

Global Challenges for Exchange

A New York View

Georges Ugeux
Group Executives Vice President, New York Stock Exchange, Inc.

INTRODUCTION

Listening to the Governor I was struck struck by the extraordinary convergence of the views of the Central Bank, the supervisors and the exchanges in India and USA. By nature those three types of institutions will have some agreements and disagreements. But they have two things in common, the first is that the failure of one is the failure of all three and the second is the privilege of the responsibility. The title I have given to my presentation is 'Global Challenges for Exchanges – A New York View' and I call it a New York View to position it clearly. First, there is no such thing as the New York View. I would love it but it doesn't exist. In my address I will deal with three aspects of globalisation, viz.:

1. Firstly I will appraise you a little bit as to how the New York Stock Exchange globalised,
2. Secondly I will describe how we tried to respond to this globalisation and.
3. Lastly I will share with you what we believe are the keys to success.

GLOBALISATION

The globalisation of the USA equity market is happening at a very fast pace. The United States market is the largest pool of equity investors in the world. The total pool that we believe is invested, based on data from the Central Bank is \$9 1/2 Billion and 50 % of that money is still owned directly by the household. However, behind the mutual funds, the insurance companies, the pension funds and the other institutional investors it is the wealth of the American people that is at stake. Their investment attitude has changed and we have seen them increasingly interested in investing in equities and I am sure that the Indian case is analogous. Again research shows that the U.S. investors now hold a staggering 25% of their holdings in equity. The institutional investors there own 40% of their assets in equity.

Along with this great surge of interest in equity investment has come an enormous increase in the extent of international diversification. In 1988, 10 years ago, US investors were having 3% of all their equity holdings amounting to \$100 billion in non-US shares and stocks. Six in the last ten years have multiplied that amount. We expected about \$500 to \$600 billion dollars in the next five years to be invested in non-US equities. Behind this formidable appetite of investors is the worldwide phenomena of privatisation. Last year the privatisation programmes of various countries accounted for about \$60 billion.

Opportunities

However the world is not yet truly global and whether we like it or not we will continue to live in different time zones. Today the world is divided into three major time zones. The world wakes up

in Asia and the first market to open is Japan at 9.00 a.m., which is about midnight GMT. Then for a few hours, Asia and Europe are working together till finally the New York market reopens at about GMT+3. There is a 3-hour gap between the closing of the New York stock market and the opening of Tokyo.

These time zones have one very important implication. There is no way the New York Stock Exchange (NYSE) will provide, on its own, a 24 – hour trading of international equities. What the world needs are three leaders. In America, the NYSE has a leadership position in equities trading. However, in the Asian and European markets, the level of internal competition and fragmentation has precluded the creation of a meaningful, worldwide platform.

THE NEW YORK STOCK EXCHANGE

The New York Stock Exchange was created a little before the Bombay Stock Exchange (BSE) and today we have been in existence for about 205 years. We have been structured as a non – profit organisation and our membership is limited to 1366 members. Changes in membership are done through acquisition. A seat of the exchange has changed hands recently for a million dollars.

In early June 1997, for the first time in our history, we are going to cross the 3000 mark in our listed companies. By Indian standards we are small exchange. Of those 3000 companies 60% were not even listed 10 years ago in their current form. This is not a population that remains stable. Of those companies more than 10% are now non-US and the global value of the worldwide market capitalisation of all those companies is probably going to cross the historic number in 1997 of \$10 trillion. The market capitalisation of the world is \$21 trillion. If we divide the world in three parts based on market capitalisation then 1/3 is represented by the NYSE with \$7.2 trillion. The second-third is composed of Tokyo, London, NASDAQ, Frankfurt and Paris. They together represent another \$7 trillion and all the other exchange of the world together represent the last third of \$7 trillion.

The organisational structure of the NYSE differs radically from that prevalent in India. Fifty per cent of the board of directors is from the representative of the brokerage industry; they are the specialists on the floor, they are also the broker dealers and they are financial institutions. But one of the important components of our progress is that there are both representatives of the listed companies and representatives of the investors.

