

An insight to the regulatory issue arising from the demutualisation of the Nigerian Stock Exchange

THE Nigerian STOCK EXCHANGE



Innovative Compliance

A white paper by OpenSpaces Compliance Consultant Ltd

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Introduction

The demutualisation of the Nigerian Stock Exchange (NSE) from an institution set up for the benefit of its members to a profit-making entity raises a number of critical issues. These issues are primarily a) the ownership of the exchange, b) corporate governance and c) how to manage and resolve the conflicts of interest between the regulatory function of the NSE and its commercial interest as a profit-making entity.



A white paper on the conflicts of interest between a demutualised NSE's commercial activity and its regulatory function and how this can be resolved.

To a large extent, the Securities and Exchange Commission of Nigeria (**SECNG**) Rules for Demutualisation of Securities Exchanges in Nigeria (**Rules on Demutualisation**) has addressed squarely the ownership and corporate governance issues. The Rules on Demutualisation restricts a single individual or entity from holding more than 5%, of the equity or voting rights of the exchange. Additionally, members of a stakeholder group cannot hold more than 40% in aggregate of the equity of the exchange. The requirement that at least 1/3 of the Board of Directors of the NSE should be independent addresses the corporate governance issue.



Therefore, the purpose of this white paper is to shed more light on the conflict of interest between the regulatory function and the profit-making activity of the demutualised exchange and to make suitable recommendations on how it can be resolved. It is hoped that our recommendations can form the basis of the NSE's plan for the independent management of its regulatory function, a key requirement of the Rules on Demutualisation.

Executive Summary

The recent decision by the members of the Nigerian Stock Exchange (**NSE**) to transform from a mutually owned (for the benefit of its members) exchange to a for-profit company is a strong statement of intent that the NSE's management and members are determined and unwavering in their drive to actualize the **NSE's vision 'To be Africa's foremost securities exchange driven by regulation, efficiency, liquidity and innovation'**. On completion of the demutualisation process, the NSE will join the growing list of demutualised exchanges in Africa and across the world.



The NSE's demutualisation will throw up fundamental conflicts of interest challenges that must be resolved to protect and preserve the integrity of the market and increase investor confidence.

The Demutualisation of Exchanges (**DOE**) is not a new trend as the first took place in 1993 when the Stockholm Stock Exchange demutualised. DOE has been mainly driven by the tangible benefits such as access to capital and a more flexible governance structure that enhances resolute actions in response to changes in the business environment. In Africa, this has also been driven by the desire to transfer these institutions from state ownership to private sector ownership.



The NSE's demutualisation will throw up fundamental conflicts of interest challenges that must be resolved to protect and preserve the integrity of the market and increase investor confidence. The first challenge is how the NSE will address the conflict of interest flowing from its new status as a for-profit company (and possibly listed on its own exchange) with its responsibility as a self-regulatory organisation responsible for the oversight of trading and listing on the exchange. The second challenge is the conflict of interest that will arise in the event of the NSE deciding to list on the Exchange i.e. Self-listing. These challenges have been encountered and addressed by demutualised exchanges (**DME**) globally and as reviewed by our consultants, being addressed through two principal means:

We recommend the creation of the NSE Regulatory Organisation (NSEREG) as an independent subsidiary of the demutualised NSE to undertake its regulatory function.

1. A separation of the DME regulatory responsibilities from the listing and trading business through the creation of a separate regulatory body that is not accountable to the exchange; (**Separation Model**); or
2. Retention of the DME regulatory power alongside its listing and trading business but with additional safeguards to ensure that the exchange exercises its regulatory powers fairly. The additional safeguards include oversight by an independent body or a supervisory ministry, restriction on the percentage (%) shareholding by any one single entity in the DME, (**Integration Model**).

We recommend that to effectively and transparently manage the conflicts of interest between its regulatory function and profit making activity that the NSE adopts the separation model through the creation of a new regulatory organisation i.e; the **NSE Regulatory Organisation (NSEREG)** within but independent of the NSE. NSEREG's responsibilities would include 'Conduct and Prudential Regulation' of NSE Dealing Members (and equivalent on demutualisation) and enforcement of listing rules etc. NSEREG would be part of the NSE but independent by having a separate governance structure and funding arrangement.

