates, CME has a strong incentive to regulate vigorously and monitor its member firms in order to maintain a robust industry and, through its combined market and regulation model, CME has shown that it is unequivocally equipped to address such emergencies. To alter such a model in the face of the Refco success could risk the integrity of the industry.

E. <u>International Acceptance Demonstrates Model's Success</u>

The demutualized, publicly-traded exchange model is internationally accepted. As a publicly-traded exchange, CME is not alone in effectively combining its market center and self regulatory functions. Internationally, for example, demutualized exchanges such as Euronext, N.V. (through its various markets), the Singapore Exchange (SGX), OMX (through its Stockholmsborsen market), and the London Stock Exchange (LSE), all employ a model that generally combines the market center function with the self-regulatory function. The broad acceptance of such a model, combined with the absence of any demonstrable failures, provides strong evidence that the model effectively permits demutualized exchanges to satisfy their selfregulatory obligations.

2. As the futures industry adapts to increased competition, new ownership structures, and for-profit business models, what conflicts of interest could arise between:

i) an SRO's self-regulatory responsibilities and the interests of its members, shareholders and other stakeholders; and
ii) an SRO's self-regulatory responsibilities and its commercial interests?

<u>CME Response</u>: In the context of a demutualized, publicly-traded exchange, CME does not believe that conflicts of interest are inherent or likely to arise between the self-regulatory function and the interests of members, shareholders, stakeholders or profits. To the contrary, for the reasons discussed above, CME believes that a demutualized, publicly-traded exchange has a strong incentive to obviate conflicts of interest and ensure that markets are fair and credible.

Moreover, by taking affirmative steps to reduce the potential for conflicts, such as increasing the representation of independent members on our board of directors and disciplinary committees and chartering a board-level Market Regulation Oversight Committee ("MROC"), comprised of non-industry directors, to oversee the self-regulatory function, CME has consistently demonstrated an unparalleled commitment to a marketplace free of conflicts.

3. Given the ongoing industry changes cited above, please describe how selfregulation can continue to operate effectively. What measures have SRO's taken thus far, and what additional measures are needed, to ensure fair, vigorous, and effective self-regulation by competitive, publicly-traded, for profit SRO's?

CME Response: We believe that the continued movement toward demutualization will continue to drive more effective self-regulation, in that exchanges will have a stronger incentive to ensure market integrity.

With respect to measures that SROs have taken to ensure effective self-regulation, CME has been at the forefront to ensure that self-regulation is fair, vigorous and effective. For example, in April, 2004, CME became the first futures exchange to appoint a board-level MROC devoted to self-regulatory oversight. MROC, which operates independent of management and the Board of Directors and has access to outside counsel, is charged with reporting to the full Board of Directors on an annual basis concerning the independence of CME's regulatory functions from CME's business operations, the independence of CME management and regulatory personnel from improper influence by industry directors regarding regulatory matters, and CME's compliance with its statutory self-regulatory responsibilities. MROC's charter helps to ensure that the self-regulatory function is fair and free of conflicts of interest. (MROC's specific responsibilities are discussed in response to Question 6 below.)

CME has also strengthened its disciplinary process—and mitigated any perceived conflicts—by increasing the representation of independent members on its chief disciplinary committees—the Business Conduct Committee ("BCC") and Probable Cause Committee ("PCC"). As discussed more fully in response to Question 8, these committees now include substantial non-member representation to ensure that such independent members have significant input in disciplinary proceedings.

4. What is the appropriate composition of SROs' boards of directors to ensure the fairness and effectiveness of their self-regulatory programs?

CME Response: CME does not believe that there is a "one-size-fits-all" approach with respect to composition requirements for effective self-regulation. At CME, we strive to ensure the fairness and effectiveness of self-regulation through a combination of governance initiatives, which include taking steps to ensure that our Board operates independently of management by having at least a majority of independent directors and providing additional assurances that our SRO functions are being administered on a fair and consistent basis through the independent oversight of MROC. In addition, we believe that it is important to have significant non-industry representation on the Board because such directors add important perspectives, such as public company and financial expertise and unqualified neutrality on issues that might impact various classes of our market users. CME's Board is currently comprised of seven non-industry directors (out of 14 directors nominated by the Board).

4. Should SROs' boards include independent directors, and, if so, what level of representation should they have? What factors are relevant to determining a director's independence?

CME Response: CME believes that boards of directors should be comprised of at least a majority of independent directors. CME has both advocated and implemented such a position, which is consistent with accepted corporate governance "best practices" regarding board composition.

CME does not, however, believe that there is a bright-line definition of "independence" that can ensure that a board functions effectively and independently. We do recognize that the inclusion of directors with no other relationships to the industry on the boards of SROs is important to mitigate any perceived conflicts of interest. However, we also believe that directors who are members or end-users of an exchange organization have an invaluable understanding of the business and can provide

useful perspectives on significant risks and competitive advantages. Indeed, the inclusion of exchange members on CME's Board has been essential in transforming CME from a century-old mutual organization to a thriving publicly-traded company and from a largely floor-based open outcry business to one of the largest electronic trading platforms in the world. We would be concerned about the adoption of any bright-line standard that would automatically prohibit a board from finding a member of an exchange organization to be independent regardless of the particular facts and circumstances his or her relationship with the exchange. Such a requirement would prohibit all members from serving on key board committees and would result in exchanges losing the benefit of their insight without the benefit of any analysis as to whether the use of our markets actually impairs a particular director's independence.

As set forth in our categorical standards of independence (available at www.cme.com), we believe that as long as a director satisfies the independence requirements of the NYSE and NASDAQ listing standards and our categorical independence standards relating to affiliations with charitable organizations, consulting services and share ownership, his or her independence will not automatically be impaired based on membership status so long as their transactions as members are made in the ordinary course of business on terms consistent with those prevailing at the time for corresponding transactions by similarly situated, unrelated third parties.

Furthermore, CME believes that it should be the responsibility of the board to determine whether, based on all the facts and circumstances, including the level of trading activity and influence of the particular member, as to whether he or she is independent of the exchange. State corporation laws generally require a board to exercise its business judgment to act in what it reasonably believes to be in the best interests of the company and its shareholders regardless of a director's status as a member of the organization. Directors must fulfill their responsibilities in a manner that is consistent with their fiduciary duty to their owners, in compliance with all applicable laws and regulations. We believe that rather than a blanket independence standard regarding membership, a comprehensive conflicts of interest policy is more appropriate to address any potential conflicts of interest that may arise due to an individual's trading activities.
For example, CME keeps records as to the trading activities of its directors, if a matter is presented to the Board that could have a significant impact on a director's trading, that director is expected to recuse him or herself from the matter. (The foregoing procedures are set forth in more detail in the Company's Director Independence and Conflict of Interest Policy available at www.cme.com.)

6. **Should self-regulation be overseen by an independent entity within an SRO?**
   i) **If so, what functions and authority should be vested in such an entity?**
   ii) **At least two futures exchanges have implemented board-level regulatory oversight committees ("ROCs") to oversee their regulatory functions in an advisory capacity. Commenters are invited to address any strengths or weaknesses in this approach.**

CME Response: CME does not believe that the self-regulatory function should be overseen by an independent entity within the SRO. Such a model is beset by several laws:

First, if the board of an independent entity reports to the parent board of the company, conflicts—to the extent that they exist—would likely continue to persist because the regulatory function and the market center function would ultimately report to the same board of directors. Such an independent entity model would thus not improve upon any perceived conflicts of interest concerns.

Second, formally separating the regulatory function from the market center function could harm self-regulatory efforts because the separation could reduce the familiarity of the regulators with market practices. Such a forced division of expertise would hamper, rather than help, regulatory personnel in attempting to understand and regulate the market.

Third, in transferring the regulatory function to a separate entity, any synergy between the market center and the regulatory function could be jeopardized. In particular, as exchanges seek to innovate, their regulatory systems might not be as well designed for effective surveillance because the regulators may not have had the opportunity to provide input into the development and implementation of the technology.

Finally, requiring the establishment and maintenance of a separate entity would add an additional layer of bureaucracy to the organization, which would increase costs without any corollary benefit.

Rather than experiment with a proven model, we believe that the appropriate mechanism to ensure fair and effective self-regulation is through a regulatory oversight committee ("ROC"). At CME, the ROC (also referred to as the MROC) is comprised solely of non-industry directors and is charged with the following significant responsibilities:

- to review the scope of and make recommendations with respect to the responsibilities, budget and staffing of the Market Regulation Department and the Audit Department with the goal that each department is able to fulfill its self regulatory responsibilities.

- to oversee the performance of the Market Regulation Department and Audit Department with the goal that each department is able to implement its self regulatory responsibilities independent of any improper interference or conflict of interest that may arise as a result of a member of CME serving on the Board or participating in the implementation of CME's self-regulatory functions.

- to review the annual performance evaluations and compensation determinations and any termination decisions made by senior management of CME with respect to the Managing Director, Regulatory Affairs, and the Director, Audit Department, with the goal that such determinations or decisions are not designed to influence improperly the independent exercise of their self-regulatory responsibilities.

- to review CME's compliance with its self-regulatory responsibilities as prescribed by statute and the rules and regulations promulgated there under.

- to review changes (or proposed changes, as appropriate) to Exchange rules to the extent that such rules are likely to impact significantly the self-regulatory functions of the Exchange.

We believe that the MROC represents an aggressive and appropriate step towards independence in self-regulation. Importantly, the formation of the MROC represents a best practice model for exchange self-regulation, and we encourage the Commission to recognize, and other futures exchanges to follow, our lead.

7. The parent companies of some SRO's are subject to the listing standards of the securities exchanges on which they are traded. Are such listing standards relevant to self-regulation and to conflicts of interest within DCMs?

CME Response: Directors are required to oversee the company for the benefit of its shareholders. In taking action on behalf of the company, directors should be free from conflicts of interests to ensure that transactions are fair to the corporation and are made on an arms length basis. CME has taken steps to ensure that its Board acts independently by, among other things, complying with the independence standards of the NYSE and NASDAQ and instituting its Director Independence and Conflict of Interest Policy.

We believe that all corporations, including DCMs, would benefit from these policies. For example, the listing standards that apply to publicly traded companies are designed to raise the bar for corporate accountability by increasing the independence of the board of directors and its committees. Under the requirements, at least a majority of the directors must be free from material relationships with the company and certain of its committees must be comprised solely of independent directors. We believe that having a majority of independent directors and independent board committees provides additional assurance that a board will act independently of management and free from conflicts of interest.

8. What is the appropriate composition of SROs' disciplinary committees to ensure both expertise and impartiality in decision-making?

i) Should a majority of committee members be independent? Should the composition of SROs' disciplinary committees reflect the diversity of the constituency? Should similar safeguards apply to other key committees and if so, which committees?

ii) Should SRO disciplinary committees report to the board of directors, an independent internal body, or an outside body?

CME Response: CME believes that SRO disciplinary committees should have independent, non-SRO committee members. In this respect, CME has pioneered changes to the structure of its disciplinary committees. For example, non-members were added to CME hearing panels in 1990 and the degree of influence of non-members has been consistently expanded—most recently in 2004, when CME increased the proportion of independent panelists on its disciplinary committees.

Presently, CME's Probable Cause Committee (the "PCC"), which is the committee responsible for the issuance of charges involving allegations of trade practice violations, is composed of three non-members and four members, plus a non-voting member chairman. CME's Business Conduct Committee (the "BCC"), which is the committee that is responsible for resolving such charges, is composed of two non-members and three members, plus a nonvoting member chairman.

We believe that it is important that the level of representation for independent members is consistent across all types of disciplinary cases. While some exchanges use non-member panelists in the disciplinary process only when a case appears to involve customer harm, CME believes that independent, non-industry panelists are a useful component in *all* types of disciplinary cases before the PCC and BCC.

We further believe that ensuring that a disciplinary committee has the requisite level of expertise is best accomplished by encouraging members and users of an exchange's products to

participate in the disciplinary process. Such individuals not only understand the nature and jargon of the futures business, but possess first-hand knowledge of the often complex and technical workings of the business. The result of such participation is that case resolutions are commensurate and responsive to the charges brought. In each non-summary proceeding, CME includes at least one broker, one local trader and one firm (*e.g.*, FCM) representative, thus ensuring a multitude of market perspectives. Based upon our feedback with the community that we serve, the level of market expertise is appropriate.

Moreover, impartiality is best accomplished by requiring SRO disciplinary committee members to abstain from participating in a disciplinary matter if there is a perceived or actual conflict of interest or the member has engaged in an *ex parte* communication concerning the merits of the matter. Importantly, CME Rules 416 (Conflicts of Interest) and 417 (Prohibited Communications), make it clear that CME will not tolerate violations of these important precepts.

Lastly, we do not believe that the CFTC should mandate a reporting requirement with respect to disciplinary committees. At least in the case of CME, an adequate oversight structure currently exists. The BCC and PCC chairmen, as well as the heads of the Market Regulation Department and Audit Department, have unfettered, *ex parte* access to the MROC to discuss any issue, including a potential conflict or concern. Moreover, at least once per year, the MROC meets with the BCC and PCC chairmen (and the heads of the Market Regulation Department and Audit Department), without CME staff or management present, to examine any potential conflict or concern, as well as to discuss the strengths and weaknesses of the disciplinary program. Finally, to the extent that a party to a disciplinary proceeding believes that it has been aggrieved by an inappropriate committee decision, the party is accorded ample recourse, which includes the right to appeal the decision to a hearing panel of the Board of Directors with respect to any decision that imposes a fine greater than $10,000 or a suspension greater than five business days, as well as recourse to the CFTC and federal court. Such a structure
ensures independence with respect to the BCC's and PCC's role in the self-regulatory process.

9. What information should SROs make available to the public to increase transparency (*e.g.*, governance, compensation structure, regulatory programs and other related matters)? Are the disclosure requirements applicable to publicly traded companies adequate for SROs?

CME Response: As a public company, CME is subject to the disclosure and reporting requirements of the Securities Act of 1933, Securities Exchange Act of 1934 and the rules and regulations promulgated thereunder by the SEC. In addition, CME is subject to the disclosure requirements of the NYSE and NASDAQ, which require CME to make publicly available on its website numerous corporate governance documents and provide annual certifications regarding its compliance with the listing standards.

In accordance with the foregoing rules and as a matter of best practice, CME makes widespread disclosures to its shareholders and the general public. For example, CME files financial reports on an annual and quarterly basis with the SEC. It also has created a corporate governance section on its website that contains CME's key corporate governance documents, including its Director Independence and Conflict of Interest Policy, Corporate Governance Principles for its Board of Directors, categorical standards of independence, charters and memberships of its Board standing committees, and biographies for each of its directors, including their relationships with the exchange. This high level of disclosure goes far beyond that of any non-public SRO, and CME welcomes such transparency.

10. What conflicts of interest standards, if any, should apply specifically to DCOs, both stand-alone DCOs and those integrated within DCMs?

CME Response: CME believes that the same general conflict of interest standards that apply to other organizations should apply to DCOs. For example, CME employees, whether in the Clearing House Division, the Audit Department, the Market Regulation Department or the Business Development Division are expected to dedicate their best efforts to CME and avoid any conflicts with the interests of CME. As such, in order to maintain the highest degree of integrity in the conduct of our business and to maintain independent judgment, all CME employees and directors are required to avoid any activity or personal interest that creates or appears to create a conflict between an employee's interests and the interests of CME. We believe that such a premise should apply to all types of organizations. CME specific standards are embodied in our Code of Conduct, which applies to all employees and requires annual disclosures of all conflicts through a questionnaire and certification process. Moreover, because CME is conscious of its responsibilities to avoid conflicts, the Market Regulation Department and Audit Department have adopted a compliance policy that stresses the importance of protecting the confidential information that member firms provide to CME as part of CME's oversight responsibilities. The confidentiality policy is available at www.cme.com.

CME further believes that the conflicts of interest standards that apply to the disciplinary committees, such as CME's BCC and PCC, should also apply to clearing house risk committees. The CME Clearing House Risk Oversight Committee is a risk-management oversight committee that has ancillary disciplinary authority. The committee is comprised of 11 members, which include: 1) five broker-dealer/FCMs (*i.e.*, Morgan Stanley, J.P. Morgan, Goldman Sachs, Bear Stearns, O'Connor); 2) one FCM-only firm; 3) one settlement banker; 4) three floor members; and 5) one CBOT member firm representative (in connection with CME's agreement to provide clearing services to the CBOT). Because clearing firms own a significant amount of the collateral available to the CME Clearing House, we believe that their interests should be principally represented on the committee. Importantly, the CME conflict of interest rules applicable to the BCC and PCC—CME Rules 416 (Conflicts of Interest) and 417 (Prohibited communications)—also apply to the Clearing House Risk Oversight Committee to ensure that conflicts do not impair the process.

Finally, the MROC oversees the activities of the Clearing House Division and helps to ensure that CME protects market users from being harmed by potential conflicts of interest by clearing members, individual exchange members and other market participants involved in exchange regulatory and disciplinary processes. Indeed, the credibility of the futures markets depends upon the avoidance of even the appearance of such conflicts, and the MROC takes an important step in that direction.

We thus believe that conflicts of interest measures are appropriate for DCOs, and that CME's conflicts avoidance measures represents a best practice model.

11. What conflict of interest standards, if any, should be applicable to third-party regulatory service providers, including registered futures associations, to ensure fair, vigorous, and effective self-regulation on their part.

CME Response: CME believes that third-party regulatory service providers, such as the NFA, should be subject to the same governance standards as other SROs. To exempt such providers from comparable regulation not only would encourage regulatory arbitrage, as new contract markets shop for the low cost (and concomitantly low quality) provider, but invite disparate qualities of regulation. Ultimately, such an approach would serve to commoditize the self-regulatory function and thereby damage the credibility of the futures industry.

In addition, virtually any third-party regulatory service provider is likely to be subject to itsown conflicts of interest. For example, a majority of the NFA's Board of Directors is comprised of futures industry participants, many of whom are employed by intermediaries that have a significant financial stake in the outcome of regulatory developments and investigations. In a similar fashion, the Futures Industry Association's Board of Directors, which supports the NFA's role as a provider of regulatory services, is comprised primarily of representatives of large intermediaries. Not a single futures exchange is represented on the FIA board. Respondents to disciplinary proceedings, however, generally are intermediaries or employees and agents of intermediaries. The CFTC should thus mindful of such an inherent conflict of interest and seek to ensure that strong conflict avoidance standards apply to all third-party regulatory service providers.

Conclusion

Thank you for the opportunity to comment upon the Commission's study. If you have any questions or comments, please do not hesitate to contact me or Matthew F. Kluchenek, Director and Associate General Counsel, at (312) 338-2861.

Respectfully submitted,
Craig S. Donohue

Deutsche Börse

A. Introduction

Deutsche Börse Group welcomes the opportunity to provide comments on the March 2006 consultation report of the IOSCO Technical Committee entitled "Regulatory Issues Arising from Exchange Evolution." We participated in the background study associated with the report by completing a detailed questionnaire in January 2005 on our exchange structure, our ownership and business model, associated regulatory issues, information about exchange linkages, and clearing and settlement arrangements.

Deutsche Börse Group is a listed company, which, among other activities, operates the Frankfurt Stock Exchange. It is the leading exchange and settlement organization worldwide by market capitalization. Our service range covers the entire service chain from trading to central counterparty services, clearing, settlement, custody, and the notary function. Deutsche Börse Group is committed to improving the efficiency of markets.

B. Comments on the March 2006 IOSCO Consultation Report

1. General Assessment

As an increasing number of exchanges worldwide change ownership structure in favor of publicly listed, for-profit entities, Deutsche Börse agrees that a formal assessment of the proper role of regulators is warranted. We therefore appreciate the aims of the consultation paper and the opportunity to make the following comments.

2. Specific Comments

B.2. (a) Key issues raised by the changing environment, balancing commercial and public interest functions: We question the assumption that a for-profit exchange would have a natural tendency to neglect its public interest function, as assumed in the report. We believe that it should be emphasized—as mentioned in the fourth paragraph of section B.2. (a) of the report—that for-profit exchanges are "cognizant of the commercial consequences of compromising high regulatory standards." Indeed, Deutsche Börse Group is strongly motivated to deliver high regulatory standards and maintain its reputation as a fair and orderly market organizer to earn the confidence of its customers and investors. This is in stark contrast to the statement in the report that for-profit exchanges' "management and widened shareholder base may be less attuned to, and less interested in, broader market interests."

In addition, under German law, the exchange is legally obligated to take the public interest into account. Stock exchanges, derivatives exchanges as well as commodity exchanges in Germany are regulated by the German Exchange Act (*Börsengesetz*) which entitles them as institutions under public law with partial legal capacity. The law obliges the operator of an exchange to build up a self-regulated organization (SRO), while a private company is required to make the exchange capable of functioning. In this context, Deutsche Börse Group operates the Frankfurt Stock Exchange (*Frankfurter Wertpapierbörse, FWB*). The German Exchange Act requires that the exchange involve

the Exchange Council—consisting of exchange members and other stakeholders—in important decisions related to the exchange (see below for more details).