An interesting observation is that while exchanges like London, Tokyo, Germany and ourselves trade a fraction between 60 and 80% of their market capitalisation, the only major dealers market which is the National Association of Security Dealers Automated Quotation (NASDAQ) trades it two and a half times. That does not necessarily mean that there is more liquidity. It means that there is more volume, which means that the dealers trade more among themselves.

FACING THE CHALLENGES

Privatisation Programmes

The major force driving internationalisation is the worldwide interest in privatisation. We have had an activity of six trillion dollars on the primary market side. The NYSE is now the premier market for global privatisation. Twenty per cent of the non-US listed companies have made their arrangements through the international capital market including New York. We are already at a stage where major companies like British Telecom, ENI in Italy, are at their second, third or even post part of privatisation. We have gained experience in dealing with government in very delicate privatisation matters and we have learnt that confidentiality is crucial. The Securities and

Exchange Commission (SEC) and the NYSE are insiders when governments want to talk to us about privatisation projects and we respect their strict confidentiality.

Capital Raising

The most important part of the activity of an exchange is the capital raising. In the last five years in the US \$43 billion have been raised. Private placement represented \$18 billion and many of those privatisations ultimately become publicly trading companies. NASDAQ has raised \$12 billion for non-US firms. When you look at the average size of those transactions, not surprisingly, the NYSE has had a major share of these big capital transactions.

In emerging markets however we have seen much larger numbers. Unibanco, a Brazilian bank, has put on the market one-third of its capital in a transaction worth a billion dollars of which 70% has been placed in the US, 10% in Brazil and 20% in the rest of the world. It is to take advantage of the interest of US investors that the growing number of non-US companies have listed on the NYSE. We expect by the end of June 1997 to have 315 of them.

What does that mean for the companies? A key element for them is to reach US institutions and retail investors. The 144 private placements only scratch the surface of the US investor community. You have to go through the full registration and the listing to be able to tap the smaller institutions in the retail sector. Listing also increases the analyst coverage and a consequence of listing in the US is indeed an immediate increase in global trading of the stock.

Dual Listing and Competition

The one thing I would like to reassure you is that we have always seen that US listing has increased the trading volume on the domestic market. It is not about trying to get the biggest slice, it is about growing the pie. It is about growing liquidity, it is about raising capital. The fundamental purpose of a listing on the NYSE is the lowering of the cost of equity by the company. The first thing that increases liquidity is not volume but transparency. The broadening of the shareholder base not surprisingly enhances the stock price.

Investor Confidence

The key asset of any exchange in the world is the confidence of its investors. It is the level of confidence that investors have in the integrity, functionality and transparency of the market that determines the success of a market. An important lesson is that it is futile for a Central Bank, the government, the regulators, to try to organise the structure of the market place. Regulatory fiat cannot dictate investor confidence. It depends on the exchanges and the investor community. While market regulation is necessary to build investor confidence, it is not sufficient.

The first level that creates investor confidence is the quality of information and also the scope of that information, a result of globalisation, companies are now scrutinised on the basis of international standards of disclosure. People have tended to criticise the SEC in the United States. But reality is the reality is the reasons why SEC strictly regulates the quality of information is because it is necessary to create investors' confidence in the securities market.

Disclosure Standards

We will all benefit and we hope it will happen in 1998 to have at last, international accounting standards prevailing as a single worldwide standard. Accounting is a convention, a language. What is important is the content. So we should be able to agree on the international accounting standards and we have been working in the same direction as other stock exchange regulators in the world to try to get that by the Spring of 1998. That will break the barriers between countries. We all should be able to produce accounts that everybody understands across the world.

But the point that goes beyond the content and quality of the information is its timeliness. The market sometimes has been forgiving when the information was not totally complete and there

were some uncertainties but the market does not forgive management that does not come forward with the information the moment an event taken place.

