BENEFITS AND CHALLENGES OF DEMUTUALIZATION: A STUDY ON BANGLADESHI STOCK EXCHANGES

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Abstract: “The existence of an efficient capital market is one the most integral preconditions to a developing economy and the recent trend that is changing the dynamics of capital markets all over the world is demutualization. Demutualization basically refers to transition of a non-profit member owned exchange into for profit, investor owned organization. This paper, through an extensive analysis of the subject matter, makes an attempt to shed some light on the demutualization process, its major driving forces, benefits and drawbacks. It also focuses on the conflicting outcomes that demutualization might result in and tries to examine the applicability of “demutualization” in Bangladeshi stock market context. Finally, the paper concludes that gradual demutualization, whilst attending to the risks involved, might just be the stimulant that the Bangladesh Capital market needed”.

INTRODUCTION

Stock markets around the world are going through various changes to be proficient and to provide their stakeholders with better facilities. One of the major changes is demutualization. It’s now become the widespread global phenomenon considered as a means of meeting development and competitive challenges and even to address failure to carry out credible operations. Researchers have explored this subject and its potential benefit for the stock markets around the world as most of the exchanges have gone through this process.

Before the trend of demutualization stock exchanges all over the world were means mutual or member owned organization which is run for raising capital from members and providing them various financial services. Most of the stock exchanges were operated as mutual organization where excess income was not distributed to the members as profit. The most important characteristic of the mutual exchange is a strong and close identity between the owners of the stock exchanges and its clients because the owners are the clients and they share the profit according to their participation in the ownership. As stock exchanges are going through technological advancement and competition, new threats along with opportunities are created for it. At the same time there have been increasing demands from regulators and the public that stock exchanges elevate their

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standard of governance and provide equitable representation to all stockholders. But the mutual exchanges are failed to ensure standard and efficient governance. As a solution to this and to keep pace with the advancement, stock exchanges began to change their ownership form.

The trend is recent and the first exchange to demutualize was Stockholm Stock Exchange in 1993. By the end of year 2000 numerous additional stock exchanges had demutualized including London stock exchanges, the Paris Bourse, Amsterdam Stock exchanges. Many emerging stock and future markets are also considering demutualization. As in emerging economies like Bangladesh, a mutual stock exchange is seen as an institution, serving national interest. But to avoid instability, liquidity and other financial ratios it is the demand of time to implement demutualization of stock exchanges in Bangladesh. Moreover After having a massive crash in Bangladesh's stock exchanges, demutualization was the only way to separate stock exchanges' ownership from regulation. To be more secured and risk averse, it may act as a buffer against any financial shocks. The four-member investigation committee on the recent stock market crash already submitted its report to the finance minister suggesting some recommendations to improve transparency in the operation of the nation's two stock exchanges: Dhaka Stock Exchange (DSE), and, Chittagong Stock Exchange (CSE). The investigation report revealed the alleged manipulation of the market operation through issuing of illegal placement and preference shares, loan settlement through shares, asset re-evaluation, share split, and a series of ill-motive transactions. The recommendations they put most emphasis on is the demutualization of stock exchanges.

LITERATURE REVIEW

Demutualization has become an extensive reality, one with growing demand in emerging market countries (Elliott, 2002). The concept is initially used to refer explicitly to conversion process adopted by insurance companies. Because of the positive aspects of this process demutualization is now common in savings and loan industry, stock exchanges and agricultural cooperatives around the world. It is no more a new term in the corporate world. So we find several studies about it. Not all the authors comply with the concept of demutualization.

Much of the literature on stock exchange demutualization focuses on various perceived weaknesses of the non-profit mutual organization. According to this literature, decision-making at a nonprofit exchange is problematic because nonprofit decisions require consensus (Aggarwal, 2002), respond to a median voter which shifts as membership diversifies, or produce an increasingly insular, “clubby” membership. Demutualization should bring about better, faster decisions as the for-profit responds to the market for corporate control (Bradley, 2001), for instance by investing in new technology (Aggarwal, 2002).
Cameron (2002), stated that, mutual as a way of operating financial markets were never going to survive corporate membership of exchanges, far less computerization in the financial sector, the information age, the Internet revolution, or globalization. They reflected the coffee shop origins of the markets, the shouted order across the crowded, noisy and frequently smoke filled room, where every trader knew every other trader, and what they were good for. The wonder is not that they are coming to an end, but that they lasted so long. And surely it would now be impossible to deny that the securities community has reached an implicit consensus that demutualization maximizes efficiency incentives and is critical to the survival of international exchanges (Cha,1999).