Background

At its Extra Ordinary General Meeting held on Thursday 30th March 2017, the members of the Nigerian Stock Exchange (NSE) voted unanimously to approve the transformation of the NSE from a mutually owned organisation for the benefit of its members to a for-profit commercial organisation. The decision taken by the members of the Nigerian Stock Exchange marked the achievement of a major milestone in the NSE’s journey of transformation from a regional exchange to a world class exchange.

By agreeing to demutualise, the NSE has joined the growing number of exchanges in Africa and the rest of the world that have changed status from a mutually owned company to a for profit and/or publicly owned entity. The first demutualization of an exchange was in 1993 when the Stockholm Stock Exchange demutualised and as at September 2017, the following stock exchanges in Africa and the rest of the world had demutualised:

The first demutualization of an exchange was in 1993 when the Stockholm Stock Exchange demutualised...

Fig 1. List of demutualised exchanges

Africa		Rest of the World	
1	Johannesburg Stock Exchange	1	Stockholm Stock Exchange
2	Rwanda Stock Exchange Ltd	2	Copenhagen Stock Exchange -
3	Nairobi Stock Exchange Ltd	3	Italian Stock Exchange
4	Casablanca Stock Exchange	4	Amsterdam Exchange
5	Botswana Stock Exchange	5	Australian Stock Exchange
6	Zimbabwe Stock Exchange	6	Helsinki Stock Exchange
7	The Stock Exchange of Mauritius	7	Hong Kong Stock Exchange
8	Trop X- Seychelles	8	Iceland Stock Exchange
9	BRVM <i>(A regional stock exchange serving the following countries: Benin, Bourkina Faso, Guinea Bissau, Cote d Ivoire, Mali, Niger, Senegal and Togo)</i>	9	Athens Stock Exchange
		10	Stock Exchange of Singapore
		11	Paris Bourse
		12	Toronto Stock Exchange
		13	London Stock Exchange
		14	Oslo Exchanges
		15	Nasdaq

What is Demutualisation?

Demutualisation is the process of converting a non-profit, member owned organisation to a for-profit, investor owned corporation. In relation to stock exchanges, the process requires separating ownership from the right to use the exchange’s trading system. In a mutualised exchange, a broker who wishes to trade on the exchange has to be approved as an owner and/or member in order to trade, whereas in a demutualized exchange, the broker does not need to be a member of the Exchange before using the exchange’ systems and facilities to execute transactions.

When demutualisation occurs, the right of exclusivity to the usage of the company’s services is detached from the ownership of the mutual company

As such, demutualisation, by implication involves a mutual company divesting itself from its original purpose, i.e. the provision of specific services for the benefit of its members, at the lowest price that can be attained. When demutualisation occurs, the right of exclusivity to the usage of the company’s services is detached from the ownership of the mutual company.

Procedurally, there are three known forms of demutualisation that have been employed to accomplish the transition and these are mentioned briefly in Fig 2 below:

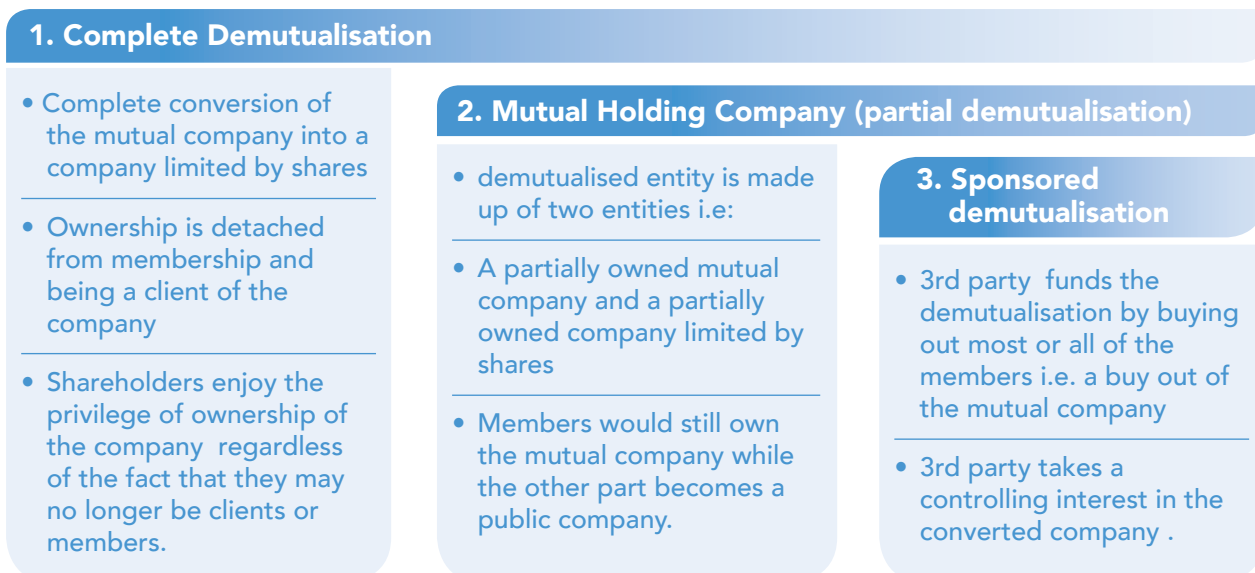


Fig 2 - Types of demutualisation

Benefits of Demutualisation

It is generally acknowledged that demutualisation confers the following benefits on an exchange:

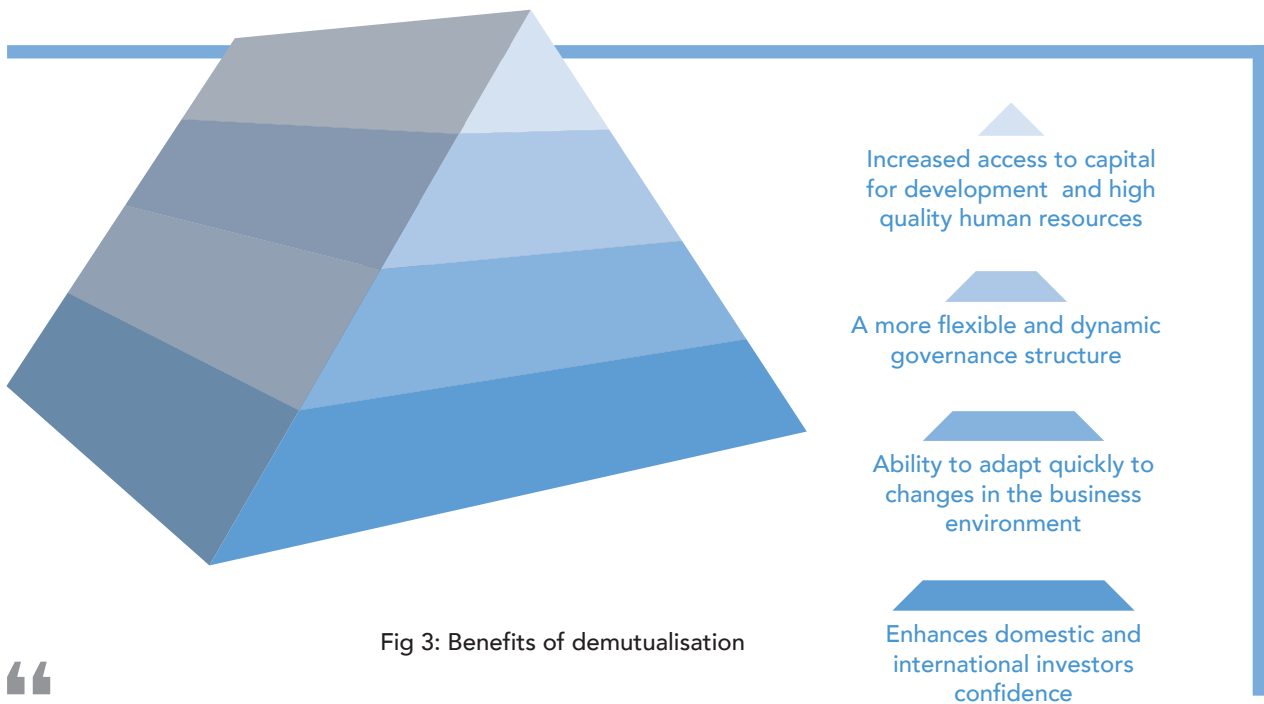


Fig 3: Benefits of demutualisation



As a demutualised entity that is PROFIT-SEEKING, the NSE will be in a better stead to capitalise on new income opportunities, free from any limitations arising from conflicting member interests and existing laws and more importantly be able to better support the economic growth of Nigeria