TRANSACTION COSTS

Institutional investors face severe competition. For performance they say that they will trade where it is best and cheapest. The international consultants give a scale of at least 1 to 10 in terms of the transaction costs. And the worst exchanges will have ten times the transaction costs. Here transaction costs reflect the spread and it is also the ability of a block to influence the pricing, i.e. impact cost.

Market Integration

The second important is the state of the state –of the art electronic networks. For Indian exchanges to become international global exchanges it is obvious that the 22 exchanges need to be connected to one another. The fragmentation of the liquidity pool creates a situation that is neither good for investors nor for Indian companies. We have been impressed by the progress that has been made in this field and we appreciate the difficulties faced in consolidating the regional exchanges into one market.

We live in a world of competition in the US. Any regional exchange can offer a better price than we do. And, furthermore, we have to publish that price and when the NYSE specialist executes a transaction, if the prices are better in Boston, Philadelphia, the Pacific or Cincinnati we are legally forced to execute the transaction at their best price. So exchanges have to be competitive to survive.

Clearing and Settlement

I do not need to spend too much time on the reliable custody and clearing methods. The Indian efforts are steps in the right direction. However I must emphasise that dematerialisation is the trend and the quicker it happens the better. Across the world it has happened country by country and I would like to share a great secret with you India is not the only market in the world where tax considerations play a role when it comes to dematerialising securities. In addition, costs influence investors directly. You just charge the cost of the paper to the investor who wants a piece of piece of paper and you give a better price if he accepts to work electronically. Let the economic forces drive the paper out of the market and put you on electronic books.

Transparency

The third element, the transparency of the orderflow is also critical. Transaction Information is expected to be available in real time for retail and institutional transactions since this helps pricing decisions. We need that and there are many markets which do not have it yet. Transparency is much better in an order-driven auction market like the one you have developed in India. The dealer based market is not amenable to transparency by nature.

Block Trades and Insider Trading

The key challenge that we all facing is how to avoid problems with the block trading upstairs. In other world how to ensure that important institutional transaction not only get reported quickly but ideally executed on the floor of the exchanges.

Insider trading is another major challenge. No market participant should be able to be a privileged player and abuse that position. The definition which you have gone through, which as you will see will develop over time of who is insider and who is outsider, is particularly critical. There should be no ambiguity about who gets the information as an insider and therefore is totally debarred from trading or who is outsider. As per NYSE regulation, if a listed company informs the specialist on the floor of a transaction that they want to announce confidential

information, the specialist has to suspend trading in that stock pending the news announcement. This is important because otherwise nobody will trust the market maker.

REGULATION OF MEMBERS

One of the key challenges that Indian security markets are facing is the supervision of a broker-dealer community. India has a very fragmented population. It has much more stock brokers than we have in the US, though we are slightly bigger. NYSE authorities do visit and inspect the member firms on an annual basis. For example, Merrill Lynch has about 40,000 sub-brokers and hence we almost have a team living in Merrill Lynch.

The economic costs of inspection are huge. The NYSE has 1500 people and one third of every employee of the NYSE is in regulation. We pay 500 people and half of them just to regulate and manage the funds. We regulate, with 250 people, 490 of the 8,000-brokerage firms we have in the US. But these 490 firms represent 95% of the volume.

Regulation is an expensive affair and I think the regulators, the central bank and the exchange have to realise this. There are some avenues for improvements in this regard. The growth of the volume makes exchanges slightly better off financially. The new clearing systems and development of the trading, and the consolidation of the brokerage industry, will happen in India as it did happen in every other market.

MARKET DESIGN

I would like to make a point here as well about the electronic markets. I will make it very clear that the SEC has announced a complete revision of the electronic markets with a purpose of regulating them as well. The fact that electronic markets exist is a good thing. Everything that facilitates transactions is important but we cannot tolerate a system where electronics is a proxy for non-regulated markets. An electronic market is supposed to improve processes and systems. It is not about cheating on regulations and that is very important. The new regulations are also going to put some limits on the private placements and the possibility to trade international stocks in the US when they are not listed. All those are issues of integrity.