Demutualization is seen as a trigger for the restructuring of stock exchanges. Opening membership to new investors changes the focus of exchanges. They can freely pursue business opportunities without being restricted to the vested interests of members. Hart and Moore (1996) show that as the exchanges faces competition, outside ownership of the exchange becomes more efficient than a members cooperative.

Some studies argued in favor of demutualization while others suggested against it. Those who supporter demutualization argue that it can help the stock exchange to modernize its technology, achieve good governance, avoid concentration of ownership power in a particular group of stock exchange participants and, ensure financial decision-making by ensuring that resources are allocated to business initiatives and ventures that enhance shareholders’ value. On the other side, antagonists to demutualization argue that the above mentioned anticipated benefits of demutualization may in reality not be achieved. Rather, with certain conditions, those may be obtainable under a mutual or cooperative structure (Hansman, 1988; and Hart and Moore, 1996).

By converting member-owned, non-profit organizations into profit-driven investor-owned corporations, demutualization will give exchanges access to capital that can be used both for investment in new technology and for participation in the ongoing consolidation of the industry. In the process of providing the exchanges with capital, demutualization is also expected to strengthen the corporate governance of the exchanges (Reena Aggarwal,2002).

On the other hand, opponents of demutualization do not believe that the process may bring the expected benefits to the capital markets of the country. They think that the benefits of demutualization can also be obtained with a mutual governance structure. Additionally, they point out that forming a new financial institution is very hard considering the fragility of the investor confidence to the financial system especially in the context of emerging markets (Lee, 2002:15).

Any cost savings that caused by demutualization could be low in comparison to the benefits that can be obtained from the presence of brokers, with ownership interests in the exchange. In many developing countries, the creation of any
financial institution is awfully hard, and the creation of investors is often harder than the creation of brokers (Lee, 2002). Demutualization may also allow for new risky businesses that usually do not take place when the stock exchange is under a mutual structure (Worthington and Higgs, 2006).

According to Serra Eren Sarıoğlu the changes in the traditional organization structures of the stock exchanges are being driven mainly by three forces: (a) increased global competition, (b) technology and the rise of “Electronic Communication Networks (ECNs),” and (c) growing conflicts of interest between existing owners. Although it is believed that demutualization brings various benefits to the stock exchanges, there exist lots of problems in the process of demutualization. The first problem stock exchanges face is to determine the structure of the exchange after demutualization. The second crucial problem is the determination of the owners of the demutualized exchange. The third problem is the management of the exchange.

Now we shall try to find out those authors who have suggested for demutualization. According to Scullion (2001), demutualization is not merely converting into for profit organization owned by its members. An exchange is genuinely demutualized when it maximizes its potential of market capitalization to the fullest and alongside it also increases its shareholders value.

Mendiola and O’Hara (2003) investigated the effects of the change of governance in stock exchanges on performance and evaluation. They found that exchange performance tends to improve after the change of governance.

Demutualization can permit the stock exchange to modernize its technology, create a flexible management structure that is more responsive to market conditions and, get an initial infusion of capital and allow for easier access to capital. It also enhances financial decision making by allocating resources to business initiatives and ventures that increase the shareholders’ value (Lee, 2002). Thus, demutualized stock exchanges are in general expected to bring better performance of exchanges.

Aggarwal (2002), took three demutualized stock exchanges: Deutsche Bourse, the London Stock Exchange, and the Australia Stock Exchange, as sample to examine their performance. She found that in the form of the stock-price performance of the three exchanges that have been operating as publicly traded companies for at least one year— is encouraging.

Krishnamurti et al. (2003) have compared two stock exchanges operating in India with different corporate governance structures. Bombay Stock Exchange (BSE) was a non-profit cooperation at those times, while National Stock Exchange (NSE) was a demutualized exchange, both exchanges had similar operating systems. By using “Hasbrouck’s measure of market quality”, the researchers found out that NSE is better than BSE by means of corporate governance.
Morsy and Rwegasira (2010), analyzed and evaluated the financial performance of demutualized stock exchange between 1996 and 2004. They examined whether or not financial performance improved after implementing the demutualization program. Financial performance of stock exchanges that have undergone the demutualization program is measured in terms of eleven measures. Results were mixed and exhibited different change in performance for the samples of demutualized stock exchanges. But, in their examination, most of the profitability ratios showed significant increases.

In a study of Shamshad Akhtar, he showed that mutual associations often charged fees to cover expenses but kept the charges low to serve the interests of member brokers; and expenses were not managed effectively given issues with governance and management. The Cost and Revenue Survey 2000, undertaken by the FIBV confirmed that the mutual exchanges and associations were relatively less cost competitive and profitable. Demutualized exchanges, with a new strategic mandate, were the most profitable bourses and earned an average return of 41%.