– Oscar Onyema,
CEO NSE



The NSE’s CEO acknowledged these benefits in his address at the Extra-Ordinary General Meeting of the NSE (held on Thursday 30th March 2017) to approve the demutualisation when he stated that:

“...The approval of the demutualisation process (by the NSE’s members) will generate substantial motivation for the development of an agile Exchange thereby consolidating its innovativeness and strengthening its leadership both at local and international levels whilst also adding value to its stakeholders. As a demutualised entity that is PROFIT -SEEKING, the NSE will be in a better stead to capitalise on new income opportunities, free from any limitations arising from conflicting member interests and existing laws and more importantly be able to better support the economic growth of Nigeria.”

The conflicts of interest arising from demutualisation

Notwithstanding the likely benefits of demutualisation that could accrue to the NSE, transformation from a member owned organisation, set up for the benefit of its members, to an independent for-profit exchange will throw up a number of conflicts of interest (**COIs**) challenges.

These COIs arise from the role of the NSE's for-profit business as the main platform for the trading and listing of debt and equity instruments in Nigeria's Capital Market (**NCM**) and its role as a self-regulatory organisation (**SRO**) responsible for the regulation and oversight of Capital Market Operators (**CMOs**) and the enforcement of trading and listing rules.

Resolution of the conflicts of interest between a demutualised NSE's commercial operations and its regulatory function is a critical part of the demutualisation process.



Fig 4: COIs challenges of a demutualised NSE

The details of these COIs are explained below but it should be noted that they are not peculiar to the NSE, as all DMEs have faced and addressed the same challenges as part of the demutualisation process.

A. Conflict of Interest in Listing Activity

As Listing fees are a major source of revenue, will a demutualised NSE 'relax' listing standards to increase listing activity?

Customarily, whenever there is a listing, it is seen as an indicative factor of quality endorsement for what is being listed. If the listing standard set by the NSE is seen as rigid and unattainable, a significant number of firms will be cut off from the trading platform, leading to a possible loss of revenue from listing fees. However, if the standard set is too liberal, mediocre quality securities end up being listed, with the unwanted consequence of an erosion of profits for investors, which is also likely to adversely affect the status of the exchange. This is not as farfetched as it sounds as the London Stock Exchange (LSE) (a demutualised exchange) in a bid to attract Emerging Market based companies in the early 2000 lowered the listing requirements for companies based in emerging markets. The resulting effect was that a lot of emerging market companies listed on the LSE eventually failed with investors (institutional and retail) losing their money. The companies failed because they did not meet the UK's corporate governance standards (which had been lowered for them) especially the protection of minority investors. The case of Eurasian Natural Resources Corporation (**ENRC**) is particularly relevant and instructive.

Will shareholders demand for profit lead to a decline in listing standards and market regulation?

B. Conflict of Interest in Regulating Market Operations

Similar to the COI in listing activity, will the NSE sacrifice robust regulation of trading on the altar of order flow bearing in mind that order flows lead to trading fees, a significant source of revenue for exchanges?

The functionality of exchanges requires them to regulate trading activities on one side of the coin and on the other side enact or enforce rules that control trading activities. Included in the genre of regulation are overseeing trading activities,

the identification of suspicious activities, the detection of such activities, and in event of misconduct, taking all appropriate means to address and eliminate such misconduct. This is by no means an easy or casual balancing act, which may engender a COI between the regulatory and business function. Competition with other exchanges may also put the NSE under duress to generate an order flow.

