Will exchange alliances work?

To compete with bigger international rivals, Asia's exchanges are working together through partnerships and networks. But some disconnects must be fixed before they reach their potential

Ashley Lee, staff writer

Global competition between securities exchanges has never been tougher. And it's a phenomenon that will become only more prevalent as a growing number of platforms look to attract international investors. The US and European markets have responded by consolidating, the most recent example being IntercontentialExchange's (ICE) $8.2 billion purchase of New York Stock Exchange EuroNext (NYSE).

Exchanges in Asia, however, have taken a different approach. Instead of M&A, they have looked to expand their presence through links and partnerships.

In the past, exchange cooperation agreements ran the risk of being somewhat superficial. But as global competition has increased, many exchanges have become eager to tout their relationships and establish far-reaching networks. They are striking deals to establish their own turf and, where possible, keep out rivals.

"Linkages are a means to an ends, and the aim is to make access easier and cheaper," says Nick Ronalds, managing director and head of equities at the Asia Securities Industry and Financial Markets Association (Asifma). Their goal, he says, is to make it as easy and efficient as possible for investors and their intermediaries to access the market.

According to Asifma's executive chairman, Mark Austen, the big question is whether these links will drive costs down, or if costs will remain the same or even increase. Ultimately, he says, these agreements don't create competition. Instead, they provide links between existing exchanges and allow investors to trade on the link – perhaps with additional cost.

Asean Exchanges Trading Link

This month marks the first anniversary of the Association of Southeast Asian Nations (Asean) Exchanges Trading Link (Asean Link). Established to attract investment from international and local retail investors, the Link is part of a broader initiative to strengthen the development and integration of Asean's capital markets by 2015.

"Regional financial integration will help improve capital flows among the Asean countries, and those funds are likely to be more stable," says Thiam Hee Ng, senior economist in Asian Development Bank's Office of Regional Integration.

The Singapore Exchange (SGX) and Bursa Malaysia (BM) launched the Asean Link in September 2012, with the Stock Exchange of Thailand (SET) joining the following month. Together, these three exchanges contribute two-thirds of the market capitalisation of the seven-member Asean Exchanges initiative. The four members yet to join are the Hanoi Stock Exchange (HSE), Ho Chi Minh Stock Exchange (HOSE), PT Bursa Efek Indonesia (IDX), and the Philippine Stock Exchange (PSE).

The Asean Link uses a broker-to-broker interface. It allows brokers in one jurisdiction to execute trades through another that is licensed in the corresponding market. It's a similar arrangement to that used in the initial phase of the *Mercado Integrado Latino-Americo* (Mila), which links Peru, Colombia and Chile's exchanges (see boxout).