In a study conducted by O’Hara and Mendiola (2003), the financial performances of the demutualized and listed stock exchanges have been investigated. The stock exchanges were Singapore, Athens, Deutsche Börse, Euronext, Australian, Hong Kong, London and NASDAQ. According to the findings of this study, the demutualization did not seem to increase the performance of the exchanges in regards of accounting-based measures. However, in the means of return-based measures, the returns of demutualized exchanges were greater than their market indices.

Otchere and Oldford (2011) tried to examine whether corporatization of the exchange is necessary to improve the performance of the exchange. They found that both demutualized but member-owned exchanges and publicly traded exchanges exhibit higher levels of profitability and operating efficiency than mutually-owned exchanges.

Not merely converting a mutual exchange into for profit organization may not ensure the success. Changes to the governance structure may encourage innovation, but the incentives of innovation and benefits from demutualization will only occur when ownership actually changes hands and nonmembers are become owners. (Steil, 2002).

Besides, demutualization can obtain a governance structure that is more flexible in responding to industry and market conditions, avoid concentration of ownership power in a particular group of stock exchange participants and ensure financial decision-making by ensuring that resources are allocated to business initiatives and ventures that enhance shareholder value (Morsy and Rwegasira, 2010: 39).

Along with the benefits and advantages of demutualization there are also many risks. One of the most common threats of demutualization is conflict of interest.
These may be of resource conflict, executive time conflict, broker supervisory conflict and many others. (David Holthouse).

Demutualization brings with it some new sources of conflict of interests. First, the exchange’s drive for profit is argued by some to carry the risk of increasing the scope and intensity of conflict. Second, the self-listing of the public issue on its own exchange can pose issues of conflict of interest if listing standards and its oversight are compromised by the exchange concerned. Finally, demutualization triggered extensive debate on the merits of self-regulation. (Shamshad Akhtar).

In a detail study of conflict of interest arises in a demutualized exchanges, John W. Carson (2002), showed that most of the specific conflicts are frequently managed by escalating decisions or ensuring appropriate corporate governance stewardship or management supervision, but these responses only move management of the conflict to the highest level, where arguably the conflict is greatest because it is the responsibility of the board and senior management to reconcile the two mandates. This kind of response places a high degree of reliance on the integrity of people and processes at the top, and on supervision of their management of conflicts by the regulator.

Reena Agarwal, (2002), stated that by converting member-owned, non-profit organizations into profit-driven investor-owned corporations, demutualization will give exchanges access to capital that can be used both for investment in new technology and for participation in the ongoing consolidation of the industry. In the process of providing the exchanges with capital, demutualization is also expected to strengthen the corporate governance of the exchanges

OBJECTIVES
The main objective of this paper is to discuss about the nature of demutualization and analyze the driving factors of it. In the light of this main objective, specific objectives are:

1. to analyze the stock exchange demutualization process in emerging market with a particular reference of Bangladesh Stock Exchange, and
2. to find out the challenges that the exchange can face and have to overcome in the context of Bangladesh.

METHODOLOGY
This outcome is mainly based on secondary data, which was collected from other previous studies. This data includes qualitative and quantitative information related to this issue. These data were collected from different journals of business, newspapers, academic articles and websites.
DEMUTUALIZATION

Demutualization is the transition of a non-profit member owned exchange into a for-profit, investor owned organization. In other way it is the separation of ownership from the right to use the exchange’s trading system. In this process a customer-owned mutual organization (mutual) or co-operative changes legal form to a joint stock company. In the mutual ownership model, only the owner of the exchange can trade on the exchange, which means a broker had first to be approved as an owner. But only brokers who wished to trade on the exchange would be approved as owners. If a broker resigned from the exchange or left the business, its membership (ownership) would cease. Demutualization separates these roles so that one can be a shareholder without being a broker and trading privileges will not depend on the ownership.

Once demutualized, a stock exchange becomes fully exposed to market forces like any other business. Therefore the role of the regulator and the level of cooperation and trust between the regulator and the exchange being demutualized are absolutely vital. Mutual governance structure of any exchange may not serve the purpose of making mutual benefit all time and sometime they have to face new competition at that moment they find it favorable to be converted into for profit organization through demutualization.

Demutualization can unfold many scopes for the exchanges which may not possible for the member owned mutual organizations. It is set of processes, customs, practices, policies and laws which is directly affecting the way an organization is working. Demutualization does help an exchange to improve its corporate governance. It would increase the role of nonmember stakeholders in the affairs of the exchange. It provides a remote access for investors, for foreign and domestic which increasingly essential to attracting and even keeping, their business. A demutualized exchange can also borrow from conventional lender like banks whereas mutualized stock exchanges have to look up to their guarantor for finances. All these benefits make demutualization process more attractive and efficient for the stock exchanges to survive in the competitive economic world.