***B.2. (b) Key issues raised by the changing environment; misuse of regulatory powers*:** We do not share the strong misgivings about a possible misuse of regulatory powers by profit-driven exchanges expressed in this section. There is compatibility between profit-orientation and self-regulation in that the provision of a neutral, fair, and transparent trading platform for an exchange operator is essential to maintain and attract customers and therefore to grow business. As described above, exchange operators are strongly motivated to maintain a reputation for fairness. Furthermore, as described in more detail below, exchanges—particularly in Germany—operate in a highly regulated environment, setting high standards for investor protection and control of market abuse and closely monitoring enforcement. This occurs through corporate governance standards, existing regulation and supervisory frameworks, as well as new initiatives underway at the EU level in the context of harmonizing financial markets.

If the exchange operator is itself a listed company, it needs to adhere to higher transparency and corporate governance standards than any other corporation, either by law or by an industry standard. In the case of Deutsche Börse Group specifically, as a listed company in Germany, it complies with the German Corporate Governance Code (*Deutsche Corporate Governance Codex*). The Code—finalized in early 2002 by a commission consisting of major stakeholders and appointed by the German Justice Minister—establishes rules for the management and supervision of German listed companies and contains internationally and nationally recognized standards for good and responsible governance. The aim of the Code is to make Germany's rules of corporate governance transparent for both national and international investors. Although the Code is not an act of parliament and therefore not binding in character, the supervisory board and the management/executive board of every listed German corporation must issue an annual declaration of conformity stating whether and how far it complies with the recommendations of the Code ("comply or explain"). The Executive and Supervisory Boards of Deutsche Börse Group have fully accepted the recommendations of the German Corporate Governance Code in order to create the conditions necessary for strong, internationally comparable corporate governance. To date, Deutsche Börse Group has put all suggestions of the Code into practice, e.g. varying lengths of terms of office for Supervisory Board members, performance-related compensation of Executive Board members, etc.

In addition, as described above, in Germany stock exchanges, derivatives exchanges as well as commodity exchanges are regulated by the German Exchange Act. As one of its objectives, the Act counteracts conflicts of interests. This is achieved through, for example, requiring that the Exchange Council—which consists of 24 members representing customers as well as other stakeholders—is involved in all decisions related to exchange regulation (including fees) and appointment of the management of the exchange. Strong influence among all parties involved in exchange trading deters Deutsche Börse Group, or other exchange operators, from misusing regulatory powers, such as through providing one-sided benefits to any party. In the case of Deutsche Börse

specifically, the rule books of the FWB clearly define the competencies of the FWB as defined by the German Exchange Act and provide a high degree of legal certainty. The rule book grants the right to the Exchange Council to enact the exchange rules and regulations (*Börsenordnung,* § 13 I *BörsG*). Rules for admission and exchange trading are detailed such that decisions are transparent, comprehensible, and reliable. The rule book has to be approved by the Exchange Supervisory Authority in the State of Hesse and must be in line with the legal framework provided by the Exchange Act.

Lastly, an exchange operator is under the supervision of its respective exchange regulator, which monitors whether the exchange operator complies with obligations arising out of the fact that it runs a regulated exchange. In Germany, exchange supervision maintains high market integrity through involvement of various authorities. The German Federal Financial Supervisory Authority (BaFin) monitors all trading activities, disclosure of price relevant information, director's dealings, and the rules of conduct. BaFin also investigates insider offences. The Trading Surveillance Unit (HÜSt) as an independent body of the FWB additionally monitors price discovery processes, rules and regulations, and open positions of specialists and brokers. It is instructed and supervised by the Exchange Supervisory Authority in the State of Hesse, which is mainly responsible for the legal and market supervision of the exchange. The most important duties of the Exchange Supervisory Authority are the supervision of the price formation processes, the investigation of violations against the exchange rules and regulations, and the supervision of lawful conduct by the exchange bodies. The authority is also in charge of the supervision of trading participants admitted to exchange trading.

Together, the compatibility between profit-orientation and self-regulation, the German Corporate Governance Code, the German Exchange Act, and existing exchange supervision effectively mitigate the risk that Deutsche Börse would misuse regulatory powers.

***B.2. (c) Key issues raised by the changing environment; financial risk and exchange viability*:** The report assumes that the for-profit operator of an exchange will be inclined to take on greater commercial risk than a mutual exchange, which the report concludes could jeopardize the stability of the exchange. It should be clear that for-profit operating entities of SROs have the requirement, incentive, and ability to manage risks strictly. For example, for Deutsche Börse Group, risk management is an elementary component of its management and control. Effective and efficient risk management is fundamental to safeguarding Deutsche Börse's interests (both in terms of corporate goals and continued existence). As such, Deutsche Börse has established an enterprise-wide risk management concept in terms of processes, roles, and responsibilities applicable to all staff and organizational entities of the company (including the FWB) to ensure that risk development can be identified and dealt with at an early stage. The risk management framework ensures that all risks—including operational risks, financial risks, project risks, and business risks—are recorded, assessed, controlled, and reported. Deutsche Börse's strong risk management program—which covers, for example, the risks associated with its cash and derivatives exchanges of loss resulting from the possibility of inadequate or defective systems and internal processes, of human or technical failure, of

inadequate or defective external processes, or of damage to physical assets—effectively mitigates the possibility of exchange failure.

Furthermore, risk management is strictly defined under German law. The German Stock Corporation Act (*Aktiengesetz*) states that the Executive Board must achieve appropriate measures, in particular an oversight system, such that developments threatening the continuity of the company are identified early (§91 (II)). Specific measures to achieve this aim are further defined in the Act. The German Commercial Code (*Handelsgesetzbuch*) outlines how company risk management goals and processes, as well as details on actions taken to mitigate specific risks, must be disclosed in management reporting and that such disclosure should reveal a realistic picture of the company (§315 (I) and (II) 2. a. and b).

C. Regulatory responses to exchange evolution; introduction: We would request clearer terminology where the heading "separation of functions within an exchange" is used. A clearer heading would be "separation of regulatory versus commercial functions within an exchange."

C.2 Separation of functions with an exchange, introduction: It may be interesting to add as an example the role of regulators versus operators in Germany, as described under comments to B.2. (b) above, to the discussion.

C.4. Oversight arrangements; (c) specific terms and conditions added to an exchange's authorization: The report notes: "Some jurisdictions of SC2 members have set minimum capital requirements for exchanges to maintain." We caution that minimal capital requirements are not relevant for exchanges. An exchange itself is a platform which facilitates transactions and does not take on the risk of counterparties meeting their obligations. If integrated exchange organizations also carry out post-trade activities, they need a bank license for this in many legislations, and therefore are already supervised by the competent authority responsible for the banking sector. In these cases, double regulation needs to be avoided.

D.1. Broader regulatory issues arising from the new business models; background; introduction: We would again like to emphasize that a for-profit motive is beneficial for customers and markets in that it provides incentives to innovate and develop market structures in the interest of both users and investors. At Deutsche Börse Group, examples of innovative additional services include the Automated Trading Program (ATP) introduced in spring 2004, the central counterparty (CCP) introduced in April 2003, and the periodic introduction of new exchange-traded fund products, among many others. These services have contributed to liquidity on the Frankfurt Stock Exchange, which ultimately benefits users.

D.7. Broader regulatory issues arising from the new business models; monopoly operation: The report questions the fairness of the fee-setting process in a situation of little or no competition. We would like to point out, first, that within Deutsche Börse fees are set with the involvement of the Exchange Council, as described in the response to B.2

(b) above. Second, we would also like to point out that competition of exchanges with off-exchange trading platforms is increasing. Combined with growing competition at a global level, this greatly enhances competitive pressure on all exchanges. In the US, the off-exchange competition is made manifest by the growing market share of alternative trading platforms (ATS). In Europe, the Markets in Financial Instruments Directive will give systematic internalizers and multilateral trading platforms (MTF) official status and put an end to any concentration rule that still exists in some legislations.

Furthermore, in this context it is interesting to note that operators driven by commercial motives are in fact under greater pressure to fulfill customers' needs (e.g., lower pricing) than member-owned exchange operators, since members' interests may conflict with those of their customers. As an example, the introduction of electronic trading, which lowers trading costs, may cut into the margins of members in the case of a member-owned exchange.

E. Conclusion and recommendations: We would like to point out that many of the final recommendations discussed in the report are being addressed at the European level through legal initiatives under the EU Financial Services Action Plan, such as the Prospectus Directive, the Market Abuse Directive, and the Markets in Financial Instruments Directive, among others. Related to ***recommendation 3*** in particular, we would caution against overregulation and for leaving as much leeway as possible for self-regulatory arrangements. As described above, SROs have a strong incentive to provide market integrity.

We look forward to reviewing the final report of the Committee on regulatory issues arising from exchange evolution in the coming months. We hope that you have found these comments useful and remain at your disposal for further discussion. If you have any questions please do not hesitate to contact:

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EALIC

European Association of Listed Companies AISBL-IVZW

Re: Public comment on Regulatory Issues Arising from Exchange Evolution
EALIC, the European Association of Listed Companies, promotes the common interests of European issuers on a European level. Its scope of activities includes the legal and regulatory framework specific to listed companies in general and to the issuing and trading of securities on European markets in particular.

EALIC was incorporated in December 2002 as an international non-profit association. Its current memberbase counts six national associations of listed companies, namely VEUO (Netherlands), ANSA and AFEP (France), ABSC-BVBV (Belgium), ASSONIME (Italy) and SEG (Poland). In addition, some seventy public companies from the mentioned countries, as well as from Portugal and Spain, are direct members of our association. As such EALIC represents many hundreds of leading issuing companies to date. A document describing who is who in EALIC is enclosed for your convenience. (*Enclosure 1*)

EALIC welcomes the initiative taken by IOSCO to consult with stakeholders regarding the regulatory issues that arise from the evolutions that stock exchanges have gone through in the last decades. As the representative association of listed companies in Europe, we take great interest in the developments surrounding stock exchanges and our members have been closely following the ongoing consolidation initiatives. Attached hereto, are two statements that we issued regarding the topic. (*Enclosures 2 and 3*) Our statement dated 26 June is dedicated to the impact of a concentration of stock exchanges on the regulatory and supervisory level.

As to the IOSCO Consultation Report dated March 2006, EALIC finds its contents very pertinent. We agree overall with the conclusions and recommendations of the Report and wish to underline, in particular, the necessity to address the conflicts of interest that might arise when a for profit or listed stock exchange also acts as a regulator.

We stay at your disposal to discuss the attached positions at your convenience.

Yours sincerely,

Dorien FRANSENS
Secretary General

Federation of European Stock Exchanges

I. Introduction and Summary

1. The Federation of European Securities Exchanges (FESE) welcomes the opportunity to respond to the IOSCO Consultation Report: "Regulatory Issues Arising From Exchange Evolution". FESE **supports the overarching objectives** of the Report with regard to updating the 2001 Report and raising the awareness of IOSCO members regarding the measures taken by other supervisors to address the issues they may be facing in relation to conflicts of interest.

2. Members of FESE, which account for nearly 40 exchanges in Europe, have extensive experience with the issues discussed in the Report. European exchanges have been at the forefront of demutualization and conversion to for-profit structure which have gained wide traction around the world today. These processes have in large part been driven by increased competition and technological innovation. Moreover, due to the unique experience of the European integration process, the regulatory environment faced by FESE members has also undergone major changes over the last decade, specifically in the last five years, with important consequences for the regulatory role of exchanges and their interaction with other market participants, investors and the market as a whole.

3. By and large we find the Consultation Report **clear, well written, and balanced**. Based on the experiences of our members, we broadly agree with the key recommendations of the Consultation Report, especially with regard to the recommendation of **greater cooperation between supervisors** and **information flow between exchanges and supervisory authorities**. Moreover, we believe that there is **no need for IOSCO to revise any of the standards** referred to in the report. Additionally, in the context of Europe, we **do not see any need** for **national authorities** to review and supplement the measures in place in their jurisdictions.

4. Our views on the issues raised in the Consultation Report, explained in further detail in the next section, can be **summarised** as follows:

- The implementation of the FSAP in the EU has meant that many of the traditional regulatory roles delegated to exchanges have been curtailed and/or taken over by the securities supervisors (the impact of these changes varies from country to country depending on the national legislation that existed before the FSAP). This **regulatory transformation** clearly mitigates the potential conflicts of interest that are defined in the Consultation Report, since the exchanges do not have

many of the roles assumed to create a conflict of interest with their demutualized, for-profit structures.

- On the other hand, exchanges have retained certain regulatory functions and/or share responsibilities with the securities supervisors in several areas. In all of these areas, the maintenance of high regulatory standards by an exchange does not contradict its for-profit purpose, but rather it is **a prerequisite for commercial success** through positive branding and reputation. This is because exchanges, irrespective of whether they are mutualised, demutualised, for-profit or not-for-profit, listed or unlisted, have an interest in ensuring that they offer **fair, orderly and efficient marketplaces** for buyers and sellers, whether these are members, users, or customers of members and users. To ensure that their markets are attractive to buyers and sellers requires surveillance by exchanges and their operators of transactions which are made subject to exchange rules and regulations and using exchange approved facilities. That is as much a commercial imperative as a regulatory imperative.

- Fairer markets attract investors; thus, demutualization and conversion to for-profit structure does not conflict with a commitment to high regulatory standards. FESE's members' continuing commitment to the highest standards of self-regulation, whether they be demutualized, private or not, proves this.

- In addition to the market incentives for good regulation, an exchange also enjoys **proximity** to its market, which allows surveillance of its markets and users in a manner that is impossible for supervisors receiving delayed transaction reports and other market information. For all these reasons we **caution against regulators taking over SRO tasks** and **intervening unduly** in the internal structure of exchanges.

- Exchanges and supervisors share a common strong interest in a well regulated market. Both in the EU context and more globally, the market operator / regulator relationship works best when it operates as a "**partnership"** - there must be a shared understanding between market operators and regulators given their common desire and purpose in ensuring and maintaining well regulated markets. This partnership needs to be based on high-level international standards regulating not just the relationship between exchanges and regulatory authorities but also for the roles and responsibilities of regulatory authorities (e.g. for investment firms, multilateral trading facilities (MTFs) and exchanges). The EU's FSAP sets out high standards for these areas in Europe. Complementary to this, the IOSCO principles could provide the basis of a global convergence to high level standards that minimize regulatory arbitrage.

- Finally, the Report should more explicitly recognise that **evolution does not only mean demutualization** or conversion to for-profit structure; it includes, for example, the emergence of systematic internalisers and MTFs/ECNs. These developments raise some problems which also need to be taken into consideration in any analysis of the evolution of the role of exchanges.

5. Below we provide our comments in the following structure:

   II. Comments on the four basic findings of the study;
   III. Comments on the two main questions posed by the Report; and
   IV. Comments on the Report's conclusions and recommendations.

II. Comments on the four basic findings of the study (Section E)

6. The fundamental purpose of exchanges is to allow multiple buyers and sellers to come together to set prices at which they will buy and sell financial instruments. Exchanges, irrespective of whether they are mutualised, demutualised, for-profit or not-for-profit, listed or unlisted have an interest in ensuring that their marketplace offers a fair, orderly and efficient environment for

buyers and sellers, whether these are members, users, or customers of members and users. To ensure that their markets are attractive to buyers and sellers requires surveillance by exchanges and their operators of transactions which are made subject to exchange rules and regulations and using exchange approved facilities. That is as much a commercial imperative as a regulatory imperative. In fact, demutualization might reduce the conflicts of interest in certain areas (this is hinted at, but could be discussed more extensively, in Section B2a of the Report).

7. In addition to the market incentives which foster good self-regulation by exchanges, which apply at a global scale, there are also factors more specific to the EU that mitigate the potential conflicts of interest. Namely, the regulatory role of exchanges has undergone a major change as a result of EU legislation (FSAP) over the last five years, affecting all of the main areas mentioned in Section B1. For example, the **Market Abuse Directive** has shifted the primary responsibility for detecting and preventing market abuse to competent authorities. The **Prospectus Directive** has shifted the responsibility for approval to competent authorities (existing delegation of powers to cease by 2008 unless a Commission study finds otherwise). Similarly, as acknowledged by the Report on pages 13 and 15, the **Markets in Financial Instruments Directive (MiFID)** establishes a common framework for the regulation of exchange members, exchanges, users of MTFs, and MTFs. In addition, issues such as access to regulated markets and governance structures have been clearly addressed in MiFID.

8. In our view, the discussion of the potential conflicts of interest discussed in Section B2 in the context of the EU needs to take into account the large extent to which the new regulatory framework limits the scope of potential conflicts of interest.

9. On the other hand, these changes do not mean the elimination of each and every self-regulatory role for exchanges in the EU. While regulatory authorities in certain countries, and certainly those in the EU as described above, might have been given prime and/or statutory responsibilities for authorisation and ongoing oversights of investment firms (including credit institutions), prospectuses, listings, market abuse, and oversight of exchanges, it is exchanges that have the technical and human expertise and resources to monitor intra-day trading, transactions, and, particularly in the case of derivatives exchanges, positions. For example, although the above-mentioned directives limit the direct regulatory role of exchanges in Europe, regulated markets still continue to have certain functions which are vital to securing safe and orderly markets, as explicitly recognised in these directives.

10. For example, despite the changes introduced by MAD as described above, trading surveillance remains part of exchange responsibilities, which requires exchanges and regulators to work closely together in monitoring for, detecting, and investigating potential market abuse (see, for example, the provisions related to the prevention and detection of market abuse as established in Article 6 Para 6 of MAD and Article 43 of MiFID). Competent authorities are in many cases too remote from trading to detect abuses and rely heavily on exchanges to identify market abuse, although the competent authorities might then assume primary responsibility for investigating the suspected abuse. Prevention is difficult; enforcement action will discourage abuse and rules and regulations state what is abuse, but that is not the same as prevention. Hence, there is a strong argument for competent authorities and exchanges to be "**partners"** in ensuring the integrity of markets.

11. Consequently, regulatory authorities and exchanges ***share*** responsibility for market integrity; without an enormous increase in the resources of regulatory authorities that is likely to continue to be the situation for the foreseeable future, which is why exchanges continue to perform a certain set of regulatory functions important to the quality and integrity of the market.

12. The model established in the EU largely corresponds to such a partnership model. This "partnership" requires on the one hand regulators not to intervene in key areas that could restrict

the capacity and approach of the exchange to determine its self-regulatory functions. On the other hand, it requires a regulatory framework set by law that takes into account the needs of an exchange to carry out its self-regulatory functions. While the FSAP is a very good basis for this framework, the FSAP measures may need to be revised at some point in the future with the purpose of bringing the different provisions fully in line with the requirements of a partnership model as described above.

13. There are also some aspects of the FSAP Directives where the shift of the supervisory responsibility from regulated markets to competent authorities – in conjunction with greater potential fragmentation of trading due to proliferation of execution venues - might bring new challenges to the marketplace as a whole. For example, the three different venues provided for post-trade transparency for investment firms to execute their obligations under Article 27 and 28 of MiFID, of which regulated markets is only one option, could lead to data dispersion with unpredictable consequences for price transparency and best execution. Thus, the Report should note that, while most of the steps undertaken by securities lawmakers and regulatory authorities *"to ensure that exchanges continue to perform regulatory functions in a proper manner"* have been appropriate, some of the steps taken towards these or other objectives may have unintended consequences that frustrate these objectives.

14. We agree in principle with the approach taken in Section D2 summarised by the statement that the "*challenge for regulators is to allow normal commercial practices as much freedom as possible but to recognize that in the exchange environment they also need to protect the principles of pricing integrity, client interests and best execution. This requires regulators to have both clear principles in respect of incentive schemes and a good understanding of the incentive schemes being used by trading platforms, whether located in their own jurisdiction or offering competing services from external locations."* However, as all of these regulatory principles are already addressed in the EU context via the FSAP measures, we see no need for the authorities to consider additional measures to ensure competitive behaviour in the context of the markets where FESE members operate. Of course, IOSCO provides the perfect forum for regulators to learn from each others' experiences as regards revising regulatory standards in face of technological and product change, and the EU's experience should be illuminating in this process.

15. Regarding Section D4 c) "Cross-border corporate groups", although we agree with the overall analysis in this section, we would like to underline that the regulatory and supervisory efficiency of the overall framework established by the Lamfalussy process has a very important impact on the regulatory role of exchanges. The efficiency of the supervisory and regulatory cooperation has to continue to improve in order to facilitate cross-border groups such as Euronext or OMX among the FESE membership. For example, some aspects of the implementation of MAD have already been identified as obstacles to the smooth operation of the cross-border supervision of such groups.

16. We agree with the need to consider the pressure on regulatory authorities in Section D8 and believe that more attention needs to be paid to these pressures.

17. To the extent that commercial functions can be considered to create conflicts of interest for the regulatory role of the exchanges, it should be recognised that exchanges can employ a variety of effective methods to ensure that their regulatory functions are not impacted on negatively by their commercial functions. Our members employ a range of tools in this regard.

18. We agree with the need to consider conflicts and inconsistencies between exchange and listed company legislation (Section D9). In our experience, these conflicts are adequately addressed by the Prospectus Directive and the Transparency Directives which have shifted the duty of enforcing initial and ongoing disclosure obligations to the competent authorities.

19. The financial resources of exchanges in Europe are regulated in MiFID which mandates that a regulated market must have *"available (…) on an ongoing basis sufficient resources to facilitate its orderly functioning."* (Article 39(1) (f)). Thus we see further capital requirements for exchanges as unnecessary and support the EU's decision not to impose any such requirements as outlined in the White Paper for Financial Services Policy 2005-2010.