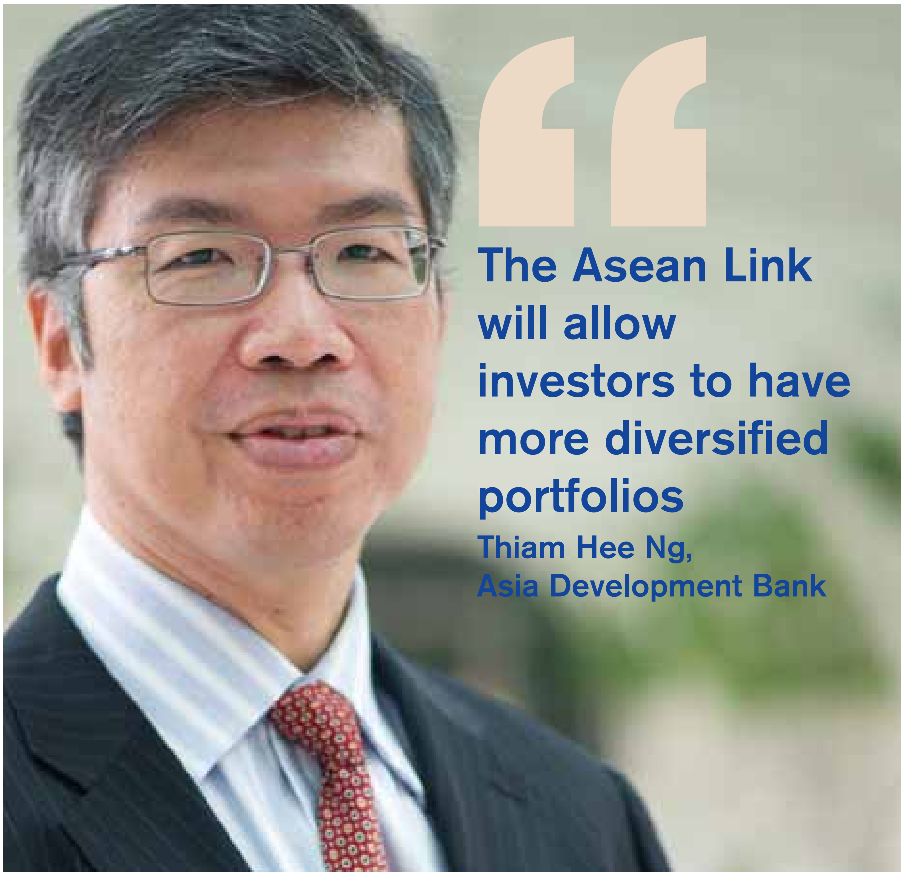
Based on its first year of operation, sources have given the Link mixed reviews. Some dismiss it as a talking shop, and note that the broker-to-broker interface involves higher fees. "It's easy to overestimate what the trading link does," says one. Others are more positive, noting the success of its public relations campaign among retail investors, which roadshowed across the region.

The Asean Link is likely to boost trading volumes on the participating exchanges, but sources were not aware of data backing its impact. More data will help evaluate its success.

Retail focus

A major criticism of the Asean Link is that it focuses on retail investors rather than institutional investors, who already have access to the different markets.

Ng says the Link will help with the allocation of funds across different countries, and allow investors to have more diversified portfolios. While he doesn't expect investors to move money from their savings accounts to invest in stocks, they may move some of their assets to different jurisdictions. In turn, Ng says, this may increase overall investment because people may feel that their portfolios need more diversification. Malaysia, Singapore and Thailand are close economically, but there are enough differences to create portfolio diversity.



Local regulations

The broker-to-broker interface helps the Link sidestep some regulatory issues that would arise if a direct link were established. For instance, each jurisdiction applies its own taxation, currency controls and foreign investment policies. And there is no central clearinghouse for these trades.

But the member exchanges have urged regulators across Asean to consider local rules when adding new members to the trading link. Dr Pakorn Peetathawatchai, executive vice president and head of corporate strategy and finance division of SET, notes that countries looking to join the link must consider currency controls.

"For example, if the Vietnamese exchanges were to join, the Central Bank of Vietnam would have to think about whether that would be possible without lifting the currency controls," he says.

Sources agree that the cost of trading is an issue. The broker-to-broker interface means investors must pay fees to two brokers – one in their local jurisdiction and one in another Asean jurisdiction – for arranging the transaction. Some governments have responded by reducing tax burdens for those that use the Link. For example, capital gains tax is waived for inbound investments into Thailand that are executed on the Link.

Harmonisation

The Link has been criticised for its lack of ambition, especially compared to the European common market. The broker-to-broker interface means that local exchanges and regulators retain their independence, and in many cases, their own rules. But the politics behind the Asean Link initiative are vastly different from those that spurred the creation of the European framework.

Some say that the Link doesn't involve passporting or mutual recognition, and therefore isn't as effective as the European common market. But that is a poor analogy because the underlying political driver for the closeness that led to some EU securities market developments aren't present in Asean, says Stephen Revell, co-head of Freshfield Bruckhaus Deringer's global capital markets practice.

"The analogy with the EU doesn't get you anywhere because the underlying politics are fundamentally different, and therefore the output is very different," he says. "The Link is more about collaboration than mandated cooperation."