A demutualised NSE, focused on profits, may possibly not give its self-regulatory role the utmost attention it requires. While profit making is seen as the objective, the benefits of effective regulation are not necessarily visible, however, the benefits of expenditure on regulation should be glaring, because it is this very regulation that will determine the success or otherwise of the conversion experience. If the allocation of resources for self-regulation in both human and monetary terms is compromised, this will negate the fundamental objective of separating ownership and usage in a demutualised entity.

C. Conflict of Interest from the NSE self-listing on its exchange

Should the NSE as part of the demutualisation process decide to list on the exchange, how will it regulate itself or can it indeed self-regulate?

The issue of a demutualised exchange listing on its own exchange is not uncommon and the London Stock Exchange is an example as it is also listed on its exchange. Does self-listing make the possible conflicts with overseeing competing entities or business associates that are also listed on the exchange worse?

Resolving the Conflicts of Interest challenge: The approach of other jurisdictions

Undoubtedly, the resolution of the COI issues identified earlier at pages 9 to 11 by the NSE is of utmost importance as it goes to the core of the NSE's function; the integrity of the market and investor confidence. The International Organisation of Securities Commission (**IOSCO**) framed this issue succinctly in December 2000 when it stated inter alia that:

"At the heart of this is issues is the fundamental question of whether the commercial pressures [or governance structure] of a for-profit entity will undermine the commitment of resources and capabilities of the exchange to effectively fulfil its regulatory and public interest responsibilities" (IOSCO's Consultation paper on demutualisation of stock exchanges)

Demutualised exchanges have used two main methods to resolve the conflicts of interest: A separation approach or an integrated approach

As indicated earlier, the COIs challenges are not peculiar to the NSE as other DME have faced and addressed them. Therefore, in order to come up with a viable solution for the NSE, we examined how a number of DMEs in Africa, Asia, Europe and North America had resolved these challenges. We examined the approach of the New York Stock Exchange (**NYSE**), the London Stock Exchange (**LSE**), the Singapore Stock Exchange (**SGX**), Hong Stock Exchange (**HKEx**) and the Johannesburg Stock Exchange (**JSE**).

Our analysis of the approach adopted by these exchanges indicated that there are fundamentally two main approaches to resolving the COI challenges i.e:

- 1) The separation model**
- 2) Integrated approach overlaid with enhanced governance requirements.**

The key features of both approaches are explained on the following page.

**Approach
1**

The separation model

In this model, the regulatory function of the DME is separated from the business function and typically housed in a related but independent body. The underlying philosophy of this model is the belief that COIs can only be effectively managed by a complete separation of the regulatory function of an exchange from the business function as shown in the diagram below.

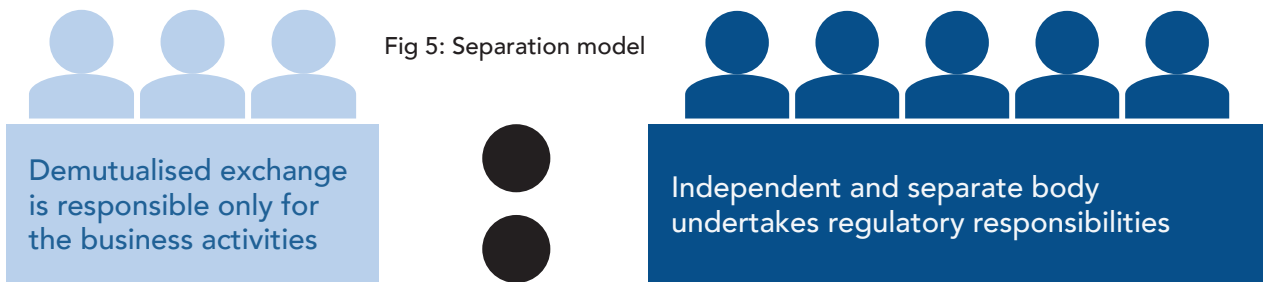


Fig 5: Separation model

Key Features

- Regulatory function exercised by a separate and independent body
- The Independent body is responsible for enforcement and compliance with trading and listing rules. May also be responsible for oversight of the conduct of users of the exchange.
- The body may or may not have oversight of the exchange
- Conflicts of interest are well managed along with greater transparency