20. With reference to D3, we would like to note that the extension of exchange activities to new fields is in itself a positive thing for the shareholders and the users. Such innovation creates benefits to customers and to the market as a whole.

21. Similarly, we see outsourcing (D5) as an essentially positive outcome for the exchanges' customers since it allows exchanges to use specialist expertise. Since the regulatory obligations remain with the regulated entity, i.e. the exchange, there is no risk of reduced oversight of the activity that is outsourced.

22. Finally, we agree that when exchanges have decided to self-list (B2d), *"all the jurisdictions of SC2 members have considered specific measures and taken appropriate steps to deal with the particular conflicts and issues that arise."* Self-listing is a practice that has taken place in many jurisdictions without any negative consequences for the investors or the market as whole.

23. Moreover, self listing (and more generally listing) has proven to be very effective in reducing the impact of conflicts of interests in listed stock exchanges. Particularly the broadening of the shareholder base decreases the conflicts of interests deriving from the overlapping of owners/users that characterises the mutualized exchanges. In addition, listed exchanges are subject to thorough market scrutiny, in particular over managerial choices. Listed exchanges are more flexible with regard to fund-raising, and therefore can easily finance IT development, strategic alliances. The status of a listed company strengthens corporate disclosure and enhances governance.

III. Comments on the two main questions posed by the Report (Section E, page 29):

> *(i) Do the existing regulatory requirements for exchange licensing/registration and operation continue to be adequate and easily adaptable to the emerging issues or are new tools necessary?*
>
> *(ii) How should the new business activities of exchanges be considered and included in the regulatory framework?*

24. We consider that the existing regulatory requirements for exchange licensing/registration and operation in the aftermath of MiFID in particular are fully adequate and easily adaptable to the emerging issues and that no new tools are necessary. Moreover, the FSAP rules and/or national rules in the EU are sufficiently flexible to take these into account.

IV. Comments on the Report's Conclusions and Recommendations (Section E)

25. In line with the observations we have made above, and by way of summarising our **main conclusions**, we would like to provide brief comments on the Report's conclusions below:

    - We support the recommendation with regard to closer *"ongoing dialogue with exchanges"* in the Conclusion 1.

- While we support the general principle that *"[r]egulatory authorities should assess whether the changes being made by exchanges require any adjustments to the regulatory framework for an individual exchange or for exchanges generally, and should address any such need for changes promptly",* as we have outlined above, we believe that the post-FSAP environment effectively addresses conflicts of interest for exchanges both by limiting their regulatory role and also by establishing measures to address potential conflicts of interest.
- The principle that *"Regulatory authorities should carefully assess the impact on resources of any changes to the regulatory model for exchanges, and ensure that the core regulatory obligations and operational functions of exchanges are appropriately organized and sufficiently resourced"* is supported. On the other hand, we caution against regulatory authorities taking over or unduly interfering with SRO tasks.
- Moreover, we believe that MiFID adequately addresses these concerns in the EU by allowing market operators sufficient room to design and employ their own sophisticated risk management techniques. In this context we support the EU's decision not to impose any additional requirements in this area.
- We support the recommendation that *"regulatory authorities should be prepared to share relevant information concerning cross-border activity"* and believe that CESR sets the appropriate context for such exchange of information to occur. As pointed out above, the EU has made great progress in this area through the establishment of the Lamfalussy process and this progress should be continued by streamlining supervisory and regulatory cooperation.
- Above all, we should note that competition among exchanges occurs more and more at a global level and acts as an important competitive force. Furthermore, if implemented well, the regulatory environment set up by the FSAP can be expected to reinforce these competitive market forces in the context of Europe and play a key role in addressing the policy concerns raised in this Report.

French Association of Investment Firms

A. WHO WE ARE

The French Association of Investment Firms (AFEI) represents investment service providers active in France. Its members include more than 120 investment firms and credit institutions authorised to provide investment services. Approximately one-third of AFEI members are subsidiaries or branches of foreign institutions. The majority of AFEI members operate in the fields of equities and derivatives and are members of the major European financial exchanges. AFEI has joined IOSCO as an affiliate member in April 2005.

The Association is contributing to all major public policy discussions impacting its members, at national, European or international level.[5] AFEI has notably already contributed on several occasions to the discussions about the developments in exchanges, alone or in collaboration with other associations in Europe and worldwide.[6] We therefore appreciate the opportunity to express here the views of our members on the important issues arising from exchange evolution.

B. KEY MESSAGES

The consequences of exchange evolution are increasingly being debated in Europe, as well as in other regions of the world.[7] Our comments mainly relate to cash equity exchanges but can be extended to derivatives exchanges. Our main observations are the following:

(i) **AFEI welcomes IOSCO's initiative** on this crucial topic. Although the organisation of markets differs in the different regions of the world, potentially meaning different issues and different focus of attention from regulators and market participants, there are a growing number of **common concerns**. As a striking sign of this change, the International Council of Securities of Association (ICSA, of which AFEI is a founding member) is currently discussing a position paper outlining high-level principles for the governance of market infrastructures. AFEI largely contributed to this work and strongly supports the conclusions reached.

(ii) Both demutualization and consolidation of exchanges could bring significant efficiency benefits to market participants. However, AFEI argues that these processes raise a number of **issues which had not been anticipated** and which now must be addressed in order to reap the full benefits of recent and future developments.

(iii) The IOSCO consultation report provides a very good general overview of the different issues arising from exchange evolution. However, concerns in Europe are now focused primarily on competition issues, including the organisation of post-trading services, and potential conflicts of interest between users and shareholders. The recent reports by the UK Competition Commission and by the European Commission[8] illustrate the importance of the discussions

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[5] Our position papers and answers to consultations are available on our website (www.afei.com).

[6] References include:
"Statement of Principles to be applied to the Consolidation of Stock Exchange and Infrastructure Providers in Europe", Joint Statement AFEI/Assosim/FBF/LIBA/SSDA, 3 Feb. 2005 (enclosed in the attached Appendix);
"Market Infrastructures in Europe: The Right Governance Models", Discussion Paper, AFEI/05-26, 3 May 2005;
AFEI submissions to the UK Competition Commission inquiry into London Stock Exchange mergers, AFEI/05-0470, 22 April 2005, AFEI/05-38, 28 May 2005;
"Post-trading in Europe: Calls for consolidation", Joint Statement AFEI/Assosim/FBF/LIBA, 20 February 2006;
"Draft Principles for the Governance of Market Infrastructures", Working Group on the Governance of Market Infrastructures, International Council of Securities Association (http://www.icsa-intl.com/), May 2006.

[7] See recently the special issue of the *Revue d'Économie Financière*, The future of financial exchanges, no. 82, April 2006 (www.aef.asso.fr).

[8] *"Report on the proposed acquisition of LSE plc by Deutsche Börse AG or Euronext NV"*, UK Competition Commission, November 2005 (http://www.competition-commission.org.uk/rep_pub/reports/2005/fulltext/504.pdf);
"Draft working document on post-trading", European Commission, DG Internal Market, 23 May 2006 (http://ec.europa.eu/internal_market/financial-markets/docs/clearing/draft/draft_en.pdf);

and the underlying stakes. Although the present IOSCO report touches on competition problems (in section D in particular), AFEI believes it does not fully account for the **concerns of market users in Europe**, and possibly, in other regions of the world.[9]

(iv) Our analysis of the exchange industry and our experience of the recent developments in Europe lead us to the following key conclusions:

- Exchanges **affect public interest** in many ways, a situation that demands appropriate governance arrangements and close regulatory scrutiny;
- In particular, AFEI draws attention to important **competition concerns** and **potential conflicts** between shareholders' interests and the interests of the wider community of market participants in the management and evolution of exchanges;
- In the light of these concerns, AFEI calls for users to have **a strong and effective voice** in the exchange governance to ensure that market users continue to share the benefits of technical progress, market development and falling costs. Clear and transparent financial policies providing guidelines for the sharing of financial surpluses may be needed to ensure a proper balance of interests;
- AFEI also calls for a clear **separation of activities** between trading and clearing and settlement, and between settlement infrastructures and custody and banking activities, to prevent hidden cross-subsidies and other forms of uncompetitive behaviour;
- Specific provisions in the by-laws of the exchanges and other infrastructure providers should be included to reflect their public interest dimension.

(v) Important **consolidation moves** involving European exchanges are currently being discussed and will probably be soon concluded. They will have major impacts on the organisation, integration and efficiency of financial markets. Users' voices and future competition rules have to be taken into consideration. Governance rules will have to be set up to ensure that the future developments of these collective infrastructures meet the **global objectives and needs of market participants**, and not only the financial rationale of shareholders. The regulatory framework applicable to the consolidated entities should also be clarified, with the view to deliver both certainty and efficiency.

(vi) In light of the dramatic changes that exchanges and other infrastructures providers are experiencing, **IOSCO** should continue investigating these issues and promote close cooperation between national regulators.

"Competition in EU securities trading and post-trading", European Commission, DG Competition, 24 May 2006 (http://ec.europa.eu/comm/competition/antitrust/others/securities_trading.pdf).

[9] See press release, *"AFMA seeks conditions on ASX/SFE merger"*, Australian Financial Markets Association, 2 May 2006.

C. DETAILED COMMENTS

Public interest

The role of capital markets in the financing of the economy, and the need to prevent systemic risk, obviously mean that regulators take a specific interest in the sector, with the aim of ensuring both secure and efficient markets and low capital costs. Although modern stock exchanges have become much more standardized, because of the demutualization process and the development of electronic trading platforms, they still play a unique role in financing economic activity, in promoting liquidity and in price formation. We therefore agree with IOSCO that *"there is a strong public interest in exchanges operating their markets in a way that promotes market efficiency and commands market confidence"* (p. 6).

In order to ensure the integrity, stability and efficiency of financial markets, regulators must address several important issues:

- Potential conflicts between the commercial interests and regulatory obligations of exchanges;
- Potential competition issues when exchanges and other market infrastructures (clearing and settlement infrastructures) have dominant positions;
- And, generally, potential conflicts of interest between owners and users, or, put differently, mismatch between on the one hand, the for-profit purpose of the company and the shareholder value philosophy, and, on the other hand, the general interest of market participants.

These points are discussed below, as well as possible appropriate responses.

Regulatory role of exchanges

Much of the IOSCO report focuses on the potential conflicts of interest between the exchange's commercial and regulatory activities. In Europe, this particular concern has become less of an issue as the general trend has been to reduce the self-regulatory role of exchanges following demutualization, with government regulators assuming most of the exchanges' regulatory responsibilities.

AFEI believes that, when exchanges have self-regulatory functions, they should ensure that potential conflicts of interest between their commercial and regulatory activities are addressed through appropriate and transparent structures, policies and procedures, under close scrutiny of relevant regulatory authorities. Several options can be investigated, as discussed in Section C of the IOSCO consultation report.

Competition issues arising from dominant positions

More relevant from a European perspective are competition issues in the exchange industry. Infrastructures for trading, clearing and settlement involve positive network externalities and economies of scale which indeed are likely to lead to dominant positions. For trading, externalities arise from liquidity effects when order flows are pooled, as rightly described in the IOSCO report (p. 27).

In Europe, examples of competition for trading (e.g. with the launch of the Dutch Trading Services by the London Stock Exchange) have prompted incumbents to modernise and to reduce fees, without

succeeding in diverting significant volumes of activity. Furthermore, competition authorities have concluded that off-exchange trading (ATMs, OTC, internalisation) is not a competitive constraint for exchanges. DG Competition also notes (*op. cit.*, p. 6): *"Demutualization has stimulated investment and innovation. However, it has only to a very limited extent led to greater competition amongst services providers"*.

Demutualisation and on-going consolidation heighten concerns that a small number of infrastructures may emerge as dominant players in a number of markets, leading to the potential for monopolistic pricing and other forms of uncompetitive behavior. Therefore, it may well be the case that exchanges are not *"operating in a more competitive market services environment"* (IOSCO, p. 5), but, on the contrary, are benefiting from increased market power.

Failing appropriate arrangements and safeguards, demutualised for-profit exchanges may be tempted to benefit from their quasi-monopolistic situation by charging non-competitive prices and reducing services. Such practices would increase transaction costs for final investors and decrease the overall efficiency of markets.

Heightened concerns in the case of vertically-integrated models

Vertical integration between exchanges, CSDs and CCPs adds further to concerns about distorted competition. Several examples of vertically integrated business models exist in Europe, including in Germany, Spain and Italy, based on possible economies of scope between trading, clearing and settlement. However, such economies of scope and the advantages of vertical integration are hotly debated. More importantly, silos create potential for severe competitive distortions:

- Use of dominant position on one segment limiting and/or distorting competition at other levels,
- Risks of restricted access, bundling and cross-subsidies,
- Lack of transparency in pricing structures and unfair prices.

The recent report of DG Competition (*op. cit.*, p. 2) confirms: *"Vertical integration may result in foreclosure at all levels of the value chain and therefore lead to welfare losses. Whilst there may also be efficiencies, so far the Commission has not seen convincing evidence to substantiate this."*

Clear vertical separation of activities

To mitigate those concerns, AFEI believes – as the majority of users in Europe[10] and in other parts of the world – that activities must be clearly separated. Where possible, trading platforms and clearing and settlement infrastructures should be owned separately. And in all cases, there must be an effective separation between trading and clearing and settlement. The separation of activities should be supported by appropriate arrangements, including separate charges for the different activities, designed to ensure that the risks of hidden cross-subsidies and other forms of unfair competition have been adequately controlled.

[10] See for instance *"The future of clearing and settlement in Europe"*, Bourse Consult, City Research Series n°7, Dec. 2005. The report indicates that *"The majority view was that exchanges should not control the post-trade process"*. It concludes with the following: *"The existence of vertically-integrated structures is an obstacle to rationalising the European post-trade infrastructure.*

Similarly, settlement infrastructure services should be separated from other risk-based, value-added activities. Separation will prevent potential bundling and cross-subsidies from creating competitive distortions with other banking players. A further dimension, which is risk-related, also supports this view, as systemic risk tends to increase when both banking and infrastructure activities are combined in a single entity. Value-added activities, subject to competitive market rules, should thus be operated by a company (normally a bank) with no privileged access to infrastructures and with separate board and management, and under prudential supervision and banking laws.

Specific governance arrangements to give users top priority alongside shareholders

Exchanges should adopt robust and durable systems of corporate governance which give users a strong and effective voice. Users must be consulted in advance about contemplated changes in tariffs, business terms and development projects. More generally, they must be able to influence the range and quality of services provided by the market infrastructures.

One way to ensure a proper balance between users' and owners' interests is by establishing clear and transparent financial policies providing guidelines for the sharing of financial surpluses between owners and users. Looking at the recent trends in the valuations of exchanges and in the distributions of dividends to their shareholders, it is quite apparent that the benefits of the increases of productivity – highly probable given the increases in traded volumes – have been directed to the remuneration of shareholders, leaving little room for cost reduction to users. Clear governance arrangements are therefore needed to avoid any abuse of dominant position and ensure fair treatment of users: owners should be able to earn a reasonable return from operational and market efficiency and innovation; improvements in costs and quality beyond that level of return should be shared with market users.

Cross-border consolidation of exchanges

Cross-border consolidation, including transatlantic mergers, further complicates the picture. It may be desirable insofar it would yield significant benefits through economies of scale and cost reduction for users. However, such moves will further reduce competitive pressures on exchanges, as discussed earlier, and appropriate mechanisms should be in place to ensure that the users of the exchanges benefit from the corporate actions engaged.

Other concerns arise as regards the consideration of the specific needs of the constituent domestic markets by the consolidated entities and the applicable regulatory framework.

First of all, AFEI believes that the respect of the local dimension is necessary, notably in areas such as rules for market access, listing and trading, together with surveillance arrangements, index composition, and, the design and implementation of technical systems. It can be ensured by appropriate local management representation and continued contacts between the management of the exchange and the local financial communities.

Second, the emergence of global exchanges calls for close cooperation between regulators. Potential divergences in views between regulators may emerge. Regulators, exchanges and market participants should work in anticipation of the contemplated cross-border mergers to clarify the applicable regulatory framework and the consequences for the different markets, with the view to deliver both certainty and efficiency.

Role of IOSCO

AFEI welcomes the recommendations put forward in the IOSCO consultation report. In the light of the issues identified and of the concerns expressed by market users, AFEI urges IOSCO to continue investigating the topic and to promote close cooperation between national regulators, in particular with jurisdictions where exchanges are contemplating demutualization and listing. Regulatory authorities should carefully consider competition issues and liaise with relevant domestic or regional competition authorities. Finally, IOSCO should serve as a forum to discuss the impact of the emergence of global exchanges on the evolution of the national and international regulatory framework.

Appendix

LIBA
AFEI ASSOSIM FBF SSDA

STATEMENT OF PRINCIPLES TO BE APPLIED TO THE CONSOLIDATION OF STOCK EXCHANGE AND INFRASTRUCTURE PROVIDERS IN EUROPE

3 February 2005

There could well be very important changes in the machinery for trading, c1earing and settling shares throughout Europe in the near future, as a result of proposals to merge with European Stock Exchanges. The turnover of Europe's exchanges and post-trade infrastructure is modest by the standards of major industries such as chemicals, construction or banking. However, the role of securities markets in the European Union is all-pervasive. It directly effects many thousands of public companies; millions of personal investors; the pensions, insurance and savings of almost of every household; and, last but emphatica1ly not least, the financing of public sector activities.

Members of the London Investment Banking Association are together responsible for most of the turnover of the London Stock Exchange and a very substantial fraction of the trading undertaking on most other European Bourses together with the members of the Associations mentioned above (AFEI, ASSOSIM, FBF, SSDA). They have therefore considered carefully the principles which, as the dominant users of stock exchanges, they believe should be followed in future changes in stock exchanges and their infrastructure. Following such principles is central both to lowering the cost of capital in Europe, and to widening and deepening its markets. Since these principles and goals are essential to the interests of the wider public and economy, we are releasing them in the attached detailed public statement. In brief the issues are:

a) how best to ensure that market users continue to share the benefits of technical progress, market development and falling costs;
b) how to avoid conflicts of interest, cross-subsidy and distorted competition.
Between the various stages of trading, clearing and settlement, there must be segregation or full separation of these various processes.
c) that the exchanges and other infrastructure providers should adopt robust and lasting systems of governance which assure and underwrite these objectives and standards, and give users a top priority in the affairs of their companies alongside shareholders.
d) that the impact on all relevant downstream markets is duly evaluated.

LIBA has shared these ideas with representatives of the Securities Industry in other European Countries, in particular with AFEI and FBF in France; ASSOSIM in Italy; and SSDA in Sweden These Associations support the principles outlined in the attached statement, save that SSDA believe that a full separation of post-trade activities may not be appropriate for certain aspects of the Swedish market. In addition, AFEI and FBF stress that the consolidation of exchanges will further reinforce the domination of existing central clearing and settlements infrastructure (CCPs and CSDs) and may impact competition in custody and banking markets. They request the unbundling of CSDs from for-profit competitive custody and banking operations to ensure fair competition in these markets.

LIBA AFEI ASSOSIM FBF SSDA

PRINCIPLES TO BE APPLIED TO THE CONSOLIDATION OF STOCK EXCHANGES AND INFRASTRUCTURE PROVIDERS IN EUROPE

A. OVERALL OBJECTIVE

To promote the further healthy development of the European Capital Markets, they must achieve over time the lowest overall costs of trading and post-trade services combined with the greatest responsiveness to users' and customers' needs.

The term "overall costs" means **the total end-to-end** cost of trading, clearing and settlement; and the internal costs incurred by market users when purchasing those services, including their costs of associated investment.

B. PRINCIPLES FOR TARIFF AND RELATED POLICIES OF EXCHANGES AND INFRASTRUCTURE PROVIDERS.

At all times, tariffs and terms of business should be so designed and implemented that:

1) **Exchange and Infrastructure providers (owners) are able to earn a reasonable return** from operational and market efficiency, and innovation. Improvements in costs and quality beyond that level of return should be shared with market users.

2) a) Pricing should be **transparent;** based **on published tariffs;** and be properly **related to production costs;**
   b) Vertically integrated organisations should **charge separately** for trading, clearing and settlement;
   c) Different categories of security may call for different tariffs, for example cash equities and derivatives;
   d) users should benefit from fair access to the infrastructure;
   e) Terms of business should reward/encourage members who **bring liquidity to the market;**
   f) **Owners should collaborate actively with ail market participants** to improve the range and quality of services provided to the market place;
   g) Rules on the management of risk, crises, market interruption and similar issues must be transparent; and include proper arrangements for the liability of infrastructures.

3) **Market users should be consulted sincerely and well in advance about changes in tariffs and terms of business, and development projects.**

C. GENERAL PRINCIPLES FOR THE EVOLUTION AND CONSOLIDATION OF THE TRADING MARKET PLACE

1) Providers of Trading, Clearing and Settlement Services must seek to minimise market users' costs over time.

The term "Users' Costs" includes not only the charges of service providers (“direct costs”), but also the internal expenses incurred by the market in purchasing their services, including the

market's costs of investment.

