

Joint Statement
Asian Shadow Financial Regulatory Committee
and
Australia-New Zealand Shadow Financial Regulatory Committee
*Queenstown, New Zealand 6 April, 2011**

Capital Market Integration and Stock Exchange Consolidation in the Asia-Pacific

- While merger/acquisition proposals emanate from the private interests of the owners/managers of stock exchanges (and are increasingly likely given modern technological developments relevant to exchanges), there are also potential social benefits in the form of reduced transactions costs, increased liquidity etc.
- Some recent cross-border consolidation proposals from stock exchanges have met opposition on “national interest” grounds. These are often ill-defined and it is important to be clear what they are.
- To the extent that mergers have adverse implications for the level of competition in provision of exchange services, barriers to entry for new stock exchanges (either regulatory or created by incumbents) warrant examination.
- Consolidation of exchanges raises a number of important financial stability issues which require up-front agreement between national regulators on crisis management and resolution mechanisms.

The Internationalization of Financial Markets

The international character of business today is very different from the past. Technology is shrinking the world and leading to increased integration of financial markets. However, capital markets have always been global, illustrated by the case of the *East India Trading Company* which started trading activities in India in the 1600s and many parts of Asia thereafter. The idea of pooling capital from individual investors made the East India Company a ‘superpower’ that lasted 250 years.

Today’s technology facilitates implementation of global strategies by firms such as stock exchanges, which in many countries have demutualized in recent decades to become private, profit oriented companies. Modern technology has seen the traditional open-outcry pit system of exchanges shift to computerized trading in the 21st century, which together with modern telecommunications makes the physical location of a stock exchange of limited significance.

National stock exchanges developed in most countries (where private ownership of enterprises was permitted) at an early stage of financial sector development. Some are thus old and long established. But in a number of emerging (and other small) financial markets stock exchanges, while using similar technology to elsewhere, have low trading volumes and involve transactions primarily among local investors, and thus do not capture the economies of scale possible. This translates into markets with low liquidity and high trade execution costs and, arguably, a higher cost of capital for domestic firms, impeding economic growth.

* The joint meeting was held on Tuesday April 5 and Wednesday April 6, prior to the Asian Meeting of the Financial Management Association, at which the Statement was delivered on April 7, 2010

This was the experience of the European national exchanges prior to recent mergers which have created multinational exchanges such as Euronext, OMX, and Deutsche Bourse, and the merger wave has also seen cross-Atlantic mergers of US and European exchanges. There is some evidence suggesting that these consolidations have resulted in lower trade execution and settlement costs,

Many analysts and market professionals suggest that similar benefits could be available to Asia-Pacific issuers and investors if exchanges in these countries were to merge. However, it is unclear as to whether the experience from the developed markets of the US and Europe is readily applicable to the region at this stage. There is a wide diversity of stages of financial and economic development, institutional arrangements, legal systems, exchange ownership arrangements, and different currencies.

Stock Exchange Functions

The stock exchange performs many important economic functions. One is to enable companies to raise capital to meet their financing needs by providing listing services (involving a certification role additional to regulatory prospectus requirements etc) for companies that decide to go public. Its trading platform enables incorporation of investor information into price discovery and also enables development of various risk management (and position taking) products such as derivatives. Other economic functions of exchanges include enabling investors to trade securities to adjust the composition of financial wealth portfolios, or to influence corporate governance.

As well as listing and trading services, clearing and settlement of transactions is also an important economic function – as is dissemination of information about individual security prices and trades and aggregate market wide information such as indices. While these activities are often provided by the exchange, modern technology has increased the potential for unbundling – with the development of alternative electronic trading platforms competing with the official exchange for order flow being a clear example.

Stock Exchanges in the Asia-Pacific

Driven by rapid economic development, increased standards of living and international capital flows, the market capitalization of stock exchanges in Asia-Pacific has more than doubled over the period 2000 to 2009 from around USD5tn to USD15tn. As a consequence, and reflecting the strength of these economies, the Asia-Pacific share of global market capitalization has risen from 16 to 31 per cent (WFE 2009).

Major Asia-Pacific exchanges in terms of equity market capitalization include Tokyo USD3.3tn, Shanghai USD2.7tn, Hong Kong USD2.3tn, Australia USD1.2tn, Shenzhen USD0.87tn and Singapore USD0.48tn. Each of these exchanges has developed rapidly over the past decade with a diversity of ownership structures and differing degrees of government involvement. Ownership structures range from the fully government owned exchanges of China in Shanghai and Shenzhen, to the perceived partial involvement of the Singapore government in the SGX in Singapore, to the fully privatized structure of the ASX in Australia.