Table 1: Name of Exchanges and Year of Demutualization

<table>
<thead>
<tr>
<th>Name of the Exchanges</th>
<th>Year of Demutualization</th>
<th>Year of Listing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borsa Italiana</td>
<td>1997</td>
<td>---</td>
</tr>
<tr>
<td>Singapore Stock Exchange</td>
<td>1999</td>
<td>2000</td>
</tr>
<tr>
<td>Hong Kong Stock Exchange</td>
<td>2000</td>
<td>2000</td>
</tr>
<tr>
<td>London Stock Exchange</td>
<td>2000</td>
<td>2001</td>
</tr>
<tr>
<td>Deutsche Borse</td>
<td>2000</td>
<td>2001</td>
</tr>
<tr>
<td>Name of the Exchanges</td>
<td>Year of Demutualization</td>
<td>Year of Listing</td>
</tr>
<tr>
<td>-------------------------------</td>
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<td>-----------------</td>
</tr>
<tr>
<td>Euronext</td>
<td>2000</td>
<td>2001</td>
</tr>
<tr>
<td>Toronto Stock Exchange</td>
<td>2000</td>
<td>2002</td>
</tr>
<tr>
<td>The NASDAQ Stock Market</td>
<td>2001</td>
<td>2002</td>
</tr>
<tr>
<td>The Philippine Stock Exchange</td>
<td>2001</td>
<td>2003</td>
</tr>
<tr>
<td>Osaka Stock Exchange</td>
<td>2001</td>
<td>2004</td>
</tr>
<tr>
<td>Tokyo Stock Exchange</td>
<td>2001</td>
<td>2006</td>
</tr>
<tr>
<td>New Zealand Stock Exchange</td>
<td>2003</td>
<td>2003</td>
</tr>
<tr>
<td>Bursa Malaysia</td>
<td>2004</td>
<td>2005</td>
</tr>
<tr>
<td>Bombay Stock Exchange</td>
<td>2005</td>
<td>–</td>
</tr>
<tr>
<td>New York Stock Exchange</td>
<td>2006</td>
<td>2006</td>
</tr>
<tr>
<td>BOVESPA (Brazil)</td>
<td>2007</td>
<td>2007</td>
</tr>
</tbody>
</table>

Source: International Journal of Management Research and Business Strategy

DRIVING FACTORS OF DEMUTUALIZATION

Demutualization has evolved as a solution of the problems arises from the intense competition among the stock exchanges and alternative trading systems. Technological advancement, lack of transparency in mutual organization, cost of trading and many other factors led stock exchanges to restructure their entrepreneurial strategies. The following factors are very visibly active as the driving factors of demutualization.

Technology Advancement and Global Competition

In the last 20 years global exchanges have gone through some radical changes. Technological developments have enabled successful operation of Alternative Trading Systems (ATS) like Electronic Communication Networks (ECNs) which have the potential of replacing the traditional stock exchanges. Technological advancement and globalization make the switching cost of the investor lower and competition more intense. The old member owned organizations fails to provide flexibility and financing needed to compete in this competitive environment. Stock exchanges should have the access to greater capital and efficiency in decision making, to survive in the economic environment. Demutualized exchanges will be able to respond quickly to preserve the value of their franchises over the long run.

Conflict of Interest

Conflict of interest may be common problem for a mutualized exchange. Investors of a mutual exchange may be defeated by the decisions of the exchange. Its ability or willingness to protect investor interest is not that transparent. Moreover the members also may try to use the regulatory power for own benefit. In this case they may stand against demutualization. In this situation
foreign investors may feel insecure to invest as they feel the exchange does not work for common interest. But in a demutualized exchange management is free to decide on operational issues is perceived to be effective and fair in enforcement. It ensures the transparency in governance.

**Investor Participation**

Globalization makes it easier for the stakeholders to move market to market and make it more competitive. A stock exchange must be responsive to the needs of its many stakeholders, including participating organizations, listed companies, and institutional and retail investors. Distributing the power of trading to one group to another may be a scope for the customers to get access to exchange facilities. Separating trading rights from ownership may be a politically and economically feasible way to affect such a shift. In a mutual organization often only broker-dealers are the members who can trade in the exchange but a demutualized exchange affords both institutional investors and retail investors the opportunity to become shareholders. It encourages the investor both domestic and abroad to participate in the trade. A demutualized exchange will have greater flexibility to accommodate the needs of institutional investor.