The collaboration between Asean jurisdictions is multi-layered, however, and the Association's securities regulators work closely as members of the Asean Capital Markets Forum (ACMF). In April this year the ACMF announced the Asean Disclosure

Mila: the original exchange integration

As the Asean Link wards off criticisms, it should take inspiration from its counterpart in Latin America. The *Mercado Integrado Latino-Americano*, or Mila, is the Andes' integrated capital market, which links the trading platforms of Peru, Colombia and Chile's national exchanges.

IFLR's cover story from April 2012 revealed Mila's first year to be mired by low trading volumes, the extension of phase I operations, and the seemingly insurmountable challenge of integrating platforms subject to different regulatory burdens and operational capabilities.

But today, Mila's fortunes have significantly improved. As at June 2013 the platform had 553 listed companies, a $667 billion market capitalisation, three indexes, and was followed by seven investment funds. Perhaps its greatest success, however, is the exposure it has given local companies to other Andean and non-Andean investors.

"Important players in the Latin American financial sector such as BTG Pactual, Credicorp and Larrain Vial have entered our market, and also consolidated their presence in the other Mila countries," says Juan Pablo Cordoba, chief of the Bolsa de Valores de Colombia.

The integration has helped the three countries and its regulators to think beyond the local landscape, said Cordoba, and has generated opportunities as a region and not just as a country.

In Peru, Mila has amplified investment opportunities and seen foreign investors diversify their portfolios, says Francis Stenning, head of Bolsa de Valores de Lima.

The integrated market's quest for greater visibility and investment, along with full consolidation, is a long process, though. Cordoba is working on a timeframe of five to 10 years.

Its next challenges include new instruments such as quota funds and exchange traded funds, incorporation of international custodian operations, and reinforcement of brokers' clearing processes. Its operations will expand in January 2014, when the incorporation of the Mexico Stock Exchange will commence.

*IFLR's feature on Mila's first 12 months is available at **www.iflr.com/mila***

Standards Scheme for multi-jurisdictional equity and vanilla debt offerings. But these standards are on an opt-in basis, and have only been implemented by Singapore, Malaysia and Thailand. In addition, separate review and discussion with each regulator is still required.

It's difficult to harmonise disclosure standards, says Sin Boon Ann, deputy managing director of Drew & Napier's corporate and finance practices. This is because they are determined by culture, judgement and past practice.

Some jurisdictions, for example, permit companies to withhold information that would be considered material elsewhere. But some companies may feel duty bound to disclose such details. "Further, while the same rules may apply across jurisdictions, the content and detail of the announcements may be very different," Boon Ann says.

> **It's easy to overestimate what the trading link does**

"A common disclosure regime would be the ultimate goal," says Clifford Chance's Raymond Tong. According to Tong, it's hoped that the Asean Link is a precursor to cross-listings, such as a Singapore-listed company listing on BM or SET. For this, counsel hope that a more harmonised regime will evolve.

Tong explains that although the unified disclosure rules comply with basic International Organization of Securities Commissions (Iosco) standards, each exchange still maintains its own rules. The next step will be to cross that bridge, and it's understood that regulators are working towards that goal.

Corporates are looking forward to having an expedited process for secondary listings. But until disclosure rules emerge, it's a topic that will remain in its exploratory phase. Once those rules are in place, however, the Link will present significant opportunities for corporates, bringing them to the attention of investors from new markets.

Next steps

When considering the Asean Link's success and prospects, it's important to remember that it has only been in operation for one year. "We are still in the early stages if you look at the number of members and types of product being traded," says Peetathawatchai.

He confirms that the Asean Link is contemplating improvements to its online trading platform, to facilitate retail investor interest. "Retail investors may want to trade online and buy or sell other countries' stocks, but that service isn't ready yet," he comments. "We need to improve the Link's infrastructure to support online trading."

In May, FTSE announced its collaboration with the exchanges of Malaysia, Indonesia, the Philippines, Singapore and Thailand to establish the benchmark FTSE/Asean Index, and the FTSE/Asean 40 index which comprises the top 40 companies on the FTSE/Asean index by market capitalisation.