Apart from structure, many of the smaller exchanges around the Asia-Pacific are distinctive in that they are dominated by “penny stocks” which may, as is the case in Malaysia and Indonesia, comprise the vast majority of listed stocks – reflecting domestic investor preferences for lower price (but higher quantity) holdings and transactions. Such institutional and cultural differences mean that cross-border consolidation involves some substantive changes which make such events less straightforward.

While exchanges in Europe and the Americas have seen consolidation through mergers, that has yet to occur in the Asia-Pacific region. Barriers to consolidation in the Asia-Pacific are likely to be greater than in a region such as Europe where financial integration, a common currency and a commonality in regulatory structures has facilitated mergers and wider consolidation. Also, while cannibalization of exchange business from technological development (facilitating off-exchange trading in “dark pools”) has been relevant in prompting mergers of US and European exchanges, the relevance of that factor for the Asia-Pacific exchanges is yet to be fully felt.

There are also “national interest” issues, whereby governments may view maintenance of domestically owned and operating financial institutions such as exchanges as important national goals. Exactly what those national interest considerations are, and how a cross-border merger would adversely affect the nation, are rarely well articulated. But the activities of stock exchanges involve a wide cast of supporting actors providing various financial services such that there are bound to be some winners and losers associated with a cross-border merger inducing self-interested lobbying.

Consequences of exchange consolidation

While private interest of exchange owners and managers drives consolidation proposals (such as the recent one between the Singapore (SGX) and Australian (ASX) exchanges), the outcome can be in the public interest. One key benefit of exchange consolidation can be to build a bigger and stronger market offering companies and investors enhanced access to a wider pool of counterparties. For companies seeking to raise capital, cross-border exchange mergers can increase the investor base, leading to greater liquidity and higher asset values. Cross-border exchange mergers and associated financial integration bring together synergies and complementarities between the financial service industries in two countries, which in turn should benefit local investors and public in general. The potential development of a consolidated and more liquid market for trading debt instruments (a regional objective since the Asian financial crisis in the late 1990s) could enhance regional financial stability.

Also relevant is the potential for economies of scale and scope arising from consolidation. While the number of stocks traded is (initially) unaffected, there may be benefits from application of a single technology across that broader base, while many of the monitoring, supervisory and marketing functions may benefit from enhanced scale reducing average costs. On the revenue side, a larger board of stocks and range of services available through the one entity may attract greater interest from the international financial and business community.

In the Asia-Pacific region strong growth and development opportunities, and the consequent need for efficient capital allocation, mean that such developments are particularly relevant. But they do need to be seen in the perspective of regional trends and consequences for national financial sector development strategies – which will influence government attitudes to consolidation proposals. Government reactions to proposals for exchange mergers in the Asia-Pacific will reflect strategies towards maximizing benefits from financial integration and competition regarding the development and location of regional financial centres.

China has become the second largest economy in the world, and the dominant economy in the region. This will promote the growth of Shanghai and Hong Kong as the regional centres for financial markets and services. Japan is the third largest economy and Tokyo remains a major financial centre in Asia. The ongoing economic growth of both Korea and Taiwan involves expanding financial service industries.

At the national government level, strategic issues become important. For Australia, for example, the question arises of whether a takeover of ASX by SGX would enhance access to Asian financial markets and the development of Australia as a financial centre or reduce that role. Similarly Singapore may be focusing on key strategic industries, such as financial services, for continued economic growth. It is unproven whether location of ownership or head office of a stock exchange generates agglomeration economies by affecting location of associated financial services and technology providers, when investors and listed companies are geographically diverse and markets are electronic. But it is one which political leaders focus upon.

Cross border consolidation of exchanges will result in a stronger financial position to provide a wider range of financial products to a bigger and more diversified investor base. It will also promote greater economic and financial integration, as well as regulatory coordination, across national borders. Such integration and coordination are likely to reduce transaction costs in goods and services and promote long term economic growth.

As well as the potential benefits, there are some potential costs and risks associated with cross-border exchange consolidation. Mergers reduce the number of entities offering listing services and trading platforms and thus may reduce competition, leading to higher fees and charges by the combined exchange. Should this occur it would have a negative impact on small and medium enterprises who cannot raise capital in global markets. This may also have a spillover effect on other industries, e.g. the local venture capital industry. Therefore it is important for regulators to open the market for competing exchanges or regulate the listing service as a monopoly.