**Broader Capital Access**

Demutualization creates an opportunity for the organization to borrow from conventional lenders such as banks which is not that easy in mutualized organization. As a profit making entity it also has the scope to introduce new financial instrument in the market. It becomes easier to introduce new product for raising capital because of the transparency in governance and strict regulation. One of the clear historical examples that show the importance of demutualization in raising capital is the replacement of floor trading with screen trading. Introducing screen trading requires considerable capital investment in the information system of the exchange. Demutualization was an efficient and rational means of raising additional capital required to finance such activity. Continued capital investments in technology can also help to respond to competition from ATS and upstairs trading.

**The Process of Demutualization**

Demutualization is itself a huge regulatory change and it requires the nonprofit mutual exchanges to change its governance structure to converted as a for profit organization. This transformation of exchanges from mutual to demutualized structure involves two key features: (a) change in the ownership structure, and (b) change in organizational form.

These tasks needed to done with great accuracy to maintain corporate governance. Demutualization brings changes in the ownership and legal structure of a mutual or a private exchange in a hope to match with the latest requirement of the coming competitive pressure and market diversification.
Ownership Structure

In a member owned mutual exchange members are the only traders which mean only the members were capable of doing trade but demutualization involves issues of transformation of ownership from members to nonmembers. It involves exchange of existing member seats by monetizing these and creating a certain value per seat. For this purpose proper valuation of the exchange should have to be done and once the value is known it will be quite clear to the members to know the value of their membership. They can convert their membership to shares and offer to sell the shares to nonmembers. Members are allowed to hold their ownership for a certain period of time. A few percentages of the shares will be held as locked shares for a certain time period and after that it will be offered to the strategic investors and then to general public if the exchange got listed. Demutualization is aimed to decentralize the power of the shareholders and for this purpose it restricts the ownership by one holder or a group of holders to non-controlling stakes of 5-10%.

![Figure 1: The process of exchange demutualization](image)

Source: Reena Aggarwal, Demutualization and Corporate governance of Stock exchanges

Legal and Company Structure

A stock exchange after demutualization has to change its legal and company structure. In general most stock exchanges are operated as member owned mutual association or registered as private limited companies with a paid-up capital base. Legal status for the demutualized exchange will similar to that for any profit-making company including decisions on number of shareholders voting procedures, limitation of liability, accounting and financial information reporting requirements, dividends distributions and other regulations.
**Mutual Versus Demutualized Exchange**

### Table 2: Difference between Mutual and Demutualized Exchange

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Mutual Associated Stock Exchange</th>
<th>Demutualized Stock Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance Model</td>
<td>Identity between owners of the organization and the direct users of trading services are very much identical</td>
<td>Ownership and trading privileges are effectively separated.</td>
</tr>
<tr>
<td>Influence on decision Making</td>
<td>Ability to influence decision of exchange is separated from a level of economic interest a member has in exchange.</td>
<td>Owners with greater economic interests are more capable of influencing decision making.</td>
</tr>
<tr>
<td>Operation Motive</td>
<td>Operators on a non-profit basis any earned profits are returned to members in form of lower trading costs or access fees.</td>
<td>Management takes actions that are for the best interests of the exchange and ultimately for its shareholders.</td>
</tr>
<tr>
<td>Ownership Structure</td>
<td>Members/Stock brokers are owners of stock exchange.</td>
<td>Stockbrokers are no longer owner but customers of exchange, shareholders are the owners.</td>
</tr>
<tr>
<td>Profit Sharing</td>
<td>Owners share net gains of the enterprise in proportion to ownership interest.</td>
<td>Entitlement of dividend is based on shareholding of exchange.</td>
</tr>
<tr>
<td>Standard Voting Rights</td>
<td>One member, one vote</td>
<td>One share, one vote</td>
</tr>
</tbody>
</table>

Source: self-analysis

**BENEFITS OF DEMUTUALIZATION**

Demutualization comes as a consequence of technological advances and exchanges responded in it are going through in a structural change. Demutualization triggers dramatic changes in exchanges’ governance structures, managements, organizations and internal processes and procedures. These changes are imperative if a successful transition to commercial status is to be achieved.

The changes in the ownership form and improved corporate governance give the exchanges some new scopes and opportunities that were not available with the mutual ownership form. A demutualized exchange is more responsive in case of competitive issues and can take decision independently from the interest of the individual members, which makes the performance of the exchange better.

Some benefits of demutualization are given below:

**Better governance:** Demutualization changes the management system of a mutual organization. In a demutualized exchange management would be in the hand of professional people selected by the directors. Management supervises the daily affairs of the exchange and board of directors will keep apart from that. As
there are independent directors in the board decision will taken for the best interest of the general investors and shareholders. However demutualization is not related with any kind of market manipulation, insider trading or any kind of market deregulation. So this will work to ensure the transparency in governance, efficiency and independence.