2) To give effect to the commitment to falling costs and involvement in proposed changes in services, owners should adopt robust and durable systems of corporate governance which give users an appropriate and effective voice and influence, Governance should reflect both the pattern of ownership and the composition of the users in the markets which the organisation serves.

a) **Central Clearing and Settlement Services** should be provided by organisations whose ownership, governance and resource allocation procedures are designed to ensure that users' interests are given a top priority.

b) **Central Clearing and Settlement Providers** should be owned by users, broadly in proportion to usage.

c) Where possible Trading Platforms and Central Clearing and Settlement operations should be owned separately.

d) Where there is the **same ownership of Trading, Clearing and Settlement, there must be effective separation, so that all conflicts are effectively handled in a way which commands market confidence**.

e) **Methods which would contribute to such segregation/separation include**:

- separate companies with their own distinct constitutions; total separation of financial accounts;
- total separation of technical platform;
- systematic avoidance of transfer pricing and cross-subsidy; periodic external audit and review by independent and respected entities; and
- appropriate oversight, if needed, by National and International Regulatory Authorities.

f) The organisation for settlement must serve users on fair terms.

g) Exclusive arrangements between trading platforms and CCPs and between CCPs and CSDs can only be justified on grounds of efficiency and investor protection.

D. SPECIFIC PRINCIPLES NEEDED IN PRESENT CIRCUMSTANCES

1) Proposals for change arising in the present corporate actions should:

a) be designed to promote and deliver further market efficiency through standardisation, harmonisation and inter-operability and, where appropriate, further consolidation.

b) **Contribute to competition between trading platforms by ensuring**:

i) **low switching charges** for users wishing to move from one trading platform to another;

ii) **fair access** to Clearing and Settlement Systems for new entrants wishing to compete with incumbent trading platforms.

iii) that **providers of Clearing and Settlement Systems are able and willing to invest in systems, procedures and capacity** including connections between Clearing and Settlement Systems - which providers of trading services may require.

2) Decisions that a given exchange should change central counter party or settlement provider/location should be taken by **common agreement between users and owners of trading platforms**.

3) **Proposals for change must strike a careful and appropriate balance between:**

(a) Limiting wasteful, duplicative investments; and

(b) Recognising the costs to users of a move away from established systems and procedures.

International
Capital
Market
Association Ltd

International Capital Market Association

The International Capital Market Association is the self-regulatory organisation and trade association representing the investment banks and securities firms issuing and trading in the international capital market worldwide. ICMA's members are located in 48 countries across the globe, including the world's main financial centres, and currently number over 400 firms in total. ICMA performs a crucial central role in the market by providing and enforcing a self-regulatory code of industry-driven rules and recommendations which regulate issuance, trading and settlement in international fixed income and related instruments. ICMA liaises closely with regulatory and governmental authorities, both at the national and supranational level, to ensure that financial regulation promotes the efficiency and cost effectiveness of the capital market. www.icma-group.org. Moreover, ICMA is an affiliate member of IOSCO.

Overall, we widely agree with IOSCO's analysis; its conclusions and recommendations are unexceptionable. We acknowledge of course that practices vary widely among IOSCO members. However, we believe that it could be most valuable and in the interest of both, the regulatory and market communities, if SC2 made increased efforts to work out more definitive consensus on important questions.

On some of the sections of your consultation report, we have the following comments:

Fragmentation of markets

According to our observations and projections, IOSCO may not be right in placing too much emphasis on market fragmentation as a driver for regulatory development. As the report notes on page 8, fragmentation is more a potential than a reality.

Over the past years, if anything, markets have become more concentrated in the hands of long-standing dominant exchanges – and this process continues, even at an accelerating pace.

- In many jurisdictions, regional exchanges have, over the past decade(s) merged to form central market places per jurisdiction.
- Cross-border consolidation has already taken place in Europe (Euronext, OMX Exchanges, SWX/virt-X, etc.) and will continue.
- We have seen the NYSE/Archipelago and NASDAQ/INET mergers in the US.
- Important further intra-European or transatlantic merger negotiations are taking place.

At the current juncture, it is by no means clear to us that the MiFID regime in Europe - bringing about, among others, the end of the concentration rule - will lead to a growth in MTF or systematic internaliser rival venues.

Balancing commercial and public interest functions

We agree with IOSCO as to the central risk to the public interest as set out at the top of page 9. Where we do not agree, is the assertion that for-profit exchanges have increased incentives to deliver high regulatory standards compared with mutualised exchanges. That claim, understandably made by for-profit exchanges, appears based on their operating in an increasingly competitive environment which, as noted above, is not necessarily the case.

In fact, there is little competition between exchanges for trading volumes, at least in equity markets, and non-exchange competitors are being absorbed. The description of the lack of opposition of most for-profit exchanges to the mandatory loss of regulatory powers speaks powerfully to their true position.

Misuse of regulatory powers

The analysis section is correct as far as it goes and the two sub-issues identified by IOSCO are certainly of high relevance.

A truly comprehensive analysis of the problem should, however, include an additional factor: the lobbying strategies by exchanges to legislators (national and supra-national, as in the EU) and

regulators (and their international bodies). In many situations, exchanges - in the purported defence of investor protection or market integrity - seek changes to regulation, or the maintenance of the status quo, which will damage the competitive position of new, innovative and often lower priced and more efficient competitors. Competition is a competitive tool, as many sophisticated market participants understand well.

We observe that regulators are sometimes unwilling to recognise this and propose to IOSCO to address the issue in an appropriate way.

Uses of regulatory income

We fully subscribe to IOSCO's observations in section B.2.(b)ii and strongly support its conclusions.

Conflicts due to self-listing

We also share the observations of IOSCO in section B.2.(d) and believe that the answers to both questions posed in this section should be strong negatives.

The conflicts of interest inherent in self-approval of initial listing and ongoing regulation of the exchange as an issuer (as discussed in this section) can in our view not be solved in any way that generates confidence in investors and other market participants as to the independence of the functions. We therefore strongly support the position of those regulators identified in the paper as having recognised this and we suggest that IOSCO should firm up its recommendations and conclusions in this regard.

Governance arrangements

The logic of the discussion on exchanges owned or controlled by third parties appears to us to point clearly in the direction of IOSCO recommending that regulators adopt the policy ascribed at the end of the section to the UK's FSA. That policy is described with specific regard to "foreign controlled" exchanges. We actually see no particular reason for this limitation and suggest a more comprehensive policy approach.

Restrictions on ownership

We recognise that there should be criteria for determining who may own or control an exchange. Many regulators have powers to approve owners of significant shareholdings; it appears to us, however, that often these powers are undefined and might be used in an anti-competitive manner.

We believe therefore that such powers should be objectively justifiable and hence commend an evidence-based 'fit and proper' approach.

Specific terms and conditions added to an exchange's authorisation

We note that the discussion on financial resources does not seek to justify or explain why in many jurisdictions exchanges – despite their systemic significance – are not subject to specific and detailed regulatory capital requirements. After all, such requirements are generally applied to their members, either by the exchanges themselves or by the statutory regulator.

When and where exchanges were owned by their members, such an exemption may have been acceptable; in a world dominated by for-profit exchanges, this mismatch appears to us to be increasingly unjustifiable. It gives exchanges a significant commercial advantage over other providers of trading platforms.

We therefore suggest to IOSCO recommending a change. Should IOSCO refrain from such a recommendation, it would be interesting to receive an explanation why the status quo is deemed acceptable in terms of achieving regulatory objectives.

Competitive behaviour

As noted above, we believe that the consultation report exaggerates the extent to which exchanges compete with each other and non-exchange competitors for trading volumes. It is widely acknowledged that liquidity is sticky – and our observation is that it is not only cohesive (sticking together), but also quite adhesive (i.e. sticking to the market place where it is). Recent developments in the US, where competitors looked as if they were capable of diverting significant amounts of order flow, support this observation: Incumbent exchanges acted swiftly to take their competitors out of the equation by takeover and merger.

The historic example of the transfer of liquidity in the Bund contract has often been cited. We have never been certain that it was purely by conventional competitive means that Eurex took the Bund contract liquidity back from LIFFE. Moreover, we have the impression that in the meanwhile these two competitors have found a way of peaceful coexistence at their respective places on the maturity scale.

And of course, as the paper implies, where takeover or merger is not an option, predatory pricing can provide an illusion of benefit to exchange users – to be reversed as soon as the competitor has been routed. It is clearly difficult to determine where competition provides genuine long-term benefits to users in the form of sustained fee reductions.

As a clear conclusion of these considerations, we strongly emphasise that there is a major role in many jurisdictions for the competition authorities to be more vigilant and interventionist than has generally been the case to date.

ICMA is indeed looking forward to further work by IOSCO on the important questions addressed in this consultative document and we are, as always, available for any further discussions on these and related issues.

Yours sincerely

Richard Britton
Consultant

Gregor Pozniak
Senior Advisor

International Council of Securities Associations

We are writing to you in our capacities, respectively, as Chairman of the Working Group on the Governance of Market Infrastructures of the International Council of Securities Associations (ICSA) and the Secretary General of ICSA.[11] This Working Group, which is composed of trade associations and SROs from all over the world, has been examining a number of issues related to recent changes in the corporate structures and governance arrangements of market infrastructures, including demutualized exchanges. We support IOSCO's initiative on this issue and urge IOSCO to continue to examine the ramifications of exchange demutualization and consolidation.[12]

Exchanges play a unique role in the economies where they are located as they facilitate the development of a deep and liquid secondary market, which in turn provides transparent market prices for capital market financing and thereby contributes to the efficient allocation of capital. A deep and liquid secondary market promotes the growth and development of a vibrant primary market. In short, a well functioning and efficient exchange is critical in a market economy for effective capital formation and economic growth. For that reason the recent evolution of exchanges – which have gone from being member-owned cooperative organizations to privately owned, profit-oriented and in some cases publicly listed companies – raises important public policy issues.

One particular area of concern, from a public policy point of view, is the emphasis that the demutualized exchanges place on profit maximization for shareholders. In theory, profit maximization leads to efficient outcomes when markets are competitive. However, that is not necessarily the case for exchanges, in part because of the unique role that these institutions play in the economy. Indeed, as was noted in the IOSCO report, competition between exchanges may lead to suboptimal outcomes. In addition, as was also noted in the IOSCO report, over time exchanges and other market infrastructures often evolve toward highly concentrated and even monopolistic market structures.[13] When exchanges have no effective competition, they are free to utilize their market power and increase the fees that they charge to the firms and individuals that use their products and

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[11]. ICSA is composed of trade associations and self-regulatory associations for the capital market in broad range of jurisdictions as well as a number of international trade associations. ICSA members represent and/or regulate the firms that carry out the bulk of the activity on the world's equity, bond and derivatives markets. A list of ICSA members is attached to this letter.

[12] A separate ICSA Working Group is sending a comment letter on the report's conclusions regarding the regulatory role of exchanges.

[13] This is particularly the case for exchanges that offer both trading and post-trading services.

services. Higher fees and other forms of uncompetitive behavior, in turn, may have a negative effect on capital formation and on the overall efficiency of the economy.

For all of these reasons, the ongoing process of demutualization and consolidation between exchanges, on both a national and international level, intensifies concerns that a small number of exchanges will eventually have monopolistic or quasi-monopolistic market positions in a large number of jurisdictions which they can exploit to the detriment of market efficiency. Therefore, the members of the ICSA Working Group on the Governance of Market Infrastructures strongly support Recommendation 5 in IOSCO's report, which states that, "regulatory authorities should consider competition issues that may arise in connection with the evolution of exchanges…where such evolution impacts market integrity, efficiency or investor protection."

In response to concerns raised by the demutualization and consolidation of exchanges, the members of ICSA's Working Group on the Governance of Market Infrastructures have developed a set of Principles for the Governance of Market Infrastructures. These Principles are currently being discussed by the broader ICSA membership and therefore cannot yet be distributed. We would note, however, that the Principles are intended to provide a framework for the implementation of governance arrangements at exchanges and other market infrastructures that would promote greater efficiency and increased transparency in the operations of those organizations. In particular, the Principles seek to ensure that all users have a strong and effective voice in the governance of exchanges and other market infrastructures, that exchanges' regulatory operations are transparent and that potential conflicts of interest between the exchanges' commercial and regulatory activities are managed through appropriate structures, policies and procedures. In light of the ongoing consolidation between exchanges, the Principles are also intended to ensure that the link between market infrastructures and local market participants is maintained and the information sharing and other collaborative arrangements between regulatory and supervisory authorities regarding market infrastructures are strengthened.

In closing, we would like to thank the members of Standing Committee 2 for the work that they have done in preparing their report on ***Regulatory Issues Arising from Exchange Evolution***. It is an extremely timely and relevant report and we would urge IOSCO to continue to focus on this issue.

Sincerely,

Pierre de Lauzun, Chief Executive
French Association of Investment Firms (AFEI)
and Chairman, ICSA Working Group on the
Governance of Market Infrastructures

Marilyn Skiles
Secretary General
ICSA

June 2, 2006

Mr. Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Re: **Public Comment on *Regulatory Issues Arising From Exchange Evolution***

Dear Mr. Richard:

In my capacity as Chairman of the Working Group on Self-Regulation of the International Council of Securities Associations (ICSA),[14] I would like to comment on the consultation report entitled, ***Regulatory Issues Arising from Exchange Evolution*** prepared by IOSCO's Technical Committee's Standing Committee on the Regulation of Secondary Markets (SC2). This is an extremely complicated issue and the members of the Standing Committee are to be congratulated for the excellent report that they have produced.[15]

I will start with some observations arising from an ongoing study being carried out by the ICSA Working Group on Self-Regulation regarding the evolution of self-regulation in financial markets. The study itself has not yet been concluded and therefore cannot be

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14. ICSA is composed of self-regulatory associations and trade associations for the capital market in a broad range of jurisdictions, as well as a number of international trade associations. ICSA members represent and/or regulate the firms that carry out the bulk of the activity on the world's equity, bond and derivatives markets. A list of ICSA members is attached to this letter.

15 A separate ICSA Working Group will be commenting on other issues raised in the IOSCO report.

distributed at this point, although we look forward to distributing the completed study to IOSCO members within the next few months. As part of this project, the Working Group has conducted a survey of SROs in order to identify the core or defining features that characterize SROs across national boundaries. This was seen as important since, while the benefits of and limits to self-regulation in financial markets have attracted a great deal of attention over the past several years, there is no agreed upon definition of SROs that is valid on an international basis. Without a common vocabulary, it is difficult to understand the various ways that SROs are evolving in response to the continuing changes in financial markets.

The survey included both exchange SROs and member regulation SROs and consequently, was more inclusive than previous studies on this issue, which have focused solely on the exchange SROs. [16] The results from this study show that SROs can be defined as non-governmental organizations that:

(1) share a common set of public policy objectives including the enhancement of market integrity, market efficiency and investor protection;

(2) are actively supervised by the government regulator(s);

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[16] Although the sample size of this survey was relatively small, comprising only ten SROs, those SROs included in the survey represent many of the largest exchanges operating in the world today as well as member SROs that operate independently of an exchange or market. The participants in the survey were the Australian Stock Exchange (ASX); Bond Exchange of South Africa (BESA); International Capital Market Association (ICMA); Investment Dealers Association of Canada (IDA); Japan Securities Dealers Association (JSDA); Korea Securities Dealers Association (KSDA); NASD; National Futures Association (NFA); New York Stock Exchange (NYSE); and the Tokyo Stock Exchange (TSE)

4 Surveillance is defined as the timely review of trading activity conducted on an exchange or market.

(3) have statutory regulatory authority and/or authority that is delegated by government regulator(s);

(4) establish rules and regulations for firms and individuals that are subject to their regulatory authority;

(5) monitor compliance with those rules and regulations and, in the case of SROs that regulate trading markets, conduct surveillance of markets;[17]

(6) have the authority to discipline members that violate applicable rules and regulations;

(7) include industry representatives on their boards or otherwise ensure that industry members have a meaningful role in governance; and,

(8) maintain structures, policies and procedures to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed.[18]

I would like to emphasize that this list of core or defining characteristics is based on survey results and is not intended as a normative statement about how SROs should conduct their activities.[19] At the same time, however, the members of the ICSA Working Group believe that this list of core characteristics can help to illuminate the changes that are taking place within SROs in general, and within exchange SROs in particular.

The members of the Working Group on Self-Regulation believe that this list of core characteristics is particularly useful when examining the changes that have taken place in the regulatory operations of demutualized exchanges. One of the consequences of the ongoing

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[5] Along with the core characteristics outlined above, many SROs carry out a variety of other activities that are consistent with their mandate to enhance market integrity, market efficiency and investor protection. These activities include: (1) the provision of consumer redress/dispute resolution services; (2) the provision of investor education for consumers and educational services for market professionals; and (3) the provision of market data for member firms and other market participants.

[19] Principle 7 of IOSCO's *Objectives and Principles of Securities Regulation* contains a similar list of attributes for SROs, although they are presented in a more normative framework.

wave of demutualization among exchanges has been the emergence of a variety of models to deal with conflicts of interest between the exchanges' regulatory and commercial activities. Some demutualized exchanges continue to operate as SROs, although in most cases these organizations have made additional arrangements to separate the exchange's regulatory activities from its commercial activities. In other cases, however, the bulk of the exchange's regulatory activities have been contracted out to a third party SRO or taken over by the government regulator.

These different models – and some exchanges that have adopted each model – can be summarized as follows:

1. Exchange continues to function as a SRO – CME, CBOT, TSE
2. Exchange creates a separate corporate entity to carry out regulation – NYSE, ASX
3. Exchange retains self-regulatory function but contracts with third party supplier of regulatory services to carry out some of its regulatory activities – Nasdaq, TSX
4. Regulatory activities of the exchange are conducted in a quasi-public entity that is completely separate from the commercial operator of the exchange – FSE
5. Government regulator assumes responsibility for most regulatory activities and the exchange retains only limited regulatory authority – LSE, HKEx, Euronext Paris

This issue was discussed in IOSCO's consultation document, specifically with respect to the separation of functions within an exchange and the transfer/removal of regulatory functions from a demutualized exchange. However, the members of the ICSA Working Group on Self-Regulation believe that this issue needs to be discussed more as it appears to be the main identifiable trend affecting the regulatory activities of demutualized exchanges. In that respect, there is a degree of international convergence taking place regarding the mechanisms used to manage conflict of interest at demutualized exchanges, although the specifics differ greatly between different exchanges and different jurisdictions.

In addition to the already existing models for managing conflicts of interest at demutualized exchanges, it is likely that additional models will emerge over time. In particular, it is

possible that a single, nationwide member regulation SRO will be established in one or more jurisdictions that would carry out all regulation of broker-dealers while the exchanges in that jurisdiction would retain responsibility for regulating their specific markets. An alternative model (which is under active consideration in Canada) would involve the establishment of a single, nationwide SRO that would carry out almost all market regulation as well as member regulation for broker dealers. In both cases, the SRO would not own or operate any exchange or market, thereby completely eliminating the potential for conflicts of interest.

Given the variety of approaches that the exchanges – and regulators – have adopted in order to manage conflicts of interest at demutualized exchanges, it is not yet clear which will emerge as the most prevalent regulatory models. Furthermore, as more exchanges consolidate on a cross-border basis, there is a pressing need to consider the appropriate regulatory framework for 'global' exchanges. Therefore, it could be extremely useful for IOSCO, possibly in conjunction with private sector representatives, to examine this and related issues. Such an examination could include, for example, an in-depth analysis of the advantages and disadvantages of the various models for managing conflicts of interest that that have been adopted at demutualized exchanges. It might also be useful to explore the feasibility of establishing a mechanism for enhanced coordination and cooperation between different national SROs.

In closing, I would like to emphasize that ICSA stands ready to engaging in further dialogue with IOSCO members on these important issues and providing whatever assistance your deem useful.

Sincerely,

Joe Oliver, CEO and President
Investment Dealers Association of Canada
and Chairman, ICSA Working Group on
Self-Regulation in Financial Markets

The members of ICSA are as follows:

Association of Capital Market Intermediary Institutions of Turkey (TSPAKB)
Australian Financial Markets Association (AFMA)
Bond Exchange of South Africa (BESA)
Bond Market Association (TBMA)
French Association of Investment Firms (AFEI)
International Capital Market Association (ICMA)
Investment Dealers Association of Canada (IDA)
Italian Association of Financial Intermediaries (Assosim)
Japan Securities Dealers Association (JSDA)
Korea Securities Dealers Association (KSDA)
London Investment Banking Association (LIBA)
NASD
Securities Industry Association (SIA)
Swedish Securities Dealers Association (SSDA)
Taiwan Securities Association (TSA)

London Stock Exchange

Thank you for the opportunity to comment on the consultation report on "Regulatory Issues Arising from Exchange Evolution". We welcome the objectives of the report in terms of updating the 2001 report and raising awareness of the steps taken by regulators to address the changing exchange landscape.

As you are aware, the London Stock Exchange became a public listed company in 2000 and listed on its own Main Market in 2001. Therefore, we have had considerable experience of the regulatory considerations raised by demutualization and self-listing. Furthermore, there has been a great deal of regulatory and supervisory reform in Europe in response to market and product innovation. In the context of these developments, we trust that you will find the following comments and observations useful.