The creation of a benchmark Asean index may prompt the creation of sector indices, such as an Asean banking index. "That would certainly help businesses such as asset management companies list exchange-traded funds as an Asean asset class, which is a part of the process that we'd like to push," Peetathawatchai says.

More products may be added to the Link. Sources believe that its retail emphasis means it will focus on equities. But it will consider adding bonds and tradable Islamic products, which are important for investors in Malaysia and Indonesia.

Other Asean exchanges are looking closely at the Link. The market originally predicted that the IDX's participation was needed to attract international investors. But since then, the PSE has been the Asean exchange to draw significant international attention. An original participant in the Link, the PSE pulled out in November 2011 because it believed further effort was needed to generate interest and support from both the investing public and local brokers. There is, however, no known timeline for the PSE or IDX to join the Link. The Cambodia Securities Exchange (CSX) and Lao Securities Exchange (LSX) may participate in the future.

"We are looking to invite more exchanges to join the Link, including the LSX and CSX. But the exchanges in Asean are at different stages of development," says Peetathawatchai. "They don't all have to join the link at once. The next step might be expanding it to five exchanges, then six, then eight."

Frontier partnerships

The world's most developed exchanges are also expanding their reach, by forming relationships with frontier exchanges and

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>
> **Dr Pakorn Peetathawatchai, Stock Exchange of Thailand**

helping governments establish new platforms.

These countries' securities regimes often feature local quirks and are more basic than those of their competitors. "It's important to remember that frontier markets are so diverse – from Pakistan to Mongolia, every exchange has its own issues," says Thomas Hugger, fund manager at Asia Frontier Capital. "It's important to analyse them individually."

These tie-ups are two-way relationships. Frontier exchanges seek partnerships to raise their profiles and streamline their regulations to meet the standards expected by international investors. For developed market exchanges, partnerships can bolster their international credentials. But there is debate as to the best approach when assisting these exchanges. Here are the different models that have been used to-date.

MSE-LSE

On its 20th anniversary in January 2011, the Mongolian Stock Exchange (MSE) signed an exclusive strategic partnership agreement with the London Stock Exchange Group (LSEG) for the MSE's restructure and development.

In 2010 the frontier had been the world's fastest growing exchange, and the proposed triple listing of state-owned Erdenes Tavan Tolgoi (ETT) on the MSE, HKEx and London Stock Exchange (LSE) kept it in international focus. MSE sought a partnership to meet international investor standards.

Its relationship with the LSE would allow it to tap the established exchange's expertise on infrastructure and regulatory matters. The LSEG benefitted too, bolstering its competitive edge over Asian exchanges in attracting dual-listings from Mongolian companies. It also reportedly received a $14.2 million fee for the MSE's management.

The LSEG appointed an MSE team to oversee its development and privatisation, and establish an education programme for market participants. The partnership goals included implementing LSEG's Millennium IT system to provide trading and surveillance infrastructure, modernising market rules and structures, and broadening tradable asset classes.

The market gives the MSE-LSE tie-up positive reviews. But many stress that this was

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a natural step for the frontier exchange. The fundamentals were already there as the MSE had been operating since the early 1990s, says Gibson Dunn & Crutcher counsel Myles Hankin. Despite its relatively small market capitalisation, the MSE had a track record, listed companies, and active trading, even if turnover wasn't necessarily massive.

Rather than creating a new market, the partnership was meant to address the issues that have held the MSE back from achieving world-class status. "The partnership has shown upbeat results," says MSE's deputy chief executive officer and chief regulatory officer Saruul Ganbaatar. "We've identified and dealt with outstanding issues and done much work in improving operations and visibility of the exchange to attain MSE's full potential."

He highlights the LSEG's guidance on the MSE's operations. Together with the MSE's team, he says, the exchange has enhanced its clearing and settlement systems and moved from prefunded trading to T+3. This reflects an upgrade from an older, more basic system to an advanced one that is used globally. The LSEG was also integral in the drafting of Mongolia's new Securities Markets Law, which introduces the concepts of depositary receipts, custodian banks, and beneficial and nominee shareholders.