**Capital rising:** Not for profit mutual entities cannot get access of equity markets for capital. Their inability to access equity markets may also limit their ability to access debt markets on the same terms as comparable corporations. After demutualization stock exchanges can raise capital many sources as normal for profit organizations. One of the most important sources of income would be the new shareholder and institutions. Demutualization will facilitate foreign investment as it helps to attract strategic investors from within and outside the country. After demutualization there is also a scope of developing debt market.

**Gaining profit:** Profit gaining is not the ultimate aim of a mutually organized exchange. It is not that much goal oriented and profit seeker. But as a for profit organization demutualized exchange feel a constant pressure to grow and develop business to gain more profit. Improved structure and efficient system of exchange can increase the confidence of the companies and this may attract the listing. When the exchanges are profitable they will pay taxes to the government and dividend to the shareholders. So management will become goal oriented and strategic in decision making in a demutualized exchange.

**Broadening capital market:** Demutualization makes the exchanges interested in gaining profit based on the performance. It works as an incentive to enhance liquidity and to introduce new product and services to the market. New equity, derivatives products and commodity futures contracts, including exchange traded funds, index options and futures contracts may be introduced. There will be new innovations. Demutualize exchange can also go for international alliances and such alliances provide openings for investments and cross border listing. Literature shows that demutualization also facilitate merger and acquisition of stock and future exchanges.

**CHALLENGES OF DEMUTUALIZATION**

Demutualization may offer many benefits that a mutual exchange can’t provide. But this process has to face some challenges and the benefits depend on how well an exchange can face these challenges. Every exchange has their own way to solve these challenges. The common challenges that an exchange may face at post demutualization situation are discussed below:

The first challenge to face is the transformation of the mutual exchange into a demutualize exchange. A mere conversion from a not-for-profit organizational structure to a for-profit structure would neither ensure better regulation nor would it create investor confidence. Transferring the ownership to the
nonmembers is a critical issue. Trading right transfer is related to the valuation of the exchange. Not all the members do transfer their trading right at a time and not all the exchanges follow the same technique. So it is hard to find the true value of the ownership right at different times.

Although demutualization was evolved to solve the conflict of interest between the shareholders yet it can create a new conflict between the owners and the management. As the independent directors occupy a majority portion of the board and the chairman is also the independent director. Any decisions which are not in conflict with the positions of management may do conflict with the interest of the shareholders.

As demutualization separates the operating and regulatory authority of the exchanges, it may create an other conflict of interest. A for profit may not adequately fund its regulatory activities because there is a insufficient return on investment at the earlier stage. On the other hand the as a regulatory entity the exchange can aggressively fine trading parties as they find it as a source of profit. There is also another doubt arises regarding the ability of the regulating body to regulate its competitor members. Confidential information related to these parties can be leaked by the insiders and it can be a great challenge to the transparency of an exchange.

As a mutual organization an exchange need not to concern about their profit but an exchange has to be concern about the profitability and self-sufficiency at post demutualization. It is another major challenge after demutualization that should be kept in mind. Unfortunately it is a common trend in the emerging market to show a slower growth in comparison to the expectation at earlier stages of the demutualization. Innovation of new product and services along with the diversification of services and attracting foreign investors could be a good source.

Demutualized exchange may face competition from other listed companies as it will start operation as a for profit organization. It may faces threat like takeover bid or acquisition. Empirical studies support this potential challenge.

DEMUTUALIZATION IN BANGLADESH

Bangladesh capital market has a good position in the domestic economy. It is one of the smallest in Asia but the third largest in the south Asia region. The journey of Bangladesh stock capital market begins in 1954. It is constituted with securities and non-securities segment. Our main regulator is Bangladesh Securities and Exchange Commission (BSEC) oversees the capital markets in their designated countries to ensure that investors are protected against fraud. Bangladesh Capital market includes the stock market & the bond market. Bangladesh has two stock exchanges Dhaka stock exchange (1954) and Chittagong stock Exchange(1995). Our stock exchanges were non-profit
cooperative organizations, owned by the exchange members who are usually stockbrokers. They did not distribute earnings as dividend. Rather, any profits were returned to members in the form of lower trading costs or access fees and investment for growth. However the market was very turmoil in 1996 and 2010. The allegation for these market crashes has gone mostly against brokers, and regulatory bodies. As these groups of people are directly involved in the activities of stock exchange, they could have manipulated or influenced the market.

