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Good Markets for Good Outcomes – the Role of Governance in the World's Exchanges

Background

Established in 1961, the WFE is the global industry association for exchanges and clearing houses. Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA and 21% in the Americas. WFE's 90 member CCPs and clearing services collectively ensure that risk takers post some $1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. WFE exchanges, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over $100 trillion; around $140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable, and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally integrated financial system.

If you have any further questions, or wish to follow up on our contribution, the WFE remains at your disposal. Please contact:

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Introduction

Regulated Exchanges (Exchanges) are widely recognised as operating under the tightest regulatory standards in financial services. This reflects their position at the core of financial markets across the world. As such, high regulatory standards are entirely consistent with exchanges' own mission. Maintaining integrity and openness in their various functions is integral to their ability to act as a trusted third-party to various constituencies – a role that underpins their 'licence to operate'. So, it is in exchanges' own interests to ensure that they have clear and transparent rules regarding everything from membership and product listing to the processes by which prices are formed and made available to all who choose to participate in financial markets, whether investors, issuers or traders and market makers.

The recent failures of several Crypto-Asset Trading Platforms (CTPs) have quite naturally led to interest in regulating CTPs in the same manner as existing regulated exchanges. (*See Annex for more on this*.) But in some ways, CTPs are just one example of how important it is to ensure that markets are well run – and how important it is to formally recognise when they are. In everything from shares to carbon credits, there are dangers in ignoring the tried and tested model for running effective markets that instil public confidence and thereby contribute to long-term stability, growth, and prosperity. Markets of all sorts need – and benefit from – clear and transparent rules of engagement and functioning.

The WFE consistently supports governments and regulators in helping to shape the ethos of the current market structure which has allowed the markets to operate in the trusted manner that they do today. The WFE finds value in ensuring that, as an international standard-setter, IOSCO applies sound regulatory principles across the whole financial services ecosystem. In this document, the WFE outlines the manifestation of that ethos by exchanges today and, as a point of comparison, the importance of transferring a similar ethos to new types of future regulated exchanges.

Legislators and regulators seek to mandate professional operations which aim to prevent management failures. But it must be noted that the tools available to legislators and regulators are not aimed at preventing the commercial failures of exchanges. Regulated exchanges are subject to market discipline as well as their regulatory mandates which taken together strengthen resilience and seek to prevent the occurrence of commercial failure.

Legislators and regulators rightly focus their efforts on tools promoting markets that are transparent, fair, and orderly as the best available means for serving the public interest and preventing fraud. Legislators and regulators also seek to ensure that the products offered to investors by regulated exchanges serve these goals. Furthermore, legislators and regulators understand that there is more to ensuring that the public interest is served than the regulations. The public interest goal behind the regulations must be accepted by and permeated throughout the real economy. Well-governed exchanges embrace the goal of serving the public interest and welcome the opportunity to share our experiences and perspectives with CTPs and others who wish to service the real economy.

Importance of good governance for regulation

The securities and derivatives exchanges that are eligible for WFE membership have visibly remained effective and robust over decades, in the face of volatility, crises and huge changes in the way the economy runs, including digitalisation and more recently the crypto phenomenon. Exchanges are organised for both the short and the long-term due to their regulation, incentives, and ethos.

Exchanges are aware of the colourful and often turbulent history of equity markets dating back to the 16th and 17th centuries in Europe, if not further. Over time, the financial ecosystem of exchanges has evolved. WFE member exchanges, working closely with governments and regulators, embrace the concepts of ensuring market integrity and protecting investors – factors which collectively serve the public interest.

At the first level, serving the public interest requires exchanges' governance to further the principles of transparent, fair, and orderly markets both for exchanges themselves as well as for market participants, listed companies, and listed instruments. In almost all jurisdictions, these principles are part of the regulatory structure in which exchanges operate, although it is important to note that aspects of these three principles were embraced by exchanges before the imposition of government regulation.

It is the second level, embracing the principles behind the regulations, that is so critically important to exchanges' ability to serve the public interest. Exchanges and regulators play an important role in the creation and implementation standards and reporting in support of the financial ecosystem. Initiatives in ESG are but one recent example. Regulations may be necessary to serving the public interest, but they are not the only driver.

Importance of serving the principles behind regulation

Exchanges are mindful of their regulatory obligations and of the sanctions that can be levied by regulators.