**The separation model is the approach adopted by
the NYSE and LSE on their demutualisation**

NYSE FEATURES	LSE FEATURES
<ul style="list-style-type: none"> • NYSE Regulation (NYSER) is responsible for ensuring compliance with the NYSE's rules and federal securities law. • In addition to NYSER, other independent self-regulatory organizations such as FINRA (Financial Industry Regulatory Authority) are also responsible for regulating the conduct of brokers and dealers on the NYSE and trading activities • The NYSE, as an entity is also under the direct oversight of the USA Securities and Exchange Commission 	<ul style="list-style-type: none"> • Regulation of listing and conduct lies with two separate bodies' i.e. • The UK Listing Authority (UKLA) is responsible for the following: <ul style="list-style-type: none"> a) Operating the UK listing regime b) Reviewing and approving prospectuses c) Monitoring market disclosures • The Financial Conduct Authority (FCA) is responsible for regulating the conduct of financial services firms e.g. stock brokers, investment banks etc.

**Approach
2**

The integrated model

In the integrated model the exchange is also responsible for the regulation and monitoring of listing and trading business of the DME. The underlying philosophy is that a robust, fair, effective and transparent regulatory regime is fundamental to the success of the exchange and can only be achieved if the exchange retains this function. A failure to effectively regulate the market will inevitably lead to a loss of business and over time, migration of trading and listing business from its platform(s). In this model, regulation and listing and trading business are retained within the same entity albeit in separate division i.e:

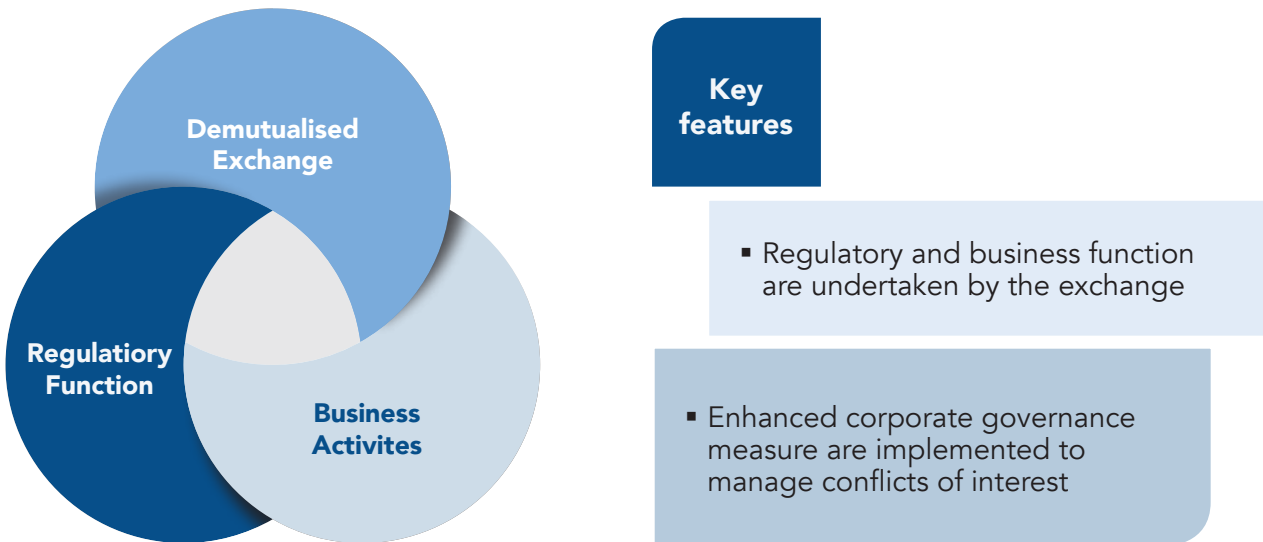


Fig 6: Integrated model

The integrated model is the approach adopted by the Exchanges listed below on their demutualisation:

Fig 7: Exchange adoption

EXCHANGE	FEATURES
<p>Singapore Stock Exchange (SGX)</p> <p><i>(Please note that in 2016 the SGX announced plans to transfer its regulatory responsibilities to a separate and independent subsidiary)</i></p>	<ul style="list-style-type: none"> Self-regulation. Monetary Authority of Singapore (MAS) directly regulates SGX in terms of its obligations as a listed company and market operator



The integrated approach requires enhanced corporate governance measures to be successful.