After having a massive crash in Bangladesh's stock exchanges, demutualization was the only way to separate stock exchanges' ownership from regulation. Through this, the market will be bringing in strategic investor (an investor - typically a company - that invests primarily for strategic rather than financial return purposes) which will help the market to grow. It will also help to gain investor confidence. As a consequences Bangladesh initiated to get its exchanges demutualized at 2011. On October 9, 2012 the cabinet endorsed the draft of the exchanges (Demutualization Act, 2012)". After demutualization the major change will be brought in the governance structure of the exchanges. Pre demutualization there was a 50-50 partnership in the board. The number of independent directors and directors from shareholders was equal. But demutualization process requires majority of independent director in the board. As per requirement the board structure of Dhaka Stock Exchange and Chittagong Stock Exchange will consist of 13 members of which 7 would be independent directors, 5 directors from shareholders, and the managing director and Chief Executive Officer will work as Ex officio member of the Board with voting right. One position among directors from shareholders will be filled with a strategic investor and the chairman of the board will be selected from the independent directors. As demutualization is aimed to meet up the conflict of interest it will manage this issue by setting separate regulatory and operating division. Regulatory division will work independently from commercial function. A committee will be formed to supervise this task of the regulatory division, which will consist of independent directors of the board. Ownership structure will also change by this process. Initially members will hold 100%(60% of which will be held in block account) ownership of the company. After three years strategic partners will hold 25% of the block account. After listing rest of the 35% of the block account will be offered to the general public. The ownership structure will be as follows:
Table 3: Changing Trend of Ownership Structure

<table>
<thead>
<tr>
<th>Condition</th>
<th>Ownership structure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Existing Members</td>
</tr>
<tr>
<td>At beginning (holding 60% shares in block account)</td>
<td>100%</td>
</tr>
<tr>
<td>After 3 years from demutualization (35% share will remain block account)</td>
<td>40%</td>
</tr>
<tr>
<td>After listing</td>
<td>40%</td>
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Source: Demutualization Act, 2012

Dhaka stock exchange and Chittagong stock exchange have already completed the major tasks of demutualization. Thus having the benefits of demutualization for stock exchanges in Bangladesh is a matter of time. However, a few challenges DSE might face at the time of implementing the demutualization process successfully.

BENEFITS OF DEMUTUALIZATION IN BANGLADESH STOCK EXCHANGES

Our capital market had not grown at the pace of rest of the world; with demutualization, the market will be able to attract the foreign investors, and the current process will go a long way in restoring the investors' confidence in the capital market after the crash. Not necessarily Bangladesh stock exchanges will enjoy the all benefits of demutualization, but it will bring some positive changes and advantages along with the change of regulation. It is expected that after demutualization investors will feel interested in stock market and put their money in the stock market. The broker community deserves compliments for its supportive role in the way forward to demutualization which is expected to get the same support from the parliament as stock market crash has adversely affected the government's economic policy. The market will have the right strategic investor because of separation of the regulatory functions from the commercial interests of the exchange members.
Demutualization will bring a much more transparent financial market for Bangladesh. It is expected as after demutualization the board will be based on the shareholders. As the board will be converted from member driven to professionally driven one it is highly expected that it will able to ensure the interest of the general shareholders. On the other hand post demutualization, after the separation of management and owner, stock exchanges will give more emphasize on regulation. As Chief Executive Officer will not have much power in this and Chief Regulatory Officer will have the sole authority to investigate any kind of transparency gap so it will helpful to reduce mismanagement from brokers side.

Demutualization may facilitate foreign investment in our stock exchanges. Now we are in a position to attract strategic investors from within and outside the country. The BSEC can work on development of the debt market. Then it will be able to truly develop the capital market. All the participants have to work in a body and then the power of synergy will be tremendous.

New equity, derivatives products and commodity futures contracts, including exchange traded funds, index options and future contracts which are not available pre demutualization may be introduced after demutualization. There will be new innovations and tools to diversify into other market and services. So it is expected that market diversification will be a matter of time after demutualization.

**CHALLENGES FACED BY BANGLADESH STOCK EXCHANGES AFTER DEMUTUALIZATION**

Demutualization is a new regulatory framework which requires a change in the regulation of the stock exchanges. This complex issue will surely bring along
with various challenges. The first challenge to face is to convert the mutual exchange into a demutualized exchange. If proper rules cannot be ensured in this process it cannot bring the transparency it was aimed to. As a public company it will converted to a profit oriented and competitive company which is accountable to its shareholder. It will also become the subject to discipline of the market and it has to maintain some regulations like reporting, maintaining profitability, release news to the market etc.

As a profit oriented organization stock exchanges should have to face the challenge to make them self-sufficient and profitable. Dealing with role of regulator and commercial operation simultaneously is a great issue. Although it can ensure transparency but if the regulatory body finds it’s profitable to make money at the cost of substandard supervision then it would be a big challenge. Stock exchanges may charge the trading participant for slight rule deficiencies. Moreover if it cannot maintain confidential information of the market participant information then its role as a regulator will be questioned. This manipulated earning will cause more damage in the long run. Like other developing countries Bangladesh stock exchanges may also be able to go through a situation of share price decrease after demutualization. Financial viability is a great concern at post demutualization period.