The experience of the Euronext suggests that exchange mergers in Europe have not enhanced the liquidity of small and medium companies. A potential risk is that the merger leads to greater concentration of liquidity on large firms, at the expense of the liquidity of small firms.

Regulatory Issues arising from Exchange Consolidation

Stock exchanges are subject to regulation aimed at ensuring investor/consumer protection, system stability, and efficient, fair, and transparent markets for capital raising and investing. Such regulations apply both to the exchanges themselves as well as to the issuers of securities traded on the exchanges and participants in the market. Historically, exchanges have played an important (self) regulatory role through specification and enforcement of listing and market rules affecting market participants. Official regulations (such as prospectus and financial services licensing requirements) complement those. The exchanges themselves are subject to regulation via authorization and entry requirements, and the oversight, monitoring, enforcement and audit arrangements required of market operators by national securities regulators.

Because cross-country stock exchange consolidation can potentially take many forms, ranging from complete integration of operations to separately operating national subsidiaries, it is difficult to specify or identify all regulatory issues which might arise. Nevertheless there are a number of general issues which warrant attention.

First, there is clearly a reduction in competition in the supply of exchange services because of the reduction in the number of exchanges. That may, however, be of relatively little consequence if users of exchange services previously faced a national monopoly anyway. More generally, the emergence of alternative providers of services (such as electronic trading platforms) provides an alternative and growing source of competition.

But one consequence is that it is appropriate for national regulators to review policies towards the authorization of new exchanges and reduce unnecessary barriers to entry. Whether such barriers have reflected prudential concerns or regulatory capture by established exchanges is open to debate, but any rationale for barriers leading to a national monopoly are of less relevance. To the extent that exchange activities (listing, trading, clearing, settlement, information provision etc.) can be unbundled, national regulators will want to be assured that barriers to entry of alternative suppliers of some of those services are not created by a multinational operator.

Second, stock exchanges play an important regulatory role through their listing and trading rules. To the extent that there is harmonization of listing and trading rules by a merged exchange, national securities regulators will wish to be assured that the outcome does not result in a lowering of standards applicable to companies from their jurisdiction, and take offsetting regulatory actions should that occur.

Third, national regulations such as prospectus requirements or financial services licensing requirements may not be harmonized. Mutual recognition of such requirements by national regulators may be necessary if maximum benefits from exchange consolidation are to be achieved.

Fourth, there is an enhanced need for cross-border regulatory cooperation and information sharing. In particular, national regulators may, from time to time, wish to apply particular restrictions (short-selling bans, trading halts) to stocks of nationally incorporated companies.

Fifth, stock exchanges are a crucial part of the national financial infrastructure, such that their potential failure (such as might occur from inadequate risk-management by the clearing house) has systemic implications for national economies. Ultimately, national governments are likely to step in to ensure continued operation of a major exchange, putting taxpayer funds at risk. Whether there is a changed likelihood of systemic risk from cross border mergers is unclear, but review of capital and other requirements for such market operators may be appropriate, and should involve regulators from economies involved. In practice, where consolidation is across countries operating under different currencies, it is likely that clearing houses and settlement facilities will remain operationally separate making national supervision and regulation feasible.

EPILOGUE

The SGX-ASX Merger Proposal

In October 2009, SGX made an \$8.3-billion cash and shares friendly takeover offer for ASX in a bid to become one of Asia's leading stock markets. A major aspect of this proposal is to develop Singapore/Australia as a southern Asian financial centre. A Report from Access Economics (prepared for the ASX) claimed that the deal would improve Australia's chances of becoming a financial services hub in Asia and lower the cost of capital for Australian companies. It said the merged group would build a conduit into Asian financial markets to improve financial flows between Australia and Asia, and connect Australian funds managers to "fast-growing pools of Asian savings".

At the time of writing it seems unlikely that this merger will proceed, given widespread concerns in Australia about the deal from a "national interest" perspective. Whether foreign ownership or location of a stock exchange for local companies and securities has substantive national interest implications is far from clear, given the electronic nature of current exchange activities. While it is likely that intermediaries providing access to the exchange and other services might find their competitive positions affected by increased international competition, that is a private cost and special interest not to be confused with national interest (and potentially more than offset by gains to users of those services). And whether there are agglomeration economies which a shift of the head office of the exchange offshore is unclear.

The process followed in this merger provides useful insight into how not to proceed. Negotiations with governments, aimed at clearing "national interest/foreign ownership" hurdles have preceded provision of full information to stakeholders via an information memorandum or other means, which could have facilitated more informed debate.