<p style="text-align: center;">Johannesburg Stock Exchange (JSE)</p>	<ul style="list-style-type: none"> ▪ The JSE’s regulatory activities are undertaken by its Market Regulation Division and it is responsible for the monitoring of trading activities to identify possible market abuse and oversight (regular monitoring) of JSE members’ compliance with their regulatory obligations. ▪ The Financial Services Board (FSB) supervises the JSE in the commission of its regulatory duties
<p style="text-align: center;">Hong Kong Stock Exchange (HKEx)</p>	<ul style="list-style-type: none"> ▪ The Hong Kong Securities and Futures Commission (SFC) has oversight of HKEx ▪ The maximum shareholding in HKEx is 5% unless exempted by the Securities & Futures Commission of Hong Kong (SFC). ▪ The Board of HKEx has public interest directors (appointed by Government). ▪ The HKEx maintains strict separation of its Regulation and Risk Management Dept. from business units. ▪ The SFC has a power of direction over the HKEx where conflict arises in regulation.

Despite the differences, the 2 approaches have the following common features:

- I. A separate regulatory agency has oversight of the DME
- II. Other regulatory bodies may also be responsible for some aspects of regulation.

Resolving the Conflicts of Interest challenge: Our recommendation

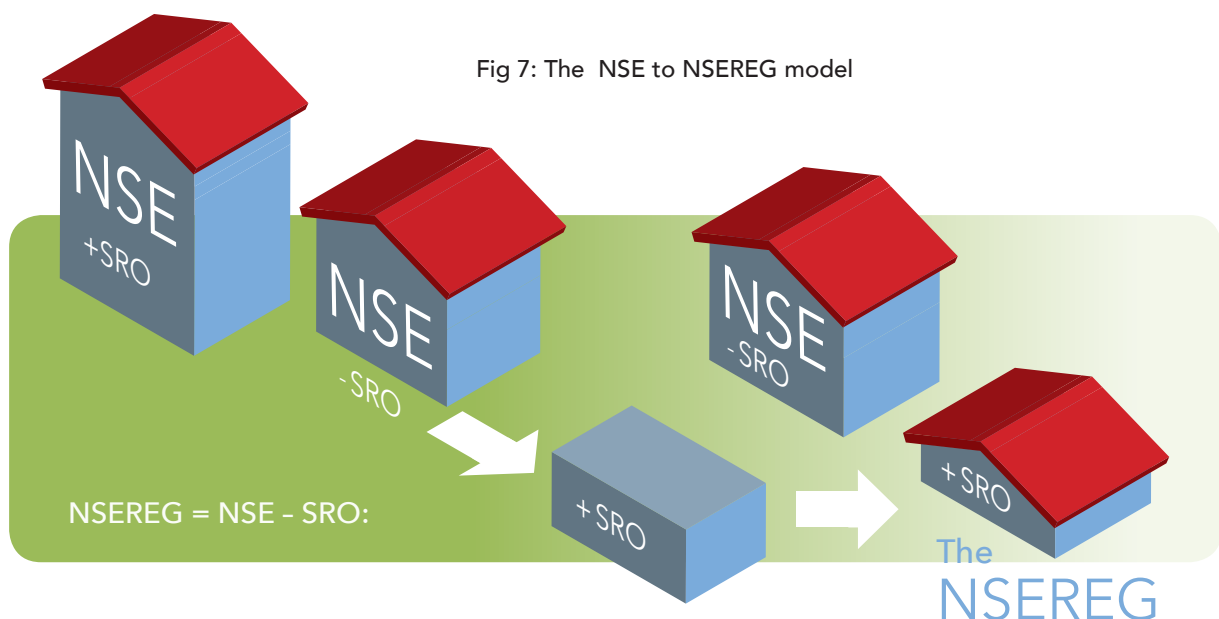


We recommend that the NSE adopt the separation approach to the management of its regulatory function, post demutualisation by creating the NSE Regulatory Organisation (NSEREG) to undertake its regulatory function.