Implications of Changing Environment for Exchanges' Regulation Role

We agree that the move by exchanges to a for-profit business model in the context of an increasingly competitive environment in the provision of market services does raise regulatory issues. However, there is not necessarily an incompatibility between the for-profit operation of an exchange and its public interest obligation. Exchanges that provide fair, orderly and well regulated markets reap positive commercial benefits in terms of attracting issuers and investors.

The relationship between regulation and for-profit exchanges should not be a difficult balancing act, but rather a virtuous circle of effective regulation promoting commercial competitiveness. Therefore, concerns referred to in (although not advocated by) the paper about a "race to the bottom" in exchanges' regulatory standards are, in our view, misguided. Furthermore, there is nothing inherent about the nature of a for-profit exchange that will necessarily lead to insufficient value being accorded to the regulatory process.

A significant element of the success of London in attracting international issuers is the quality and robustness of the regulation of our markets. We agree with the assessment that exchanges are cognisant of the commercial consequences of compromising high regulatory standards. The resources devoted by exchanges to preserving the integrity of their markets demonstrate the shared commitment to high regulatory standards.

As regards financial risk, we agree that the financial health of an exchange is important to a jurisdictions' capital markets. Of course, this is also an issue for mutual exchanges and other for-profit financial infrastructure. Obviously, for-profit exchanges owe a fiduciary duty to shareholders, but they will also be required to meet capital adequacy requirements. In the case of the London Stock Exchange we are required to meet financial resource requirements as agreed with the FSA.

Regulatory Responses to Exchange Evolution

The report states that an important element in ensuring that an exchange's regulatory responsibilities are not compromised by its commercial interests is the separation of commercial and regulatory functions. We agree that it is vital that commercial considerations should not interfere with an exchange's ability to fulfil its regulatory functions. However, we would caution IOSCO against advocating a "one size fits all" standard on this matter. There are various ways to ensure an effective separation of functions.

The report notes that jurisdictions might choose to remove a regulatory responsibility from an exchange either because of conflict or the threat of impeding competition. On demutualisation of the London Stock Exchange our former listing function was transferred to the Financial Services Authority. This arrangement has worked well and benefits from a close working relationship between the London Stock Exchange and the UK Listing Authority. Indeed Article 21 of the Prospectus Directive requires Member States to appoint a competent authority for approval of prospectuses. A sunset clause will mean that by 2011, all exchanges will need to transfer this function to an independent competent authority. More generally, the regulation of exchanges and issuers benefits from a close working relationship between regulator and exchange. It is a relationship that should be recognized as a partnership underlined by fundamental mutuality of interest.

On the specific issue of self-listing of exchanges, the London Stock Exchange has been able to manage potential conflicts in the UK by agreeing to bespoke arrangements with the FSA which ensure that the Exchange does not regulate trading or the flow of information in its own shares.

Broader Regulatory Issues Arising from the New Business Model

The report highlights that outsourcing raises a number of issues and that it should be clear which entity is responsible for a particular function. At the London Stock Exchange, we outsource the bulk of our IT requirements to Accenture. This allows us to rely on a wider base of expertise than a traditional in-house function and has helped us to take a lead in the development of stock exchange IT by means of our Technology Road Map (TRM). The benefits include reduced trading latency, improved trading capacity and strengthened resilience.

Therefore, TRM is closely aligned with FSA business objectives in terms of promoting fair, efficient and orderly markets and ensuring that the UK market is internationally attractive and sustainable. We have a clear agreement with FSA as regards Exchange responsibility for the IT function. TRM provides an excellent example of the benefits that the for-profit model can bring to investors and issuers.

The report considers the implications of market fragmentation for an exchange's role as market regulator. The European Union has recognised some of the challenges posed by fragmentation, particularly as a result of systematic internalisation and the emergence of multi-lateral trading facilities.

The Markets in Financial Instruments Directive, for example, imposes pre- and posttrade transparency requirements on systematic internalisers, alongside obligations for more traditional market operators. However, the Directive remains silent on how it envisages the frontline market supervision role that is carried out by exchanges today being extended to these new types of OTC business.

It may be that regulators can get themselves comfortable that a large, essentially unsupervised OTC market is compatible with their own regulatory objectives, although this seems unlikely. IOSCO may wish to give some thought to how it can ensure that real time market supervision across multiple market and non-market platforms might be organised.

Conclusion

We agree with the recommendations of the report. In particular, we support the advantages of an on-going dialogue with regulators in order to ensure an understanding of exchange business and practices. The exchange regulatory relationship works best as a partnership underlined by an acknowledgement of mutuality of interest. While regulators should work to ensure that the core regulatory obligations of exchanges are appropriately organised and resourced, it must be recognised that for-profit models are not incompatible with exchange's wider public service obligations. Rather they can serve to promote the interests of investors and promote resilience by means of a virtuous circle of competitiveness and orderly and transparent capital markets.

Yours sincerely

Adam Kinsley
Director of Regulatory Strategy
London Stock Exchange
akinsley@londonstockexchange.com
Telephone: +44 (0)20 7797 1241

NATIONAL FUTURES ASSOCIATION

National Futures Association

National Futures Association ("NFA") appreciates the opportunity to comment on the IOSCO Consultation Report entitled "Regulatory Issues Arising from Exchange Evolution." NFA is a registered futures association under the Commodity Exchange Act and a self-regulatory organization for the United States futures industry, subject to oversight and review by the Commodity Futures Trading Commission ("CFTC"). Since NFA does not operate a market, and is a not-for-profit organization, it does not face many of the issues confronting exchange-SROs. As a result, a number of the issues raised in the Consultation Report do not apply to NFA. We will limit our comments in this letter to those issues that directly affect NFA.

NFA has always been a strong supporter of self-regulation and we believe it is the best model for regulation in the futures industry. The present system of self-regulation in the U.S. futures industry, with a number of SROs under direct CFTC oversight, has proven effective as evidenced by the explosive growth in the market in a relatively scandal-free environment. Self-regulation has also allowed the CFTC to focus its resources on areas that self-regulation can't reach, such as enforcement actions against unregistered firms and individuals. NFA believes that self-regulation, subject to appropriate government oversight, achieves a number of important goals, including maximizing regulatory effectiveness, minimizing regulatory burdens and saving taxpayers' money.

An inevitable result of self-regulation – and its biggest criticism – is the inherent tension between the regulatory interests of the self-regulatory organization ("SRO") and the business interests of the SRO. This tension may increase when the SRO operates a market or has other economic interests that are separate from its regulatory interests. These conflicts of interest must be managed if the SRO is to provide effective regulation while treating both market participants and members fairly.

Governance Arrangements

The most important guiding principle for board composition is that the board should be diverse so that no one constituency of the SRO, including the public, can dominate board actions. An SRO's board should represent the interests of all the SRO's constituents, including members of the SRO and the public. Any conflicts of interest that arise from having SRO members on the board should be managed by ensuring that there are appropriate checks and balances in board composition, not by eliminating the market expertise offered by members.

SRO members are an important component on any SRO's board. The knowledge and experience that these individuals bring to the board is critical. There are often several ways to address a regulatory issue, and SRO members are usually the best qualified to determine which method will address the issue most efficiently - providing the necessary protection to customers and other members while minimizing the burdens on regulated individuals and entities.

SRO members should also have a voice in how they are regulated. Not only are SRO members knowledgeable, they also have a real interest in ensuring that the self-regulatory process works and that the public has confidence in the integrity of the markets and the system. Their knowledge, combined with their interest in a successful self-regulatory process, help to ensure that the process is both fair and effective.

It is also important to remember that in many instances, the members of an SRO can be subdivided into different categories based on the nature of their business. Each category should be represented on the board because they represent different interests and may approach issues with a different perspective. NFA's Board provides one model for this type of structure. Our Board is comprised of representatives from contract markets, futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors and the public.

NFA strongly believes that an SRO's board should include non-member directors. Participation by public directors ensures representation for the retail public and other end users who must have confidence in the way the market operates. NFA's Board has always had public representatives, and their participation is an important protection for those market participants. Again, however, the board should be structured to ensure that they do not dominate the actions of the board.

While we believe that all SROs should have public directors, one size does not fit all, and who qualifies should depend on the particular SRO. Strong government oversight, however, must be present to ensure that an SRO's public representatives are appropriately diverse and adequately represent the interests of non-members.

NFA's public directors have included bankers, academics, former Congressmen, and end-users, among others. We believe that there should be diversity within the public representative category, but we do not believe that the category should be limited to individuals without any industry connections. Many of our public representatives have been individuals with industry experience or affiliations, such as end-users and a former CFTC chairperson. NFA has found that public representatives with industry experience have brought unique perspectives to the board and have made many positive contributions to NFA's success.

Regulatory Structure

As with board composition, statutory regulators should not mandate a particular regulatory structure. Instead, they should use their oversight role to monitor each SRO’s ability to manage conflicts between the SRO’s regulatory and business functions and between its interests and those of its members, and require the SRO to take corrective action when necessary.

Transparency

The SRO process must be transparent to ensure that participants have confidence in the markets. NFA has always strived to make all material information readily available to both our Members and the public. NFA's Manual and website include the names and affiliations of all members of our Board of Directors, all its standing committees, and NFA's disciplinary committees. Significant actions taken by the Board - including committee appointments and mid-term Board replacements - are reported in the membership newsletter after each Board meeting, and the newsletter is posted on the website where it is accessible to the public. Rule submissions are also

posted on NFA's website, as well as the entire Rulebook. Information on NFA disciplinary proceedings is also readily available to Members and the public.

In closing, NFA supports the five broad recommendations outlined in the report and firmly believes that any governance principles IOSCO adopts should be broad enough to cover all SROs – including NFA – and flexible enough to accommodate differing SRO models (e.g., exchange or non-exchange, demutualized or for-profit).

NFA appreciates the opportunity to comment on these important issues. If you have any questions or would like additional information, please contact me at 312-781-1335 or by e-mail at kwuertz@nfa.futures.org.

Sincerely,

Karen K. Wuertz
Senior Vice President,
Planning and Development

New York Stock Exchange

The Exchange is pleased to have the opportunity to comment on the recent Consultation Report of IOSCO's Technical Committee in respect of "Regulatory Issues Arising from Exchange Evolution." The Exchange found the Report to be a pragmatic, balanced and thoughtful analysis of the evolutionary changes confronting financial markets today.

As the Report ably documents, there exists no single correct approach to the details of government regulation or self-regulatory models. IOSCO Principle 26 calls for appropriate supervisory arrangements to ensure that exchanges are properly run, while IOSCO Principle 7 provides that SROs should be subject to regulatory oversight and observe standards of fairness and confidentiality. Within these parameters there is room for nuanced responses that take account of differences in history and approach in various countries and in different markets even within a particular country.

The Exchange is proud of its own evolutionary changes which have emphasized and secured the independence and rigor of its regulatory function. Important to our structure is the fact that regulation has been placed in a separate, not-for-profit subsidiary of NYSE Group, with a board of directors that is entirely independent from those we regulate, and consists of a majority of directors who serve on no other board within the NYSE Group. This structural independence is in addition to the powerful

incentive that the report recognizes, namely the importance to the Exchange's business and brand of strong regulation and a reputation for integrity.

We recognize the inherent conflicts of interest and risks that the report details, but we agree that those conflicts and risks can and should be adequately addressed by both the SRO and its governmental regulator. We believe that the structure and approach we have put in place under NYSE Group – accomplished in close cooperation with, and with the approval of, the U.S. Securities and Exchange Commission – has in fact addressed those issues in a careful and thoughtful manner.

We applaud your constructive interest in the important issues identified in the Report. We look forward to participating as a major player in the global financial marketplace and in the formulation of dynamic responses to the evolving issues which confront our rapidly evolving financial markets.

Very truly yours,

Richard Ketchum
Chief Executive Officer

an SWX Group company

SWX SWISS EXCHANGE

SWX Swiss Exchange

Many thanks for the possibility to comment on the IOSCO Consultation Report on Regulatory Issues arising from Exchange Evolution, dated March 2006. We are of the opinion that the paper is of excellent quality, both concise and comprehensive enough in its scope. We do not have any objections nor do we suggest alterations.

We trust the IOSCO report will be of particular interest both for exchanges and their regulatory supervisory authorities when changes of ownership are considered.

If we can be of any assistance to you, please let us know.

Yours sincerely

SWX Swiss Exchange

Heinrich Henckel
CEO SWX Swiss Exchange

Thomas Fritsche
Deputy Head Legal & Compliance

WORLD FEDERATION OF EXCHANGES

World Federation of Exchanges

The World Federation of Exchanges, WFE, welcomes the opportunity to respond to the IOSCO Technical Committee Report on the *Regulatory Issues Arising from Exchange Evolution*, referred to as "the consultation report", "the report", or the "IOSCO report" hereafter.

As a preliminary statement, the WFE Secretariat would like to emphasize that although there are some obvious common issues for exchanges around the world, it believes that there are no "one size fits all" solutions. It can comfortably say that it speaks on behalf of most if not all members. It then fully supports the principle stated by the IOSCO Technical Committee in its 2001 *Issues Paper on Exchange Demutualization*, which is mentioned again in the consultation report:

> *in practice, regulatory responses to such restructuring vary according to circumstances, and there is no universal right regulatory path to follow (p.3)*

The following points are comments structured in accordance with IOSCO's own report.

B.1 Roles of an exchange
The roles listed in the consultation report match the ones under review in the WFE *Regulation of Markets Survey 2004*, which presented a comprehensive set of regulatory tasks performed by exchanges. These tasks imply the *establishment, monitoring and enforcement* of rules.

One of the main findings of that WFE survey was that "virtually all exchanges wish to retain regulation of their trading markets." And that, "furthermore, 68% of exchanges indicated that regulation was more intensive than it was 3 years ago". (See below the explanation in the part about the consultation report in section B.2.).

=> On exchanges' regulatory mission and branding
The IOSCO report acknowledges the crucial fact that "as market operators, a core function of exchanges – and often an important part of their branding – is the creation and enforcement of the rules governing the markets they operate." (p.6)

That is again in line with WFE *Regulation of Markets Survey 2004*, which pointed out that:

> *almost all exchanges which answered […] replied that regulation is a significant part of their brand or commercial strategy. Only two exchanges answered this question negatively. The view most of them expressed was that regulation was necessary and appropriate to assure fair and orderly markets and market transparency in order to maintain investor confidence.*

=> On other functions
As regards the "services beyond traditional trading services" (p. 7), the WFE Secretariat agrees with

the report that a for-profit structure encourages the development of additional services. One WFE member emphasized that the development of such services has contributed to liquidity, which lowers implicit costs and helps maintain competitive prices. Therefore, offering additional services ultimately benefits the customer.

B.2 Key issues raised by the changing environment

(a) Balancing commercial and public interest functions

The report mentioned the risk that "the for-profit exchange may be tempted to lower standards to try to generate additional revenue" (p.8)

The WFE's work strongly refutes this view, as the reputational capital (as mentioned in the report on pages 9 and 24) of exchanges is crucial to them, and is the best safeguard against any temptation to "lower standards". It should be stressed that in most exchanges, the quality of regulation is a key component by which customers of the exchange measure the quality of the exchange's service offering. Concerns such as a "race to the bottom" in regulatory standards assume that quality regulation is an optional component of exchange operations. This is not the case.

As mentioned on page 9 of the IOSCO report, for-profit exchanges are "cognizant of the commercial consequences of compromising high regulatory standards."

In addition, the governance structure of exchanges prevents such a risk as well (see the findings of WFE *Executive Summary from the Governance of Exchanges Survey* mentioned below).

The IOSCO report also mentioned the possible risk that exchanges reduce the resources devoted to regulation.

This fear is not validated by evidence from *WFE Regulation of Markets Survey 2004*, which found out that for:

> *most exchanges […] regulation costs are slightly higher, or about the same, as they were three years ago, even if their regulatory responsibilities have changed.*
>
> *Among the new responsibilities noted were monitoring corporate governance disclosure, increased surveillance due to increased market activity, and new legislation adding obligations.*
>
> *Furthermore, 68% of exchanges indicated that regulation was more intensive than it was 3 years ago because of :*
>
> - *New listing segments*
> - *Monitoring corporate governance disclosure*
> - *Increased market activity and market expectations*
> - *Increased surveillance*
> - *Staff costs*
> - *New legislation*

In the opinion of exchanges responding, "most thought that technological advances made more intensive regulation possible."

The IOSCO report mentioned that:

overall, the central risk in respect of the public interest, equally applicable to both for-profit shareholder-owned exchanges and mutually-owned exchanges, is the extent to which the exchange's short term commercial objectives are likely to overshadow its incentive to preserve its long-term reputational capital as a provider of fair and orderly markets that command investor confidence. (p.9)

Past work by WFE fully supports the IOSCO view that:

the managements of most for-profit exchanges do not regard this as a serious risk. They argue that their incentive to deliver high regulatory standards is, if anything, increased as for-profit companies: they have much to lose, especially in a competitive environment, if participants lose confidence in the protections that exchange trading offers them. This was the view of the 15 Consultative Committee members who responded to our questions. Some recognised that there could be a conflict between a for-profit exchange's short-term and longer term commercial interests, but they believed that exchanges were cognizant of the commercial consequences of compromising high regulatory standards. Several indicated that they considered the conflict as more acute in mutual organisations than listed companies. (p.9)

(b) Misuse of regulatory powers

WFE work would not lead it to share misgivings about a possible misuse of regulatory powers by profit-driven exchanges expressed in this section of the IOSCO report.

The WFE Secretariat would like to highlight one WFE member comment to the report which pointed out that there are five basic reasons supporting the compatibility between profit-orientation and self-regulation. First, the provision of a neutral, fair and transparent trading platform for an exchange operator is essential to maintain and attract customers and therefore grow business. Second, an operator that is driven by commercial motives is under greater pressure to fulfil customers' needs than a member-owned one, since members' interests may conflict with those of the wider market; such conflicts become evident, e.g., in the decision about the introduction of electronic trading, which lowers trading costs, but may cut into the margins of members. Third, exchanges operate in a highly regulated environment, setting high standards for investor protection and control of market abuse and closely monitoring their enforcement. Fourth, if the exchange operator is itself a listed company, it needs to adhere to higher transparency and corporate governance standards than any other corporation, either by law or by an industry standard. Fifth, an exchange operator is under the supervision of its respective exchange regulator, which monitors whether the exchange operator complies with obligations arising out of the fact that it runs a regulated exchange. Furthermore, in Europe, the potential for conflicts of interest is also being addressed at the EU level through initiatives underway in the context of the EU Financial Services Action Plan (FSAP).

The report also stated that "although regulatory authorities generally do not regulate fee structures, it is important that fees are fair and are not operating as a barrier to access" and mentioned in a note that "the Hong Kong SFC has a statutory power to regulate the fees charged by the exchanges as a result of the demutualization." (p. 9)

Without prejudging specific situations in specific jurisdictions, WFE as a matter of principle would be very attentive to any barrier put on exchanges' freedom to define their commercial policy. Market based solutions have been a longstanding basis for working in WFE, and this has given good results.

i) Regulation of competitors

As regards the regulation of competitors, some exchanges and their regulators have introduced procedures whereby the regulator plays the role of objectively overseeing that the exchange deals with its competitors fairly and, if necessary in extreme cases, to take decisions regarding the competitor itself. This, in addition to policies prohibiting the commercial use of confidential information obtained as a result of regulatory activities, should go a long way to assuaging concerns from competitors.

On this point, in the view of WFE Secretariat, the IOSCO report uses a somewhat surprising argument: "measures promoted in the name of high regulatory standards – for instance, in relation to access, trading or listing requirements – might also be designed with a view to restricting competition" (p.10), as if regulatory standards set too high could impede competition. Most exchanges would not correlate lower levels of regulation with greater competition. WFE members strongly believe that competition does not imply any degradation of regulations that would jeopardize investor protection and market integrity.

The IOSCO report then nuances the idea, stating that:

> *"it is possible to over-state these risks" and that the key is that "in any regulatory area, an exchange should normally have arrangements to isolate regulatory information from commercial influence." (p. 10)*

The findings from *WFE Executive Summary from the Governance of Exchanges Survey* confirmed WFE members' good practices in terms of governance, and especially as regards to the separation of regulatory and commercial activities:

> *Only five exchanges operate their regulatory and commercial activities in separate legal entities, but most of the other respondents have "Chinese walls" or a distinct organizational entity to separate these activities.*
>
> *Most organisations (28 out of 34 respondents) have publicly communicated procedures known to stakeholders in order to identify and resolve conflicts of interest. In some cases, they are included in the company's code of ethics, and some exchanges have a dedicated conflicts committee.*

ii) Uses of regulatory income

The IOSCO report notes that:

> *to the extent that a particular function is viewed as being regulatory in nature, with a for-profit entity regulators will need to consider whether or not regulatory intervention to approve or control fees and charges is appropriate. (p.10)*

Again, without prejudging specific situations, WFE matter of principle would be very attentive to any barrier put on exchanges' freedom to define their commercial policy.

(c) Financial risk and exchange viability

The WFE Secretariat welcomed the fact that the report recognizes the "regulatory expertise" (p. 10) of exchanges. WFE members indeed have a regulatory expertise which participates to market integrity.