The MSE plans to continue engaging with the LSE. Ganbaatar confirms that the MSE is in the process of creating conditions for dual-listings, and is working with the LSE to create a channel in which any issuances approved for listing in Mongolia can automatically be considered for listing on select LSE markets.

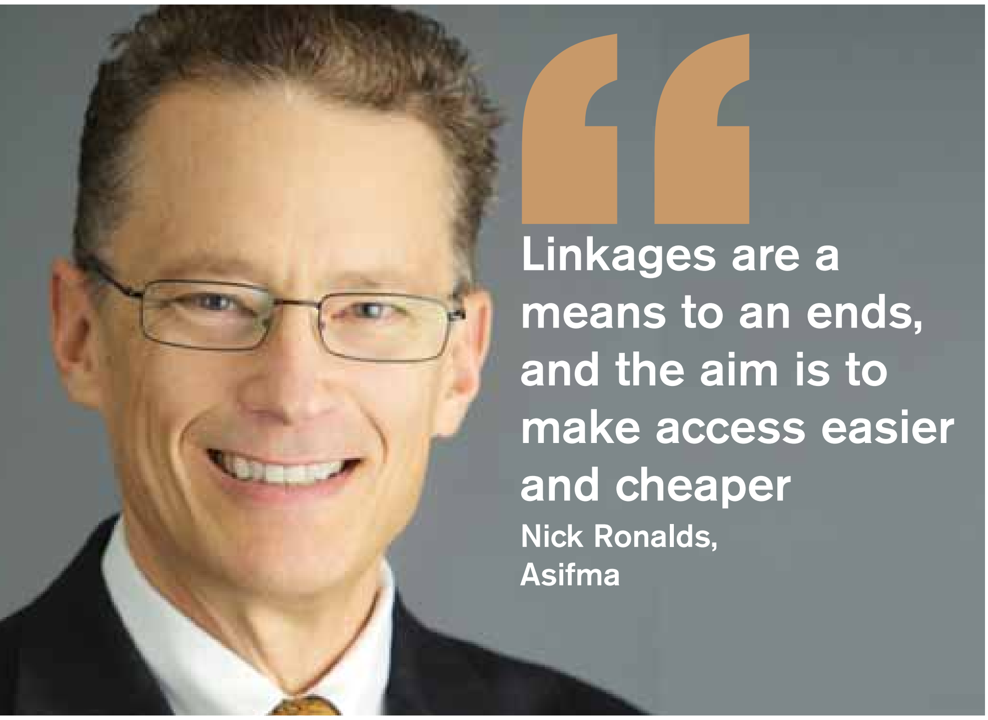
Public relations are a priority. One of the continuing goals is to boost the presence of the MSE in the international public eye. "All the important dirty work has been done on the ground, but the key now is visibility," Hankin says. It may soon receive more recognition from international investors. Mongolia has already been tapped by FTSE for possible promotion to frontier market status, which would be key to enhancing the MSE's profile globally.

JPX/Daiwa Institute of Research-Myanmar Stock Exchange

In May 2012, the Central Bank of Myanmar signed a memorandum of understanding (MoU) with the Tokyo Stock Exchange (now Japan Exchanges Group) and the Daiwa Institute of Research (DIR) to develop the Myanmar Stock Exchange. Originally scheduled to open in 2015, central bank officials have confirmed that its opening would be pushed to later this year following the passage of Myanmar's Securities Law.

DIR and Japan Exchanges Group (JPX) are providing technical assistance on market infrastructure, rule implementation, and information technology systems needed for trading, clearing and settlement. They will also host seminars on finance and capital markets.

This partnership follows the Korea Exchange's (KRX) work in developing the



CSX and LSX, and the corresponding regulatory framework. Both KRX and JPX are developing the infrastructure of emerging exchanges – particularly in Southeast Asia – to showcase their know-how and soft power in the region.

OTC alternatives

While the DIR worked with Myanmar to create the Myanmar Securities Exchange Centre (MSEC) in 1996, only two companies are listed on the platform. Instead, some Myanmar corporates trade shares on an over-the-counter (OTC) and self-regulated basis.