Following our review of the approaches adopted by **NYSE**, **LSE**, **JSE**, **HKEx**, and **SGX** to managing the COI challenges, **we strongly recommend that the NSE should adopt the separation model to effectively and transparently manage the COI challenges**. Our recommendation also takes into consideration the current regulatory framework of the Nigerian Capital Market which bears some similarity to the financial services regulatory framework of the United States i.e. both have a Securities and Exchange Commission at the apex and a number of Self-Regulatory Organisations (SROs) responsible for regulation. It is also aligned closely with best practice in corporate governance and managing conflicts of interest.

To implement the separation model, the NSE should create an independent subsidiary, the NSE Regulatory Organisation (**NSEREG**) to carry out its regulatory functions. This will entail a 'transfer' of the **SRO** status of the NSE to NSEREG.



The NSEREG should be charged with the following responsibilities:

- Regulation of the conduct of the current NSE's Dealing Members and their equivalent on completion of the demutualisation and the development of a comprehensive Conduct of Business rulebook.
- Monitoring and enforcement of the NSE's trading and listing rules.
- Act as an independent ombudsman for complaints against NSE Dealing Members

To ensure the independence of the NSEREG, we also recommend the following measures:

It is very important and critical to the success of a demutualised NSE that the conflicts of interest that emanate from such a process especially those arising from its regulatory role are addressed in a fair and transparent manner.

- I. Designation of NSEREG as a SRO by SECNG, through the transfer of the NSE's SRO status to it.
- II. The board of NSEREG should constitute majority of independent non-executive directors not including current directors and/or employees of any NSE Dealing Member;
- III. The NSEREG should be directly funded through the following:
 - a) A regulatory levy imposed on users of the NSE's services i.e. Dealing Members and Listed Companies and regulatory fines;
 - b) A set percentage of the NSE's profit before tax
 - c) A contribution from the Investor Protection Fund

Prior to setting its yearly levy, the NSEREG should consult fee payers on its budget and the level of the regulatory levy.

With regards to the self-listing conflicts of interest, our recommendation is that in the event of the NSE deciding to list, the listing process should be overseen by the SECNG and post-listing, the SECNG should be responsible for its regulation and oversight in accordance with the listing rules of the NSE

Demutualised exchanges have experienced and enjoyed appreciable success and growth and it should be the same for the NSE. Some notable benefits to the NSE include:

- Creation of a more flexible governance structure, which enhances resolute actions in response to changes in the business environment.
- Substantial investor participation in the governance of the exchange.
- The demutualization process should generate significant flexibility and access to global markets.
- Securing increased access to resources for capital investment generated through equity offerings or private offerings.

However, for these benefits to be achieved, it is very important and critical to the success of a demutualised NSE that the conflicts of interest that emanate from such a process especially those arising from its regulatory role are addressed in a fair and transparent manner. A fair and transparent resolution will enhance domestic and international investors' confidence in the exchange and in this regard, the NSE can do no wrong by looking at, and adopting some of the models adopted by other jurisdictions subject to taking into consideration local circumstances and nature of the market.

It is hoped that a thorough and unbiased approach will be taken to ensure that the overall process and the aftermath will be one that will make Nigeria proud to speak of an exchange that is among the world contenders.

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About OpenSpaces

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OpenSpaces was established to provide practical compliance and regulatory advice to financial services companies.

We have extensive knowledge and practical experience of compliance and regulation in the financial services industry of Nigeria and the UK.

Recent engagements include developing Standard Operating Procedures and Policies for Capital Market Operators on behalf of the NSE and providing regulatory advice to the London Clearing House (LCH, part of the London Stock Exchange Group). We have also assisted FBN Capital in developing its compliance framework to international standards and advised GTBank Plc on its regulatory responsibilities as an issuer of Global Depository Receipts (GDRs) listed on the London Stock Exchange.

At OpenSpaces, our philosophy is simple and straightforward: providing clients with clear, direct and commercially sound advice and solutions underpinned by our core values of **Respect, Integrity, Excellence and Innovation.**

Get in touch

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