(d) Conflicts due to self-listing

This question is resolved in most jurisdictions - there are several examples of where an exchange's listing is regulated by its regulator, and that appears to be a satisfactory solution.

(e) Regulatory efficiency

The report notes that market fragmentation could raise issues regarding exchanges regulatory roles:

> *One of the less predictable consequences of the more competitive, for-profit environment in which exchanges are increasingly operating is its implications for an exchange's role as market regulator if there is market fragmentation. A further significant issue for many jurisdictions will be the continuing ability of any single exchange to carry out certain regulatory roles efficiently.*

The WFE Secretariat would like to point out that WFE members have been discussing recently market fragmentation in the form of in internalization. WFE members are concerned with certain forms of internalization which:

- may be harmful to retail clients, and exacerbates conflicts of interest in brokers' fulfilment of their fiduciary responsibilities;
- could be harmful to markets in that liquidity is withheld from investors, and exposure to better prices in the market is denied, thus widening spreads;
- makes the measures of best execution become a hollow exercise, because they could never take into account how efficient price discovery might have been if more interest been known by the market.

C. Regulatory responses to exchange evolution

The IOSCO report seems to imply that there is an historic trend.

> *Most jurisdictions were progressively increasing the scope of statutory regulation well before the transition to the new exchange business model gathered pace. While this was sometimes in response to specific weaknesses identified in the self-regulatory system, it also reflected governmental recognition of the importance of exchanges in the capital markets – especially in equity markets – and the consequent public interest in exchanges' sound operation and ongoing viability. (p. 12)*

As mentioned before, the findings of WFE *Regulation of Markets Survey 2004* do not support this assumption. In addition, much in the IOSCO report might lead one to assume that demutualization and listing of exchanges raised more regulatory concerns although there is poor evidence to support that. On the contrary, the report mentioned several times that the differences before and after are not so important:

> *Although this balance between the commercial interests of an exchange and the public interest is also relevant to mutual exchanges – where the commercial interests of the mutual members may conflict with broader market interests – there is a view that the risk of imbalance may be greater in a for-profit entity. (p. 8)*
>
> *It should be noted, however, that mutual exchanges seeking to increase trading opportunities for their members can also face pressures to lower their listing standards. (p. 8)*
>
> *The 2001 paper recognized that this could also occur with mutual exchanges but considered that the conflicts of interest that may bring this about are more likely to occur in a for-profit exchange. (p. 9)*

C.1. Governance arrangements

WFE work has supported the position that exchanges should meet world-class corporate governance standards. It would likely caution against a position where the regulator prescribes the kinds of representatives who should sit on the governing body of an exchange. In the view of the WFE Secretariat, an appropriate balance could be struck where the regulator can prescribe the quality of person who must sit on an exchange's governing body and can regulate whether the governing body, exercises its powers in furtherance of, amongst others, the exchange's regulatory duties.

The IOSCO report emphasizes the fact that:

> *the governing body includes individuals directly representing the broader public interest, or who at least have the independence to consider whether the exchange is giving due weight to its regulatory responsibilities. (p. 12)*

The WFE *Executive Summary from the Governance of Exchanges Survey* noted that:

> *26 respondents indicated that some directors' positions are specifically reserved for persons from the following constituencies:*
>
> - *Executive managers 12*
> - *Non-executives nominated and approved 7*
> - *Participants 12*
> - *Issuers 9*
> - *Owners 10*
> - *Public sector representative 11*
> - *Other 11*
>
> *The diversity of independent non-executive directors is seen as a good way to ensure that all stakeholders are represented.*

Again, as mentioned before, the WFE survey conducted in 2005 and published in 2006 found that "most organisations […] have publicly communicated procedures known to stakeholders in order to identify and resolve conflicts of interest."

C.2. Separation of functions within an exchange

It is important to note that there are no two identical models being used by WFE members. Each jurisdiction has responded to this concern to the extent necessary.

As mentioned above in the WFE *Executive Summary from the Governance of Exchanges Survey*:

> *only five exchanges operate their regulatory and commercial activities in separate legal entities, but most of the 28 other respondents have "Chinese walls" or a distinct organizational entity to separate these activities.*

C.3. Restrictions on ownership

These kinds of prudential requirements have become very widely accepted practice.

The *WFE Governance of exchanges survey 2004* noted that:

many exchanges (18 out of 29 respondents) have restrictions on the maximum percentage of shares that can be owned by a single shareholder, from 5% to 50%; but only 3 out of 28 respondents have limitations on the nationality of outside ownership.

C.4. Oversight arrangements

The IOSCO report noted that "in general, regulators have intensified their oversight of for-profit exchanges and taken greater interest in areas such as financial resources." (p. 18)

As regards to financial resources in general, the WFE Secretariat cautions that minimal capital requirements are not relevant for exchanges. Obviously it is different in the case of CCPs for which WFE support the conclusions of the *Recommendations for Central Counterparties* issued by the Committee on Payment and Settlement Systems and the Technical Committee of IOSCO in November 2004.

C.5. Transfer/removal of regulatory functions

The IOSCO report states that:

jurisdictions might choose to remove a regulatory responsibility from an exchange either because they perceive an unacceptable conflict of interest in a for-profit exchange retaining that responsibility, or because they consider that granting an exchange an exclusive regulatory franchise might impede competition. (p.21)

It also points out that:

most countries continue to regard - and value - exchanges as front-line regulators of their markets, often providing them with legal protection in discharging any regulatory responsibilities imposed on them under legislation. (p.21)

Historically, most exchanges have felt strongly that the transfer or removal of regulatory functions should be a last resort, and are glad so see that the IOSCO paper stresses that this is a radical move and should not be taken lightly.

Most have been supportive of the view (which does not come out not too strongly in the IOSCO paper) that such a move is completely driven by the specific circumstances of a jurisdiction, and frequently for reasons other than the demutualisation, listing or for-profit motive of an exchange.

D. Broader regulatory issues arising from the new business models

D.1. Background

The IOSCO report notes that:

for-profit exchanges have a strong incentive to be active commercially. They have a broader base for funding and there is pressure to deliver returns to their shareholders - whether by raising income or cutting costs […] They also enjoy broader access to funding than mutual exchanges and have greater freedom to pursue opportunities unrestrained by the interests of any particular group of participants (although this broader access may be accompanied by a greater degree of shareholder activism). (p. 22)

As one WFE member noted, for-profit motive is beneficial for customers and markets, in that it provides incentives to innovate and develop market structures in the interest of both users and

investors.

D.2. Competitive behaviour

There is no doubt that competition regulators should consult with exchange regulators when reflecting on the exchange industry. But it would place an unnecessary burden (and potentially conflicting requirements) on exchanges if both the competition and exchange regulators were to try and regulate the competitive behaviour of exchanges. In some markets, the market regulators have an explicit mandate to consider competition questions as a central part of their work.

WFE's past work leads to support the IOSCO view that:

> *while the efficiency benefits of competition are to be welcomed, it is also important that competition is conducted in a manner consistent with market integrity and investor protection. (p.23)*

WFE acknowledges that:

> *the challenge for regulators is to allow normal commercial practices as much freedom as possible but to recognize that in the exchange environment they also need to protect the principles of pricing integrity, client interests and best execution (p.23)*

But the WFE Secretariat would think that exchanges should be given as much commercial freedom as necessary, and that regulation should primarily ensure market transparency and integrity, and investor protection.

D.3. Extension of exchange activities

IOSCO acknowledges the weight of reputational risk:

> *reputational risk should provide protection against some forms of diversification (p.24)*

As long as other related lines of businesses do not threaten the exchanges' regulatory and other public interest functions, exchanges would logically not wish to be impeded in expanding their activities. In the Secretariat's opinion, the requirement should just be that these other activities must not interfere with the exchange's ability to fulfil its mandated unctions.

The extension of exchange activities is seen by most actors in this industry as part of developing more liquidity for the markets, lessening volatility, and providing new instruments for clients.

D.4. Cross-border activity and affiliations

The IOSCO report emphasizes that:

> *perhaps the development raising the most regulatory issues is cross-border business development. (p. 24)*

On this point, the WFE *Regulation of Markets Survey 2004* pointed out that:

overall, market regulators seemed better adapted to cross-border trading than government regulators. Exchanges which answered this question[20] were primarily those which already have cross-border affiliations or trading systems. Many mentioned the existence of MOU's.

Some exchanges commented that they were well adapted for cross-border trading, but their government regulators were focused on domestic interests. One example: "The market is well-adapted for such trading. Our regulator perhaps has a more domestic focus."
The level of adaptability to cross-border trading is higher in European markets. One exchange noted that "EU has passporting arrangements in place which allow investment firms and credit institutions to provide services to other EU countries outside of their host country, and also allows them to deal on other Exchanges – thus our Exchange has been able to attract members from other EU countries." However, most exchanges apparently did not feel their government regulators were ready to deal with cross-border trading, although many respondents mentioned the existence of MOUs.

D.5. Outsourcing
The IOSCO report mentioned

an emerging issue is the degree to which an exchange should outsource its key operational functions (p.26)

WFE members agree "that this may make sound commercial sense and, in general, be in the interests of market users" (p.26) and that reputation risk would prevent the outsourcing process to result in any breach of exchanges regulatory obligations.

The JSE is an example of where the exchange outsourced the operation of its trading platform to the London Stock Exchange very successfully. The JSE retains full regulatory responsibility for the operation of the trading platform and is regulated by the Financial Services Board in South Africa. Other WFE members have done the same with the Deutsche Borse and OMX platforms.

D.6. Maintenance of unprofitable markets
WFE members would likely agree with the IOSCO point that "some exchanges may resist closure or sale of a sector if they consider it as an important part of the brand value, regardless of its level of profitability" (p.26) and in case the sector is clearly out of exchanges' range of work (public utility, public service) it should be transferred to the adequate structure.

D.7. Monopoly operation
The report questions the fairness of the fee-setting process in a situation of little or no competition. Actually, as one WFE member noted, competition of exchanges with off-exchange trading platforms is increasing. Combined with growing competition at a global level, this has been greatly accentuating competitive pressure on all exchanges. In the US, the off-exchange competition is made manifest by the growing market share of alternative trading platforms (ATSs). In Europe, the Markets in Financial Instruments Directive will give systematic internalizers and multilateral trading platforms (MTFs) official status, and put an end to any concentration rules that still exist in some legislations.

[20] Exchanges were asked: "Is your market regulation well adapted for cross-border trading? Is your government agency regulator well adapted for cross-border trading?"

E. Conclusions and recommendations

1. “Regulatory authorities should have adequate arrangements to enable them to keep the changing market environment under review and to identify emerging issues in a timely fashion. These arrangements should include ongoing dialogue with exchanges (which could include regular meetings with exchange boards and/or management or specific reporting obligations) to help ensure an understanding of their businesses and practices.”

The WFE Secretariat strongly supports IOSCO recommendation for regulatory authorities to have an ongoing dialogue with exchanges. And, as the IOSCO report pointed out that “perhaps the development raising the most regulatory issues is cross-border business development” (p.24), WFE supports all international initiatives that would allow discussing the points outlined in the report.

As “all exchanges continue to perform all or some of the regulatory functions traditionally assigned

to them” (p. 28), this dialogue is absolutely necessary.

Europeans exchanges have pointed out that in Europe the regulatory role of exchanges has undergone a major change as a result of EU legislation (FSAP) over the last five years.

As acknowledged by the IOSCO report on pages 13 and 15, the Markets in Financial Instruments Directive (MiFID) establishes a common framework for the regulation of exchange members, ATSs, and exchanges in Europe, leaving very little room for market operators to impose additional requirements on any of these regulated entities. In addition, issues such as access to regulated markets and governance structures have been clearly addressed in MiFID.

2. “Regulatory authorities should assess whether the changes being made by exchanges require any adjustments to the regulatory framework for an individual exchange or for exchanges generally, and should address any such need for changes promptly.” (p. 29)

As stated before, the WFE Secretariat believes that there is no “one size fits all solution”. It acknowledges that the situation is evolving situation, and believes that existing arrangements and balance are generally satisfactory.

3. “Regulatory authorities should carefully assess the impact on resources of any changes to the regulatory model for exchanges, and ensure that the core regulatory obligations and operational functions of exchanges are appropriately organized and sufficiently resourced.” (p. 30)

One WFE member cautions against overregulation and for leaving as much way as possible for self-regulatory arrangements. SROs have a strong incentive to provide market integrity.

4. “Securities regulatory authorities should be prepared to share relevant information concerning cross-border activity.” (p. 30)

WFE has supported better communication between regulators and exchanges in cross border issues.

There may be a need to obtain information for market oversight purposes or more generally (for example, information on listing processes, settlement procedures or trading systems). This is

especially important in Europe, where there are already two cross-border entities – Euronext and OMX. As consolidation may continue, this issue could become even more important.

5. “Regulatory authorities should consider competition issues that may arise in connection with the evolution of exchanges as discussed above where such evolution impacts market integrity, efficiency or investor protection.” (p. 30)

The WFE Secretariat would fully support the IOSCO Technical Committee view that competition between trading venues is positive, but unintended side effects on market integrity, efficiency and investor protection must be carefully monitored. These principles should remain the core features of all market organizational arrangements.

We hope the IOSCO Technical Committee finds these comments helpful. The WFE publications referred to are posted on http://www.world-exchanges.org under “publications”. We would be happy to discuss these comments further with IOSCO.

Respectfully submitted by

Thomas Krantz
Secretary General
World Federation of Exchanges

SRO Consultative Committee

Responses to SC2 Questions on Demutualization

Updated February 2005

AMMAN STOCK EXCHANGE

The Amman Stock Exchange (ASE) is considering converting to demutualized entity in its future plans.

As for the legal matters, the new Securities Law Number (76) for the year 2002 paved the way and accounted for demutualization of the ASE. The demutualization decision will be taken by the Jordan Securities Commission (JSC) Board of Commissioners, upon approval of the Council of Ministers. The Council of Ministers shall determine the entity upon which the ASE's assets and obligations shall devolve.

In its plans for demutualization, the ASE is aware of the issues that will arise from demutualization such as conflict of interest and regulatory concerns and it will take these issues into consideration. Also the ASE will benefit and learn from the experiences of stock exchanges that have already converted.

BURSA MALAYSIA

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

Bursa Malaysia completed its conversion into a public company limited by shares from a company limited by guarantee effective 5 January 2004.

Reasons for demutualising:

The Capital Market Masterplan (CMP) which charts the 10-year plan for the Malaysian capital market recommends the demutualisation and listing of the Exchange. Demutualisation and listing will enable the Exchange to better position itself to respond to the collective interests of broader stakeholders and consequently be more customer driven and market oriented. This will enable the Exchange to remain competitive and responsive to demands of its market

constituents. Demutualisation enables Bursa Malaysia to adopt a corporate structure which enables the implementation of listing.

In addition, demutualisation is expected to achieve the following benefits to:

Government, Economy & Capital Market

- Shareholding in Demutualised Exchange
- Development of the Capital Market
- Strengthening of the Real Economy
- Efficient Exchange, Competitive Economy
- Improvements in Safeguard and Increased Confidence
- Streamlined Regulatory Process

Issuers and Investors

- Representation on the Exchange and More Focussed Attention
- Operational and Regulatory Efficiency
- More Product Innovation to Meet Investors' Needs
- Improved Market Volume and Liquidity

Intermediaries – Stockbrokers and Remisiers

- Financial Benefits to Intermediaries
- Greater Focus on Core Business
- More Business Opportunities via Enhanced Innovation

Exchange

- Better and balanced Governance
- More Efficient Decision Making Process and Time to Market
- Competitive and Performance-Oriented Culture
- More Focussed and Consistent Market Development
- Good Governance Leading to Greater Transparency and Accountability
- Integrated Risk Management Framework

After demutualisation, its role has changed towards looking after the interest of the entire market comprising investors, stockbroking companies and intermediaries as opposed to mainly stockbroking companies (due to brokers membership) prior to demutualisation. Bursa, whilst a regulator, as a profit driven company, has to ensure a balanced performance of both regulatory and commercial functions. The demutualised Exchange now becomes more accountable for the quality of its markets and as such aligns the interests of public more clearly.

Regarding questions 2 and 3:

These were the potential areas of conflicts there were identified in the course of formulating the demutualisation framework of Bursa Malaysia.

Monopolistic abuse

- Bursa, the sole exchange in Malaysia, could be tempted to charge high fees for products and services, or provide very poor customer service standards, in view of its monopolistic abuse to enhance its revenue and profitability.

Inadequate risk management

- Too much focus on profits could also make Bursa Malaysia pay less attention robust enterprise wide risk management.
- It could just let any company directly through its systems without properly checking their qualifications.
- It could decide not to spend enough money on risk management systems and procedures, or set aside insufficient emergency funds for investor protection.

Ineffective or biased regulation

- Another potential concern is Bursa Malaysia may not be willing to spend enough money and resources to properly regulate the market.
- It may also be biased in taking disciplinary actions against market participants if there are relationships or competition with those participants or their stakeholders.

Avoiding non-profit or low-priority investments that benefit the market

- Bursa may not allocate sufficient resources to activities that are deemed important for the development of the industry but may not be revenue-generating.

Inappropriate governance

- In view of the important role Bursa plays in the national economy, there could be perception that Bursa may not align its interests and objectives to the broader market and public interest, or may be skewed to certain stakeholders.

Misalignment with national interest

- Finally, there is also a risk that, as a private company, Bursa may decide to only focus on its own shareholders' interests which are not in line with national interest and policy.

Although there is inherent conflict, it however can be addressed by having a proper public interest framework. In recognising all these potential conflicts of interest up-front, a 'Public Interest Framework' was designed and implemented to provide all the necessary checks and balances, which comprises the following six (6) key elements that collectively provide the mechanisms to address the conflicts and concerns:

1) **Balanced Board Structure**

- To ensure that public interest is represented and protected, the SIA, as amended by the Securities Industry (Amendment) Act, prescribes that one third (1/3) of the Board of the demutualised Exchange will comprise Public Interest Directors (as appointed by the Minister of Finance).
- The Public Interest Directors represent the general investing public and is entrusted with the charge to ensure that public interest is safeguarded in the decisions made by the Board.
- In addition, 1/3 of the Board is independent directors, to represent interest of the minority shareholders.
- The balance 1/3 is represented by nominees elected by the shareholders including CEO. Furthermore, the position of Executive Chairman has also been de-coupled into Non-Executive Chairman and CEO.

2) Shareholding and Decision-making Limitations

- Pursuant to Bursa Malaysia's demutualisation, the Minister of Finance may prescribe a limit on maximum shareholding and transferability of substantial blocks of shares, consistent with the amendments in the SIA [The restriction against any person (including any party acting in concert) holding 5% or more of the voting shares in the Exchange Holding Company, without the prior written approval of the Minster of Finance].
- Key decisions made by the Board of Bursa Malaysia that have an impact on national policy would also have to be approved by the Minister of Finance.
- This is to prevent initiatives that may not be consistent with the broader interests of the Malaysian capital market.

3) Supervision of the Company as a strategic public utility

- The position of the demutualised Bursa Malaysia as a strategic public utility required the formulation and establishment of a regulatory framework to supervise the activities of Bursa and regulate it as a self-listed entity.
- This position is not unique and has been adopted by other demutualised exchanges.
- In addition, the SC is responsible for supervising the demutualised Bursa's activities that directly affect public interest.
- This includes a review of fees charged, regulatory activities and risk management.
- The SC also has the power to issue directions to the demutualised Bursa or any of its market institution subsidiaries in the event of conflicts between the interests of the demutualised Bursa or any of its market institution subsidiaries and the interests of the proper performance of duties conferred on such parties.
- Further, the SC will continue to play its oversight role, which includes approving changes to Bursa Malaysia's rules, and carrying out any audits, if it has reasons to believe that regulatory integrity is being compromised.

- SC will also take over the role of listing authority that would normally be done by Bursa, as far as the listing of Bursa and its compliance with the Listing Requirements are concerned.

4) Risk Management Organisation & System

- Almost similar to the regulatory structure, there are three (3) levels of separation for risk management activities: Operational, Corporate and Board oversight.
- First, the Clearing, Settlement and Depository business unit has an operations risk management unit to manage the capital-at-risk due to settlement risk exposure.
- Second, Group Risk Management unit that is independent of the business units is established under Group Internal Audit & Risk Management function to oversee and co-ordinate the management of enterprise wide market risk exposure and ensure adequacy of lines of defence to minimise systemic risks.
- Third, an independent Board Committee, Risk Management Committee, oversees the overall risk management system. This is a requirement under the SIA.

5) Internal Regulatory Organisation Structure

- To ensure sufficient regulatory objectivity, the demutualised Bursa has incorporated three (3) levels of separation for regulatory activities.
- Firstly, all current regulatory activities are organisationally independent and separate from the business units.
- The centralised Regulations Division is resourced, measured and managed independently from the performance of the business units.
- Secondly, Disciplinary Committees at subsidiary level have been formed, comprising members who are not attached to the Regulations Division, to adjudicate and decide on any action to be taken against market participants who are found to violate exchange rules.
- Thirdly, an Appeals Committee comprising independent directors or Public Interest Directors provide an independent channel for market participants to appeal against any decision made by the Disciplinary Committees.