If the brokers will not find confidence in demutualization then it will be a serious problem for the exchanges after demutualization. Although the possibility of this happening is very low but it can be a threat as the investors do have other alternatives. If it happens then demutualize exchanges will have to compete with the alternatives the investors think better.

The demutualised exchange’s ability to quickly respond to new pressures and opportunities may be thwarted if it is still subject to excessive regulatory oversight, with lengthy periods required for rule and policy changes to be approved, while alternative trading systems can implement changes overnight.

POLICY IMPLICATION

Demutualization of Stock exchange is a tough issue, both from regulatory and business perspectives in a developing country like Bangladesh. New issues and challenges can arise with the passage of time, but regulators belief that like other countries we can also manage these problems successfully. Members and stakeholders related to stock exchanges have an important role to play in the demutualization process.

The success of demutualization depends on the performance of the directors. So selection of independent and neutral directors is a big issue in case of demutualization. Any kind of mistake or ignorance in selection may cause to deteriorate the performance of the exchanges. Although there is every chance of corruption in this case, as existing members of the DSE are entitled to select
directors which is unlike other countries. Selection of worthy and professional independent directors may accelerate the success of converting a mutual organization to a for profit organization. So the selection of directors should be clear and transparent to everyone.

Stock exchanges will require a great support from BSEC after demutualization. As stock exchanges should have to concentrate on market diversification and introducing new product and instruments, they require the authority of the capital market in their favor. In some cases listing regulations may need to be relaxed to increase the number of listing which will increase the earning of the exchanges after demutualization. It will be quite complicated for the exchanges to enjoy the benefit demutualization without the assistance of BSEC.

At the beginning the post of strategic partner will remain blank but regulators should have to be concern about searching strategic partner after that. Strategic partners can contribute to the technology, introduction of derivative products and can help to enhance the capacity of the product and they will feel attracted if the capital market will have enough growth.

After demutualization stock exchanges need to diversify the market and introduce new products. As demutualization unfolds the scope for new product and instrument it should be implemented. Profits can be gained my attracting investors from home and abroad by redefining the existing and offering new product like derivatives, short selling, future, Islamic products etc. New product innovation in the capital marker requires technological advancement to cope up with the competition. Without advanced trading system and technology stock exchanges will not be able to provide and maintain new product and diversification trading platform and order management system need to be updated.

A committee can be formed to oversee the role of the regulation and operation of the stock exchanges. It may help to reduce the conflict of interest between these. This committee will work as a watch dog over stock exchange and take corrective measure if they find any unethical practice or conflict of interest.

CONCLUSION

Our economy is not that young to suffer the downturn from mistake, but it starving for a matured and stable market. The stability came through a variety of sources namely educated investors, institutional investors and capital market regulation. Through various forms of reforms and automation the capital market of Bangladesh won the confidence of investors from all walks of life. Now Bangladesh Securities and Exchange Commission has be upgraded to an A category regulatory agency, which ensures the regulators access to international cooperation on securities market worldwide. In addition to that the government facilitated our capital market by structuring its monetary and fiscal policies in a pro capital market manner. One of the new responses of Bangladesh government
to improve capital market is demutualization. It was a time need after the great incident of the capital market debacle. It’s not like that demutualization was the only way to recover from that situation and market will not also get any immediate benefit from this but it was one of the most suggested actions. By replacing the cooperative structure of stock exchange with a corporate structure demutualization would allow lots of advantages by the means of the development of the markets. Not all the benefits of demutualization are applicable for Bangladesh. Rather, the contingent upon some factors unique to Bangladesh. It will create a governance structure that is more flexible in responding to industry and market conditions, avoid concentration of ownership power in a particular group of stock exchange participants and ensure financial decision-making by ensuring that resources are allocated to business initiatives and ventures that enhance shareholder value. This increasing efficiency in the management of the exchange will stimulate the confidence of the investors both local and foreign, to the capital market. So in the process of demutualization the authorities concerned should focus on those factors from which optimum benefits can be arrived. There is no doubt that demutualization will resolve many of the problems faced by mutual exchange. However, there will also be some risks involved in the process of demutualization like new conflicts of interest, brokers not feeling any loyalty in the market, becoming a potential take-over target, and regulatory problems. Benefits of demutualization can’t be perceived if these risks are not minimized. But there is no short run impact of demutualization we have to wait few more years to see the effects of demutualization in the capital market.

REFERENCES