Some query the need to bring in advanced IT systems, let alone development partners, to improve the country's capital markets. "The 'build it and they will come' approach is hardly ideal," says one. "Organic growth will be better in the long-term." Although sources agree that the OTC system needs improvements, they feel that it can be adapted to the financing needs of Myanmar's small to medium-sized enterprises (SMEs).

"Honestly, people here don't understand what a stock is, much less how to trade one," says Jeremy Rathjen, vice president of research at Myanmar research and consulting firm Thura Swiss. There isn't that level of financial education in Myanmar, he explains, and so installing the world's most technologically advanced system feels like the wrong fit.

As an alternative to a full-fledged exchange, Thura Swiss has developed an OTC platform on which companies such as First Myanmar Investment can trade. Rathjen says that whether a company uses this or another platform, the bottom-up approach is the right approach. "It fits better for the market's current stage of development," he said.

DFDL's William Greenlee emphasises that the timing of the stock market's establishment is very important for investors, as they need an exit strategy. "It's not just a badge of honour," he says. "It's a very important part of any commercial business environment."

Multiple partners

Sources warn that JPX's suggested listing rules for the Myanmar exchange could include stringent standards, such as a requirement for candidates to demonstrate two years of profitability. It's feared that this would preclude the listing of most OTC companies and SMEs, as they would require significant pre-deal restructuring.

But lawyers note that companies going public – regardless of jurisdiction – undertake rigorous preparation, to meet regulatory requirements.

Myanmar's exchange is scheduled to open by the end of this year and more advisors may informally participate. While JPX has signed a MoU with the Myanmar government, Greenlee says this doesn't mean that it will be the only group advising officials on the creation of the stock exchange.

In Laos, for example, KRX was highly influential in the LSX's development, and had an equity stake in the exchange. But SET also appeared to maintain close, albeit unofficial ties, while other international organisations provided capacity building. Given the tremendous international interest in Myanmar, it seems likely that others will offer their input.

China Exchanges Services Company

Exchange cooperation throughout the Asia-Pacific has taken many forms including partnerships, MoUs, links, and strategic agreements. New alternative routes, however, are now being explored.

For example, in 2012 the Hong Kong, Shanghai and Shenzhen bourses established a joint venture known as the China Exchanges Services Company (CESC). CESC is meant to develop index-linked and other equity derivatives, cross-border indices for products traded on the three markets, and an industry classification system for listed companies. In July 2013, it introduced futures linked to its CES China 120 Index.

When acquisition isn't an option

While partnerships may facilitate cross-border trading, a lack of competition has led to higher prices. Asifma's Ronalds notes that Asia's relatively high trading costs are a problem. "We've started looking at costs in the region and at Asian exchanges specifically, and have found that some are higher by orders of magnitude than those of the US, Europe or Japan," says Ronalds.

The mentality across the Asia-Pacific that every jurisdiction must have an exchange is part of the issue. SGX's 2011 bid for the Australia Securities Exchange (ASX), for example, was rejected due to national interest concerns – a decision Australia's then-treasurer described as a "no brainer".

At this point in time, Asifma's Austen says, Asian jurisdictions operate along the lines of a 'national airline' mentality. "Every jurisdiction must have an exchange," he says. "It's a point of pride." But it's a view that no longer holds sway in the US or Europe, where exchanges are considered trading venues that bring investors together at the lowest cost possible, and allow issuers to raise capital in the most efficient manner.

For Asia, exchange competition to the level seen in the US and Europe is a radical idea. But greater competition may prompt innovation. "There is less competition among exchanges than in Europe and the US," says Ronalds. "As a result, they're not driven by the same dynamic that has been driving innovation and cost efficiencies in Europe and the US to the benefit of investors."

He cites ICE's acquisition of NYSE as an example. This will introduce a new model, new ideas, new technologies, and will transform the global exchange market. But in Asia, the potential for transformative acquisitions is limited because of the 'national airline' mentality. "That does limit some paths on the evolutionary road for Asian exchanges," says Ronalds.

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