6) Establishment of a fund, i.e. Capital Market Development Fund

- The CMDF has been established under the SIA as a fund administered by a Board made up of seven (7) members appointed by the Minister of Finance with recommendations from the SC.
- It is set up to ensure that a proportion of the funds raised from the Bursa's eventual listing will be reinvested into programmes aimed at facilitating the development of the Malaysian capital market for the benefit of a broad spectrum of stakeholders, including intermediaries, investors and issuers.
- This is to ensure that there are funds set aside for activities that are beneficial to the broader capital market, but which may not be in the commercial interest of the Bursa.

- The objectives of the CMDF are broadly set out as follows:
- The promotion of the capital market in Malaysia to be an efficient, innovative and internationally competitive market;
- The development and upgrading of skills and expertise required by the capital markets in Malaysia;
- The development of self-regulation by professional association and market bodies in the securities and futures industries; and
- The development and support of high quality research and development programmes and projects relating to the capital market in Malaysia.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

To align or change the organisational culture from a previously 'regulatory-based' organisation to a 'performance-orientated' one with strong commercial objectives. Divisions and departments had to be restructured in business units and functional units with clear objectives. Training programmes to re-orientate and re-align staff on the new direction were and are still being undertaken.

CHICAGO BOARD OF TRADE

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

The Chicago Board of Trade (CBOT®) lists futures contracts and options on futures contracts on a variety of agricultural, financial, and stock index products. CBOT Holdings, Inc. currently has a pending registration statement (Form S-4) on file with the U.S. Securities and Exchange Commission, which describes the proposed restructuring (or demutualization) of the Exchange. Once the SEC declares the registration "effective", the members will be asked to vote on the proposal. The Board of Directors approved the proposed demutualization based on its belief that it will enable the Exchange to enhance its competitiveness within the futures industry, while preserving its ability to provide trading benefits and opportunities to its members. Specifically, the Board believes that the demutualization will, among other things, allow the Exchange to:

- Maximize the value of the business by adopting a for-profit approach to business with a view towards optimizing volume, efficiency and liquidity in the Exchange's markets;
- Increase the Exchange's ability to respond more efficiently to changes within the industry, markets and applicable regulations by modernizing its corporate governance structure;
- Segregate more easily the Exchange's different lines of business into separate subsidiaries through a holding company structure, which could provide greater flexibility in administration and allow these subsidiaries to focus more effectively on particular markets, products or services;

- Distribute profits from the operation of the business to the stockholders; and
- Facilitate the creation of public markets for the equity securities of CBOT Holdings and engage in capital-raising transactions and other securities issuances following a subsequent approval by the stockholders of CBOT Holdings.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

The CBOT's own regulations currently address conflicts of interest, and will continue to do so if the proposed demutualization is completed. Pursuant to CBOT Regulation 188.04(a), a member of the Board of Directors, the Executive Committee, the Regulatory Compliance Committee, or a disciplinary committee must recuse himself from deliberations and voting on a matter if he has a family or employment relationship, or a direct and substantial financial relationship, with a person or entity that is identified by name as a subject of the matter. Members who believe that they have such a relationship must voluntarily recuse themselves. If a member is not sure if a particular relationship falls within the criteria requiring recusal, he must disclose the relationship to the designated Exchange staff liaison, who will determine whether recusal is required, based on the information provided by the Board or committee member.

A member of the Board, the Executive Committee or the Business Conduct Committee (BCC) must recuse himself from deliberations and voting with regard to recommending or taking emergency action, as defined in Commodity Futures Trading Commission Regulation 40.1, if the member knowingly has a direct and substantial financial interest in the result of the vote based upon either Exchange or non-Exchange positions that could reasonably be expected to be affected by the action. Regulation 188.04(b)(2) describes the positions that a member should consider in determining whether a financial interest is direct and substantial.

Members who believe that they have such a financial interest must voluntarily recuse themselves. If a member is not sure if a financial interest, of which he has knowledge, is direct and substantial, he must disclose the interest to the designated Exchange staff liaison, who will determine whether recusal is required, based on the information provided by the member. Regulation 188.04(b)(2) provides a limited exception from the recusal requirement, permitting a member who has such a financial interest to participate in deliberations, but not voting, if the deliberating body determines that his participation is necessary to achieve a quorum, or if the member has unique or special expertise, knowledge or experience in the matter.

A member of the BCC must recuse himself from deliberations and voting with regard to matters relating to the Committee's surveillance of any expiring futures contract, if the member personally owns or controls positions in such expiring futures contract or any corresponding options contract. Prior to the relevant BCC meeting, Exchange staff reviews any large trader data submitted to the Exchange by Committee members, and the members of the BCC are also asked whether they own or control any such positions, prior to the Committee's discussion of the expiration.

Members of the Board of Directors may be required to recuse themselves from deliberations and voting for other reasons or in other circumstances than those addressed in CBOT Regulation 188.04, if required by Delaware corporate law.

The Exchange's Board of Directors is currently made up of 18 individuals, four of whom are non-members. Assuming the demutualization has been completed, the Board will consist of 16 individuals, three of whom will be independent directors, after the 2006 annual election. If there is a qualified initial public offering of shares of CBOT Holdings, following a second approval by the stockholders, the Board will be reconstituted, and at least nine of 17 directors will be independent. However, the Exchange strongly believes that it is important to retain significant representation on the Board of individuals who participate in the exchange's markets, and can therefore contribute the necessary expertise to the Board's deliberations.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

There is no inherent conflict in being both self-regulatory and demutualized, and there has been no evidence that the trend toward for-profit futures exchanges, or changes in the competitive environment, have led to any decrease in the effectiveness of self-regulation. To the contrary, as more exchanges have entered the business, there is a real competitive incentive for all exchanges to attempt to distinguish themselves on the basis of their integrity, the efficiency of their markets, and their fairness to customers. In particular, it would be contrary to any exchange's own business interests and, if it is demutualized, the interests of its shareholders, to allow its integrity to be compromised by conflicts of interest in its decision-making.

Effective self-regulation can enhance the brand name and reputation of an exchange. A demutualized exchange does not have any motivation to seek to attract volume or increase its profits through lax self-regulation. To the contrary, it is "good business" to maintain the integrity of the exchange. Potential participants will be drawn to a market that will treat them fairly, and on which they are likely to obtain prices that are determined by market forces and the liquidity of the market, rather than abusive or manipulative practices. On the other hand, an exchange that would allow the fairness of its marketplace to be compromised by narrow business interests will lose its business, through a loss of customer confidence. The market integrity of a for-profit exchange can be expected to be a strong marketing tool.

Some have suggested that in light of the trend toward exchange demutualization, regulatory services for exchanges should be performed by an independent third party regulatory services provider, rather than by the exchanges themselves. The CBOT strongly believes that rule enforcement, disciplinary and related functions can be, and are, effectively performed by exchanges, whether or not they are demutualized.

In particular, the regulatory services that are provided by exchanges encompass much more than the investigation and prosecution of potential trade practice or market abuses, and the performance of audits and financial reviews. The regulatory staff of an exchange is in a unique position to develop relationships with the exchange's members, member firms, or market participants which offer opportunities for education, answering questions, and preventing violations from occurring through increasing their awareness of the exchange's rules and regulations. Moreover, an exchange is in the best position to interpret its own rules.

One of the essential functions of a futures exchange's market surveillance staff is the surveillance of expiring futures contracts to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process. This surveillance process can involve frequent meetings with the exchange committee that has the responsibility for monitoring expirations, and numerous letters and phone calls between the market surveillance staff and large participants who remain in the market during the delivery period. Exchanges' market surveillance staffs have an opportunity to become very familiar with their own market participants in this manner, and in turn, can effectively coordinate with other regulators.

The staff of an exchange that conducts its own audits and financial surveillance becomes very familiar with member firms' accounting staffs, internal controls and other procedures and financial positions based on frequent routine interaction, including audits, regular financial surveillance, and the routine surveillance of the potential financial impact of large trader positions. An exchange's audit and financial surveillance staff, which has developed relationships with member firms through such regular contact, is frequently aware of developing problems, and is in a position to respond by intensifying its monitoring efforts and requiring increased reporting to the exchange. An exchange's audit and financial surveillance staff is also keenly aware of the impact that one member firm's financial problems may have on the exchange's clearing house and other member firms and their customers, and is strongly motivated to attempt to ensure that such consequences do not occur. The CBOT believes that the performance of these functions by exchange staffs has resulted in the impressive record of the U.S. futures industry in averting or minimizing the impact of financial failures.

There are also important benefits to be gained by an exchange that maintains its own investigative staff. Particularly, in the case of an open outcry market, such an investigative staff is in a position to act very quickly, because it has immediate access to brokers and traders on the floor. Members who are the subjects of investigations may be more likely to cooperate with the exchange's own investigators than those of a third party, because they are more likely to know them, and because they are strongly motivated to maintain their trading privileges and reputations at the exchange. Similarly, other exchange members are more likely to file a complaint with the exchange's own investigative staff. At the CBOT, the investigative staff also spends time on the trading floor, monitoring trading at various opens, closes, and expirations, and is frequently consulted about the Exchange's trading rules and regulations by members who wish to avoid taking actions that could violate those provisions.

Exchanges also can effectively provide a forum for disciplinary proceedings resulting from rule violations that lead to prompt and effective disciplinary action. Disciplinary committees that include representatives of the various categories of members who appear before them have the insight necessary to perceive violations and their consequences, and impose appropriate penalties. Given that market integrity is crucial to the success of a for-profit exchange, demutualized exchanges as well as those that are mutually-owned should be permitted to decide for themselves whether to perform their own self-regulatory services or whether to outsource those services to a third-party provider.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

The CBOT has already addressed the major issues that are faced by both mutually-owned and for-profit exchanges. These issues include, among others: ensuring the fairness of the composition of the governing board, regulatory oversight, and disciplinary committees; minimizing potential conflicts of interest in decision-making; and maintaining an appropriate separation between the self-regulatory functions and the business functions of the Exchange.

A major change in any industry will present some issues that were not anticipated. As exchanges both new and old continue to develop experience functioning as shareholder-owned organizations in a competitive environment, they should be allowed the flexibility to develop and, as necessary, modify the ways in which they address the issues that present themselves.

DEUTSCHE BÖRSE GROUP

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

The demutualization of the Frankfurt Stock Exchange took place in 1989. The reason for demutualization was the improvement of the course of business and the ability to shape the development of the industry. On the basis of demutualization we are having the essential financial and human resources to run an exchange successfully on an international basis.

The SRO for the Frankfurt Stock Exchange is Frankfurter Wertpapierbörse (FWB), which is an institution under public law with partial legal capacity. The demutualization of the Frankfurt Stock Exchange involved only its operating and administrating structure. All the regulatory functions have been kept under public law.

The administrating and operating institution of the Exchange is Deutsche Börse AG. The company is listed since 2001. Deutsche Börse AG makes available the necessary staff, the financial resources and the facilities and premises. Organized under private law, Deutsche Börse AG has the possibility to operate in an economically justifiable way.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

There is a strict differentiation between private and public law in Germany. Public entities fulfil sovereign duties which are regulated by own rule books containing public laws. There is no mix up between public and private law and therefore a public entity is not allowed to execute declarations of its attention under private law, what -in fact- means that a public entity is not able to deal with any contract. Hence for all private deals the public entity requires a separated operating company under private law.

Stock exchanges are regulated by the German Exchange Act which entitles them as institutions under public law with partial legal capacity. This means on the one hand, that any operator of an exchange is obliged by law to build up a SRO and on the other hand, that a

private company is also required to make the exchange capable of acting. The SRO for the Frankfurt Stock Exchange is the Frankfurter Wertpapierbörse (FWB) which is operated by Deutsche Börse AG (DBAG). Hence this "dualistic" system is a mandatory need in Germany. In comparison with other European juridical system the German model ensures the indefeasible legal status of the stock exchange, especially with regard to its self-regulatory role.

There are several provisions in place ensuring that no conflicts of interest will arise. First of all it is of the greatest interest for DBAG as well as for the German Regulator to prevent any conflicts of interest. Especially for DBAG as a listed company following an international business strategy it is vitally important to attract international investors and companies by providing a transparent and efficient market place and therefore to be above any suspicion to get in conflicts of interests.

Being a listed company Deutsche Börse AG has to comply with the German Corporate Governance Code. The German Corporate Governance Code presents essential statutory regulations for the management and supervision (governance) of German listed companies and contains internationally and nationally recognized standards for good and responsible governance.

Moreover there are three "pillars" the FWB is based on which avoid and ensure that DBAG will not get in any conflict of interest by operating its SRO.

Firstly the influence of DBAG towards FWB is limited. The exchange act ensures that the Exchange Council which determinates exchange regulations and appoints the management of the exchange consists of 24 members giving strong influence to all parties involved in exchange trading. Therefore DBAG won't be able to provide one sided benefits to any party.

Secondly exchange supervision in Germany is extremely strict and it is also carried out by different authorities in order to maintain high market integrity. The German Securities Supervisory Authority (BaFin) monitors all trading activities, the disclosure of price relevant information and director's dealings and the rules of conduct. Finally they investigate insider offences.

The Trading Surveillance Unit (HÜSt) as part of the FWB additionally monitors price discovery processes, rules and regulations and open positions of specialists and brokers. It is instructed and supervised by the Exchange Supervisory Authority in the state of Hesse which is mainly responsible for the legal and market supervision of the exchange. The most important duties of the Exchange Supervisory Authority are the supervision of the price formation processes, the investigation of violations against the exchange rules and regulations, the development of fraud prevention and the supervision of lawful conduct by the exchange bodies. The authority is also in charge of the supervision of trading participants admitted to exchange trading.

Thirdly the rule books of the FWB are providing a high degree of legal certainty. Competences of the FWB are clearly defined by the German exchange act. It grants the right to the Exchange Council to enact the exchange rules and regulations (Börsenordnung, § 13 I BörsG). These rules for admission and exchange trading have to be very detailed, making decisions transparent, comprehensible and reliable. The rule book has to be approved by the

supervisory authority and of course has to be in line with the legal framework provided by the exchange act. All bodies of the FWB act in the public interest.

Together these three pillars ensure that the risk for DBAG to fall in a conflict of interest by operating a SRO does not exist.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

See 2.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

In the past, the legally and economically responsible body of the Frankfurt Stock Exchange was the chamber of commerce and industry (IHK). The ownership has changed with demutualization in 1989. Furthermore, the (share) ownership of Deutsche Börse AG as a joint-stock company has changed since Going Public in 2001 separating owners from members. At the end of 2003 the composition of Deutsch Börse's shareholders was

- Private investors 4%
- Institutional investors 93%
- Strategic investors (pre-IPO investors) 3%.

With respect to the main business area of the Frankfurt Stock Exchange, there have been no essential changes. As a result of the stringent legal separation of the Frankfurt Stock Exchange as SRO and Deutsche Börse AG as operating company there were no emerging regulatory issues relating to demutualization and there will be no foreseeable of them in the future.

ISTANBUL STOCK EXCHANGE

Before replying to these questions, we would like to give brief information about the legal status of the Istanbul Stock Exchange (ISE) to clarify its current status.

The ISE is governed by an Executive Council composed of five members. The Chairman of the Executive Council is appointed by the government and acts as an intermediary between the ISE members and governmental authorities including the Capital Markets Board (the regulatory and supervisory authority for the Turkish capital markets). Four other members of the Council who are elected by the ISE members represent the three categories of Exchange members: development banks, commercial banks and brokerage houses. The decisions of the General Assembly are subject to ratification and review by the Capital Markets Board. The General Assembly also decides on important matters related to the administration of the ISE. Each member has one vote at the General Assembly meetings, which can also be convened on an extraordinary basis.

The Istanbul Stock Exchange is supervised by the Capital Markets Board, which ensures the proper operation of both the Istanbul Stock Exchange and its members and protects the interests of both the public and the investing community. All accounts and financial statements of the ISE are

audited by two internal auditors appointed by the General Assembly. ISE's accounts are also independently audited.

As an autonomous, professional organisation, the ISE enjoys a high degree of self-regulation. The ISE has its own budget. Its revenues are generated from the fees charged on transactions, listing procedures and miscellaneous services. The ISE is a non-profit institution. However, it works profitably due to efficiency in operations. The profits of the ISE are retained to meet its expenses and to undertake investments. In the recent years, the ISE has transferred a significant amount of funds to the Ministry of Finance for the general budget.

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

Demutualization of the ISE is on the government's agenda in line with the privatization policy. It is initiated by the Privatization Agency. Towards the target of privatization, the ISE is first planned to be demutualized as a profit oriented company and then privatized by the government. Demutualization has not been accomplished yet. Following the determination of the consultancy firm who will clarify the road map to achieve this target, the project will take start. Demutualization in general, aims to create higher efficiency and profitability. In the ISE's case, the institution is already highly efficient and profitable. The most important benefit that the ISE may draw from privatization would be to have more independence; for example, in the case that the ISE members would become the owners of the institution.

The key factor behind the government's privatization decision, on the other hand, is the intention to generate income for the fiscal budget.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

Due to the current status of demutualization as mentioned above, the ISE is not directly related with the privatization process. Furthermore, the project is at its beginning stage. Therefore, ISE has not faced any major issues or conflicts of interest to be resolved yet.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

The ISE supports the demutualized exchange structure, which will enable the Exchange to be more flexible and independent in its operational and regulatory activities. In its current structure, as a self-regulatory body, the ISE has social responsibility and role on the market. The ISE not only supports the integrity and efficiency of capital markets by setting and enforcing appropriate rules to regulate the market towards public policy, but also considers the benefits of its members by accomplishing activities including listing, public disclosure, market surveillance and investigation of violations of Exchange rules and regulations. Currently, there is no conflict, but profit-seeking structure will obviously be at the expense of the members by increasing the costs in the future.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

There are no issues at this point; however, demutualization might cause some issues such as the roles, voting rights (or even shares) of members in the new Exchange structure, the role of the Capital Markets Board over the exchange after privatization, relationship between the private company and government agencies, and controlling the policies of profit-oriented private company according to public benefits.

JAPAN SECURITIES DEALERS ASSOCIATION

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

Yes.

Since December 1998, the Jasdaq market had been operated as an OTC stock market established by Japan Securities Dealers Association (JSDA). However, OTC stock market has many legal restrictions, such as the prohibition of at market orders and of the establishment of a futures market, which stock exchanges are permitted to engage in. Because of these restrictions, the Jasdaq market competed with stock exchanges against heavy odds.

Consequently, JSDA decided to convert the Jasdaq market from an OTC stock market into an exchange stock market. Since it was legally impossible for JSDA itself to establish an exchange stock market, JSDA decided to convert Jasdaq Market, Inc., a subsidiary of JSDA entrusted with Jasdaq's market operations, into a stock exchange. Jasdaq Market, Inc. obtained a license to operate a stock exchange in December 2004 and began operations in December 13, 2004. At the same time, it changed its name to Jasdaq Securities Exchange, Inc.

In this process, there was the option of newly establishing a membership stock exchange. However, JSDA preferred a joint-stock company. The reasons were (1) it would be difficult to get our members to agree to the creation of a new membership entity because the significant costs of establishing such an entity would have to be covered by membership fees and (2) a stock exchange in the form of a joint stock company secures additional sources of income and enables flexible capital investment, significant advantages given the importance of transaction and information systems strategies for advancing competition among stock markets.

The driving forces behind this decision to take maximum advantage of the joint stock corporation structure were (1) that other competing stock exchanges--Tokyo Stock Exchange and Osaka Securities Exchange--had already been demutualized and (2) that the Jasdaq market had been indirectly demutualized by making use of a joint stock company (Jasdaq Market, Inc.) as a subsidiary to operate the OTC stock market since 2002.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

A stock exchange should maintain aspects of a public organization because of its fundamental role as a public market operator. On the other hand, in the light of promoting efficiency of market operation, the flexible funding is also essential since a stock exchange is a processing industry with huge system facilities to maintain.

There has been concern that focusing on profitability will result in inadequate screening of listing applications and listing control. In Japan, related parties considered various issues in this regard when the 2001 revision of the Securities and Exchange Law approved stock exchanges with a joint stock company structure.

Against this backdrop, JSDA set up working groups and discussed the issue of "conflict of interest between serving public needs and profitability" in the process of forming the Jasdaq Securities Exchange. In the end, JSDA decided that effectively using the joint stock company system with converting Jasdaq Market, Inc. into a stock exchange would best serve the public by ensuring high-quality market services.

In the short run, soliciting listings by more firms will increase the number of listed companies and transactions. Therefore, it cannot be denied that there is a possibility of inadequate screening of listing application and listing control. If a stock exchange concentrates only on satisfying the needs of market participants in order to boost transaction volume, transparency of transactions or other important issues to protect investors may be undermined. If chasing profit is given priority, a joint stock company-based stock exchange will earn substantial income from various sources. However, in the long run, this situation will impose significant losses on investors, which in turn will downgrade their assessment of the market and undermine profitability. Therefore, even when the joint stock company system is adopted, a stock exchange should always be managed so as to ensure the integrity of the market along with the pursuit of profitability.

The joint stock company system also has some advantages. A stock exchange adopting such a system is required to ensure proper governance and enhance transparency and disclosure to outsiders in the same way as issuers are. This prevents the structure from becoming one that cannot earn profits over the long term.