Beyond the risk of sanction, however, exchanges know their pivotal role in facilitating the financing of the economy for the benefit of issuers, investors, and wider society. Consequently, exchanges have very strong commercial incentives to grow the real economy and to be seen as playing a vital part in that growth. Exchanges are neutral parties, which do not directly benefit from the monetary value (or change in price) of their traded products. But exchanges are acutely aware that investors must be willing to give up their assets today for the expectation of receiving greater assets tomorrow. Issuers must also be willing to cede a stake to investors. Exchanges have commercial reasons, just as regulators have policy reasons, to seek outcomes that maximise consumer confidence and economic growth and, as far as they can, financial stability.

Established exchanges are also very mindful of their reputational capital. As has been seen in many contexts, the loss of reputation can be catastrophic. The risk of losing reputation is an existential risk for exchanges. Exchanges, as well as regulators, have an incentive to protect and enhance their financial ecosystems and to maintain internal cultures that reflect their incentives.

Exchanges undertake to adopt rules and policies that align the incentives of the exchange with the incentives of their major stakeholders. Issuers, market participants, and exchanges' own staff are presented with a combination of regulations, rules, policies, and sanctions that seek to align the stakeholders' actions with those of exchanges in those areas where stakeholders' interests and exchanges' interests may diverge. This combination of incentives to the exchange itself and incentives that the exchange creates for others (notably, issuers, investors, and traders/market makers) is a critical part of the ethos that allows the markets to operate in the trusted manner that they do today.

Conclusion

In our view, it is important to differentiate between traded instruments – whether securities, crypto or carbon offsets -- and commercial failings and fraud. In running markets, the standards that exchanges adhere to are a way of ensuring that markets can function in a way where the right incentives exist, and investors are aware that they exist.

The WFE sees the benefits that technological innovation can bring to financial markets. Our comments here should not be taken as reflecting on the many legitimate and innovative businesses involved in the development and promotion of crypto or any other technology. We offer a valuable perspective on the need for CTPs, and any other new type of entrant in any other field, to be both regulated and operated under the same principles as the regulated exchanges run by our members. With respect to the principles behind a successful financial ecosystem, everyone should evolve beyond the Silicon Valley mantra of "move fast and break things" to one of "if it ain't broke, don't fix it" – and, in fact, 'respect it!'

Annex: Governance and crypto trading platforms

The growth of available crypto-related offerings globally, the large inflows into crypto-platform traded products, and the growing investor interest in crypto is impressive. The 'market capitalisation' of global cryptocurrency exceeds $1tr[1]. Although the crypto industry remains much smaller than the over $100tr market capitalisation of global equities, its potential size, rapid growth, and eloquent advocates have drawn interest from many directions.

Less impressive is the number of incidents involving CTPs and Crypto-Asset Service Providers (CASPs). Not only is the 2022 failure of FTX/Alameda still resonating, but 94 CTPs failed in 2021 alone[2] and 42% of failed CTPs since 2014 disappeared without a trace, leaving their investors with little or nothing. It so far appears that the failure in many cases was not generally related to crypto or the underlying technology. Instead, in many cases the failure was due to a classic lack of proper systems and controls, poor governance, management inexperience, a lack of segregation of client assets, significant conflicts of interest and possibly even fraud.

The WFE supports governments and regulators in subjecting crypto-asset trading platforms to the rules and laws governing exchanges to achieve a technology-neutral approach to regulation. It appears at present that many CTPs have neither the stake in seeking outcomes that maximise financial stability, consumer confidence and economic growth; nor the reputational capital of regulated exchanges. This is not to say that CTPs routinely seek to maximise founders' personal wealth, or to imply other negative motivations, but to emphasise the challenge for regulators. CTPs need to see their self-interest in accepting the principles behind regulatory standards. CTPs should not see the principles behind existing regulatory standards as obstacles to either innovation or success. We encourage policymakers to support those CTPs that recognise the benefits to investors of pursuing a regulated approach for this evolving industry.

[1] Source: CoinGecko.com, "Global Cryptocurrency Market Cap Charts". 11 July 2023, https://www.coingecko.com/en/global-sharts
[2] Source: CoinJournal.net, "42% of crypto exchanges completely vanished, leaving users in the lurch", 19 July 2022, https://coinjournal.net/news/42-percent-of-failed-crypto-exchanges-vanished-leaving-users-in-the-lurch/