In the meantime, JSDA holds 74% of the shares of Jasdaq Securities Exchange, Inc. Consequently, JSDA believes that the market will continue to be highly public oriented.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

There is a longstanding philosophy that a stock exchange should be a public organization in Japan. Because of this pressure, in many cases, a stock exchange adopting a joint stock company system will have to put its self-regulatory role above its own profit in terms of business management from the long-term point of view when there are conflicts of interest.

Although it is in the nature of a joint stock company to try to earn profits, placing the highest priority on profits sometimes leads to a permissive attitude toward non-transparent securities transactions, resulting in a setback for the integrity of the securities market. Neglecting self-regulation while chasing profits does achieve short-term gains, but will undermine profitability in the long run. No company will seek to list on a securities market that ignores its self-regulatory function. No investor will want to trade in such a market. Therefore, the market must necessarily consider self-regulation top priority in terms of quality control.

Since governmental authorization is required to operate a stock exchange in Japan, the government has powerful control over a stock exchange even if it is a joint stock company. If such a stock exchange is perceived to not be serving the public interest, the government will direct it to put its self-regulatory role first.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

N/A

KOREA STOCK EXCHANGE

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

In Korea, three exchanges, i.e., the Korea Stock Exchange, Kosdaq, and Korea Futures Exchange will be consolidated into a single, demutualized exchange called the "Korea Exchange" (KRX) by January 28, 2005. Korea decided for demutualization to enhance the efficiency and competitiveness of the market and build user-friendly market by adopting business-oriented management.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

There were discussions about whether the regulatory functions of the demutualized exchange should be undertaken by an in-house organization or independent regulatory body. We considered that if we establish an independent regulatory body, it would be difficult to utilize the expertise of the market operators. Other problems associated with the independent regulatory body were that we have to decide who would bear the regulatory costs, the regulatory structure becomes complicated, and market operation and regulatory functions cannot be separated as they interact closely. Considering these problems, we decided to establish an in-house regulatory organization within the consolidated exchange.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

Demutualized exchanges will pursue profit maximization for their shareholders. At the same time, they have to maintain the integrity of the market and enhance the liquidity of the market, which are deemed to be the public nature of the exchange. In this context, it can be said that there might be a conflict of interest between the two different goals.

However, it would be difficult for a demutualized exchange to undermine the integrity of the market in pursuit of its profit maximization. The rational is simple. When an Exchange succeeds in securing the fairness and transparency of the market, the investing public will increase, which is directly linked to the income of the Exchange. As such, the Exchange will not neglect maintaining its public nature. In the same context, the Korea Exchange will undertake the self-regulatory role even after demutualization.

4. *What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.*

As the Korea Stock Exchange has not yet demutualized, it appears that we are not in the position to answer this question.

LUXEMBOURG STOCK EXCHANGE

The Luxembourg Stock Exchange never had to convert from a mutual to a demutualised entity, as it operates since inception as a PLC. Hence, we may not answer questions 1 and 2.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

We do not think that there is an inherent conflict being self regulatory and demutualised. We even tend to consider that there are accrued pressures in order to deliver a well designed, well operated and well perceived self regulatory role. The Exchange operator is always driven by the objective of granting maximum integrity to the market place it operates and to grant maximum investor protection. The self regulatory role should always be perceived with regard to these basic and vital roles each market operator tries to attain. Of course there may be situations where not all and any goals of a true commercial demutualised company may be reached, but that is part of the fine balance between finetuned self regulation, that again may help to foster any other corporate goals of a demutualised entity.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

Separation of conflicting interests and sound management of this separation; divisions between regulatory and commercial affairs in order that the latter do not interfere on the market operator's self regulatory roles; fine tuning in delivering several tasks where there should be no mix inbetween sometimes incompatible tasks that may or should not be untertaken by one and the same department or entity (e.g. investigatory taks should not be mixed up with the competence of pronouncing sanctions and enforcing theses sanctions).

NATIONAL FUTURES ASSOCIATION

As an industrywide self-regulatory organization, NFA occupies a unique position in the U.S. futures industry. Like the exchanges, we are a self-regulatory body, but, unlike the exchanges NFA does not operate a marketplace. Self-regulation is not part of what we do - it is all that we do. We are first, foremost and only a regulatory body devoted to customer protection.

Our 4,000 Members include futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). We also regulate the activities of approximately 50,000 registered account executives who work for those Members. Our mission is to work as a partner with the Commodity Futures Trading Commission ("CFTC") to provide the industry with regulation that is both as effective and as efficient as possible. In the twenty-two years since NFA began operation, trading volume on U.S. futures exchanges has increased by over 1000%. During that same time, customer complaints have actually dropped by over 70%.

NFA is, and has always been, a strong supporter of self-regulation. Self-regulation - subject to appropriate governmental oversight - maximizes regulatory effectiveness while minimizing regulatory burdens and saving taxpayers money. Using industry committees to develop rule proposals provides the expertise to ensure that the rules are tailored to the problem - making them practical as well as effective. Including industry personnel on disciplinary committees brings a depth of knowledge to the process that members of the public simply do not have. Self-regulation also frees up government resources for use in other areas, such as enforcement actions involving unregistered firms and individuals.

NFA commends IOSCO Technical Committee's Standing Committee on Secondary Markets (SC2) for undertaking this project to revisit key regulatory concerns and responses to market demutualization in light of the continuing restructuring of exchanges, particularly those issues relating to conversion to "for profit" exchanges. It presents an opportunity to examine how changes in the industry - e.g., demutualization of exchanges, the emergence of for-profit exchanges, and the changing roles of intermediaries - affect the conflicts of interest inherent in the self-regulatory process and to analyze the best ways to manage those conflicts of interest.

Since NFA does not operate a market, we are in a different position than most other SROs and do not face many of the competitive conflicts they face. Given NFA's unique position as a non-exchange SRO, we will limit our comments to questions 3 and 4.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

As the marketplace changes, the conflicts of interest inherent in the self-regulatory process change as well and government regulators may need to find new ways to manage those conflicts. Conflicts of interest have always been present in any self-regulatory regime; it is how these conflicts are mitigated and managed that changes.

An inevitable result of self-regulation - and its biggest criticism - is the inherent tension between the regulatory interests of the self-regulatory organization (SRO) and the business interests of the SRO as well as the members who sit on committees that develop rules or consider disciplinary matters. This tension may increase when the SRO operates a market or has other economic interests that are separate from its regulatory interests. In the long term, an SRO's marketplace and economic interests should coincide with its regulatory interests, since market participants will not use a market unless they have confidence in it. It is only the SRO's short-term and short-sighted interests that may be in conflict.

These conflicts of interest must be managed if the SRO is to provide effective regulation while treating both market participants and members fairly. SRO governance is one way of managing these conflicts. Adopting sound governance principles is not sufficient by itself, however. Statutory regulators must also provide strong government oversight. These components, working in conjunction with each other, are essential to managing conflicts of interest.

Government regulators should not mandate a particular regulatory structure. Instead, government regulators should use its oversight role to monitor each SRO's ability to manage conflicts between the SRO's regulatory and business functions and between its interests and those of its members, and government regulators should require the SRO to take corrective action when necessary.

Government regulators should not mandate that certain regulatory functions be performed by an independent body. Exchanges should have the option to outsource some or all of their regulatory functions, however.

Self-regulation is a proven commodity that has played a vital role in the futures industry over the years. Currently, the industry is in a period of profound change, which has heightened conflicts of interest in the SRO process. Undoubtedly, the SRO process will have to continue to evolve in response to these industry changes and government regulators will have to vigilantly oversee this evolution.

SROs are committed to protecting investors and the public interest. Market participants need to know that the markets are well regulated, that there are rules in place, meaningful surveillance to ensure compliance with those rules and vigorous enforcement actions if the rules are violated. SRO members need to be deterred from wrongful conduct and they need to believe in the fairness of the process, in the impartiality and independence of the SRO, in the rulemaking process and enforcement of its rules. As with regulators, everything SROs do is designed to protect customers, protect market integrity and protect the public's confidence in the financial markets. Every regulator has to constantly examine whether it can do more to protect market integrity and public confidence.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

Board Composition

In order to ensure the credibility of the self-regulatory process, all market participants - including those regulated by the SRO - must have faith in that process. Market participants

must be confident that the markets are well regulated - that there are tough rules in place, meaningful surveillance to ensure compliance with those rules, and vigorous enforcement actions if those rules are violated. Merely deterring wrongful conduct is not enough, however. Self-regulation is most effective when those persons regulated by the SRO believe in the fairness of the entire SRO process, from rulemaking to enforcement. Proper board composition is essential to ensuring this credibility.

NFA believes that the most important guiding principle for board composition is that the board should be diverse so that no one constituency of the SRO, including the public, can dominate board actions. The principal method of managing board conflicts of interest is through appropriate checks and balances in board composition, not by eliminating market expertise.

Market participants that are subject to the SRO's direct regulatory authority should be represented on the SRO's board. The knowledge and experience these individuals bring to the board are essential to ensure that the board's decisions are economically viable and are feasible from a business standpoint. There are often several ways to address a problem, and market participants are usually the best qualified to determine which method will address the problem most efficiently - providing the necessary protection to customers and other market participants while minimizing the burdens on regulated individuals and entities. Moreover, these market participants should have a voice in how they are regulated; eliminating them harms the self-regulatory process by removing the "self" from "self-regulation."

Governance principles should be general enough to apply to all types of SROs and flexible enough to allow each SRO to adopt the composition that best reflects its structure and the needs of its constituents. We believe that the governing principles should simply state that the SRO should have a diverse board that represents the interests of all of the SRO's constituents, including the public, and incorporates appropriate checks and balances so that no one constituency can dominate the board.

Transparency

The SRO process must be transparent to ensure its credibility. NFA has always strived to make all material information readily available to both our Members and the public.

NFA's Manual and website include the names and affiliations of all members of our Board of Directors, all its standing committees, and NFA's disciplinary committees. Significant actions taken by the Board - including committee appointments and mid-term Board replacements - are reported in the membership newsletter after each Board meeting, and the newsletter is placed on the website where it is accessible to the public. Rule submissions are also posted on NFA's website, as is the entire rulebook.

Information on NFA disciplinary proceedings is also readily available to Members and the public. Notice of decisions issued in disciplinary and membership cases and of membership responsibility actions taken by the Executive Committee is posted on our website, and adjudicated, default, and appeals decisions are posted in full. Pending charges are also included, and all pleadings are available to the public upon request.

SHENZHEN STOCK EXCHANGE

Shenzhen Stock Exchange will not consider to convert from mutual to demutualized entity in the near future.

SYDNEY FUTURES EXCHANGE

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

Sydney Futures Exchange demutualised in 2000, primarily with the objective of broadening direct participation in the Exchange's markets (admission of new members/participants/intermediaries previously being a matter requiring the assent of existing members) and otherwise facilitating efficient management of the business.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

Demutualisation reduced the conflicts of interest inherent in intermediaries/members being in control of the Exchange's conduct of market supervision functions. Arguably, this benefit outweighs the perceived costs associated with the potential for a 'for profit' exchange to devote insufficient resources to market supervision functions. (The costs are more 'perceived' than actual because, in practice, the Exchange has not reduced its financial commitment to market supervision and has not had any inclination to do so, given the commercial benefit of being seen to operate a market that is regarded by users as having integrity). The legislative framework under which the Exchange operates was amended to impose a duty on for profit Exchanges to have procedures in place to address any conflict of interest that may arise between the Exchange's commercial objectives and its market supervision responsibilities. In practice, it is difficult to identify any such conflicts. The Exchange has, nevertheless been mindful of the need to exercise its powers responsibly, including its powers to amend the rules under which the market operates.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

The Exchange does not regard itself as any longer being a "self" regulatory organisation in the sense that the users are not regulating themselves (the users constituting a very small proportion of the owners of the Exchange and not having control of the Board). This is not simply a semantic issue. The reality is that demutualisation involved replacing self-regulation with a structure in which the Board and officials of the Exchange are not beholden to market intermediaries as to how the Exchange exercises disciplinary/market supervision powers. Market intermediaries have effectively handed over their power to Exchange officials and the Board of the Exchange. Intermediaries have continued to serve voluntarily on disciplinary committees established by the Exchange in an environment in which they have lost all leverage. This needs to be recognised as evidence of the proposition that market users genuinely believe that fairly administered informed regulation is in their

interests. The remaining regulatory issue (which is relatively insignificant when weighed against the benefit to end users of intermediaries no longer being in control of exchanges that have demutualised) would seem to be whether the profit motive causes the Board and/or Exchange officials to act too leniently in its market supervision. The Exchange cannot make any disinterested observations on that question (whilst clearly believing that its record demonstrates a continuation of the high standards maintained prior to demutualisation).

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

So long as an Exchange maintains the respect of its users as to its operation of the market infrastructure that it provides, one of the greatest risks faced by users of an Exchange to the continued efficient exercise of market supervision powers (arising from others thinking that there are significant conflicts of interest inherent in the operation of a for profit exchange) is that unnecessary additional obligations might be superimposed by legislation or regulatory commissions on an Exchange which don't actually benefit end-users. In the absence of any evidence of regulatory commissions seeking to perform themselves the task of imposing and enforcing rules on all the issues in respect of which Exchanges have decided to put rules in place, it would seem likely that Exchanges will continue to voluntarily supervise their participants in relation to some matters and regulatory commissions will continue to supervise those same participants in relation to other matters (with some scope for overlap and for regulatory commissions to address any problems by expanding the scope of their own rules/regulations/directives). Similarly, the existence of competing market operators will continue to create issues of gaps and overlaps that need to be addressed from time to time. However, rather than continuing to focus on the scope for conflicts of interest as a reason for trying to identify new controls which could be put in place as to how Exchanges supervise markets, it may be more productive to simply recognize that end-users do not seem to have exhibited the same concern about trading on demutualised exchanges as is evident in IOSCO's prolonged focussing on this perceived conflict of interest issue.

SWX GROUP

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

SWX Group has a group (or holding) structure. Its parts have different legal structures. On top of it, however, there is still an association (i.e. a mutual organisation), with a governance on the basis of “one member - one vote”. Many exchanges have demutualized mainly in order to become more flexible in their strategic moves. We have been able to restructure our markets completely in the last 15 years (going from 7 stock exchanges to one, from cantonal laws to a federal (central) one, from floor to electronic, then from one exchange to two, Switzerland and UK, within the same group; we have merged SOFFEX with DTB to become EUREX; we own one third of STOXX, the European index provider etc. etc) - and all this within given mutual structures.

Regarding questions 2 and 3:

Whatever the organisational set up of an exchange and whatever the scope of its self-regulatory powers - there will always be conflicts of interest which have to be dealt with (as there is actually in almost every business situation). It is however very surprising that there is so much talking about potential conflicts of interest in case of demutualising exchanges. As a matter of fact, there might be more reason for worry when exchanges would change the other way around, from profit oriented to mutual. Not quite surprisingly, there was this saying about "self regulation being selfish regulation" in the good old times when nobody even thought about exchanges being demutualised. Obviously, whenever there are structural changes of such a sort, the situation has to be re-ascertained carefully in order to adapt regulation and make sure that new conflicts of interest are taken care of - while possibly doing away with rules which have dealt with previous ones.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

We can't really talk from our own experience.

TAIWAN STOCK EXCHANGE CORP.

Taiwan Stock Exchange was incorporated in 1962 as a for-profit entity, without a membership structure. These questions, therefore, are not applicable to our case.

TOKYO STOCK EXCHANGE, INC.

Following the revision of the Securities and Exchange Law of Japan (promulgated in May 2000 and enacted in December of the same year) that recognizes "joint stock corporation exchanges", the Tokyo Stock Exchange ("TSE") implemented a deliberation concerning its demutualization under an "Ad-hoc Committee" composed of member securities firms.

As a result of the deliberation taken from July 2000 to May 2001, TSE changed its structure into a joint stock corporation and is currently preparing for going public (scheduled in fiscal year of 2005).

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

Following the demutualization, we believe TSE can benefit in the areas described below:

i) The transformation further clarifies management responsibility and increases the managements' accountability, thus the decision making process becomes more transparent. Clearer definition of the authority and responsibility of management brings swifter decision making.

ii) Demutualization generates a greater variety of financing sources and enhances TSE's financial flexibility for future system developments under TSE's IT Master Plan.

iii) Through the demutualization, executive officers and employees of TSE will be encouraged to change their mindset and focus on how TSE can optimize its corporate value. This will enable TSE to focus on users' needs and will strengthen the market function as a whole.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

When TSE demutualized in November 2001, it improved governance structure with the following measures:

Strengthening function of the board meeting:

i) Increasing representation by academic, listed companies and investors among board members
ii) Reducing the number of board members from 26 to 11 to promote active discussion,

Enhancement of committee system:

Enhancement of Advisory Committees (Discipline Committee, Self Regulation Committee and Market Structure Committee) and Audit Committee, and establishment of Nomination and Compensation Committee

Introduction of Executive Officer System:

Executive Officers System was adopted to increase transparency in operations and improve responsibility attitude towards work within the organization.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

Maintenance and enhancement of market integrity through the self-regulation will promote more participation of investors in TSE market, and as a consequence, it will stabilize the financial basis of TSE as a joint stock corporation. Therefore, there is no conflict between the self-regulatory functions and the profit-driven joint stock corporation.

In addition, after demutualization, TSE has taken steps to further the independence of its regulatory function by appointing a Chief Regulatory Officer and strengthening the function of the Self Regulatory Committee, including the reinforcement of its membership structure and competent authorities.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

There have been no problems since demutualization.

WARSAW STOCK EXCHANGE

1. Has the exchange considered converting (or has it already converted) from a mutual to demutualized entity? If yes, why did the exchange decide for (or against) demutualization? What were considered the key factors in this decision? In what ways, if any, does the exchange view its role to have changed after demutualization? Please elaborate.

Warsaw Stock Exchanges has never considered converting from mutual to demutualised entity due to its legal status.

The WSE is a joint-stock company created by the State Treasury on April 16, 1991 at the beginning of Polish economy transition. The State Treasury remains WSE's main shareholder with 98,8% of WSE's equity. The rest 1,2% of equity belongs to WSE's members (38 brokerage houses, banks, and listed companies).

Changes of WSE's business environment such as Poland's accession into European Union and growing competition among exchanges accelerated the process of WSE ownership transformation.

In the 2004 the WSE's privatization has begun. Currently, the Minister of the State Treasury is in the process of selecting an advisor for privatization of the WSE. The completion of the selection process is expected in January/February 2005.

The Minister's advisor will analyze privatization options and recommend the most suitable one for the WSE. There are various privatization options possible:

- public tender,
- financial institutions involvement,
- alliance with strategic investor.

Regardless of the privatization option, the goal is to transform the non-for-profit, state-owned WSE into a for-profit, private company.

Thus, whatever the privatization model would be the WSE would not become the mutual company. Brokers would be probably able to participate in the privatization as other entities with some bonuses possible.

2. What measures did the exchange consider, and then accept or reject, to resolve major issues, particularly conflicts of interests? Please elaborate, particularly on measures that were considered, and then rejected.

Potential conflicts of interests among the WSE and market participants are recognized managed and resolved on several levels:

- WSE's corporate structure,

- WSE's business activities,
- The Capital Market Council – at the Ministry of Finance,
- The Agreement for Polish Capital Market Development (market participants).

The WSE initiated in 2002 the preparation of Corporate Governance Code. The WSE monitors the implementation of the Corporate Governance Code by public companies and implements corporate governance by itself.

The WSE in day-to-day business activities consults with market participants the business decisions including the introduction of new products, changes in WSE's fees, etc.

In accordance with the strategy of Polish capital market development – Agenda Warsaw City 2010, the Capital Market Council has been created. The Council is an advisory and consultative body for the Ministry of Finance. The Council supervises the implementation of the strategy - Agenda Warsaw City 2010 oriented at improving quality and competitiveness of Polish capital market. Representatives of participants of the Polish capital market are The Capital Market Council members.

The Agreement for Polish Capital Market Development was created by market participants in April 2002. The main goal of the Agreement is developing common position and proposing solutions on key matters concerning Polish capital market and addressing them to relevant decision makers.

3. What are the exchange's views regarding the self-regulatory role of a demutualized (for profit) exchange? Is there an inherent conflict in being both self-regulatory and demutualized? Please elaborate.

Potentially, being Self Regulatory Organization and profit oriented company may create inherent conflict of interest between the exchange and its members. Regulating its own members through the adoption and enforcement of the rules combined with profit orientation potentially may lead to the situation when profit prevails over "the interest of the market participants" who are obliged to follow WSE rules.

There are the following solutions acting against potential conflicts of interests:

a) Corporate governance rules of the exchange
b) Investors Relations and transparency policy
c) Consultancy platforms
d) Formal supervision of the regulator– Polish Securities and Exchange Commission (PSEC)

Corporate Governance rules implementation and future IR policy make WSE decision process transparent to its members. Together with consultancy platforms of market participants representatives (see point above) it reduces the risk of highly conflicting decisions. Besides, acting as SRO is also under the formal supervision of PSEC.

4. What does the exchange consider to be the main emerging issues arising from demutualization? In other words, are there new issues that have arisen, or may be arising, relating to demutualization, which were not originally anticipated or addressed? Please elaborate.

Having in mind the fact that the WSE will not be demutualised but privatized directly into a for-profit private company the question does not apply to the case of the WSE.