

EXECUTIVE SUMMARY AND FINDINGS

Advantages and disadvantages

The Committee's first task in this inquiry was to examine the advantages and disadvantages of the framework for the market supervision of Australia's stock exchanges. The Committee has found that there are a number of significant advantages, most notably the following:

- familiarity with and proximity to the market – being both the operator and front line supervisor places ASX in a strong position to both recognise any irregularities in trading and respond to them quickly and flexibly;
- the exchange has the ability to adapt elements of its supervisory arrangements to meet the needs of the market and its users through changes to operating rules to reflect the needs of the market and its users and cater for developments in business practices;
- market participants and users bear the cost of regulation; and
- the framework bestows a commercial incentive on the ASX to ensure that it discharges supervisory responsibilities effectively – it has a vested interest in maintaining reputation and attracting investment.

It is clear that the majority of market participants who gave evidence to the inquiry considers that the ASX operates the market well within the current framework, maintaining a high degree of integrity and confidence.

There are also some significant disadvantages associated with the framework. Many of these have come about as a result of the exchange's demutualisation and listing. They include:

- conflicts between commercial and supervisory responsibilities – that is, questions about whether a 'for profit' exchange will devote sufficient resources to ensuring effective supervision, or be tempted to commercialise services such as the provision of information that might otherwise have been considered a public good;
- an inherent conflict of interest resulting from self listing; and
- conflicts of interest resulting from the ASX's expansion of its commercial activities, which result in it being required to supervise the activities of direct competitors.

These are not issues unique to this country. They are common to many countries throughout the world and as the Committee has made clear in Chapter 6, many jurisdictions have devoted considerable attention to identifying possible solutions.

The exchange itself argues that many of the disadvantages identified are problems of perception rather than reality. They point to the fact that there is a commercial

disincentive associated with failing to maintain the highest standards of integrity, which offsets any temptation that might have existed to take commercial advantage of its position. The exchange has also implemented a further level of quality assurance with the formation of the subsidiary company ASX Supervisory Review (ASXSR). Trade Practices Law and the monitoring activities of an ever-vigilant Australian Competition and Consumer Commission (ACCC) provide further disincentive. Lastly, there is the oversight regulator, the Australian Securities and Investment Commission (ASIC) which retains extensive powers to monitor and audit exchange activity.

Despite these safeguards, rumblings of concern about the inherent conflicts in the market supervision framework remain, particularly from competitors. The Committee has found it difficult to determine whether the basis of these complaints is commercial self-interest, perception of a potential problem or a real issue. However, even the perception of conflict can have an effect on investor confidence and thus must be examined. The issue is further complicated by a number of other issues that policy makers have to consider before acting, in particular effects on liquidity and competition. While the ASX is in a strong market position domestically and holds close to an absolute monopoly in listing and trading, it is a small player on a global scale. Australia's share of the global capital market is only 1.43 per cent. And competition is becoming increasingly global – for listing and for trading.

Companies are not constrained to list on the local exchange – they can and do list in multiple exchanges around the world, in search of optimum liquidity. While companies listing on an exchange do value integrity highly and factor that in when determining where to list, efficiencies and costs are also significant factors for them. If regulators make the conditions of trading unnecessarily costly by imposing too many layers of regulation, they run the risk of causing companies to take their business elsewhere.

Similarly, investment capital is also very mobile and investors, particularly institutional and overseas investors, can and will invest in other markets if they are either dissatisfied with the integrity of the local market or concerned about the costs of investing or levels of returns. This can affect liquidity in the local market, with serious implications both for Australian companies seeking capital through the ASX and for investors, who may be subjected to greater levels of market volatility in a market with liquidity problems.

Finally, traditional exchanges such as the ASX face increasing competition with what are colloquially known as alternative trading systems, spawned to a large extent by communications technology. Traditional exchanges have responded by diversifying and vertically integrating their services, increasing the competitiveness of organisations like ASX.

Against this background, the Committee has come to the view that no major change to Australia's market supervision framework should be contemplated at this point. While ASIC has found, and the ASX has investigated, instances of market misconduct, little evidence was presented that the supervisory framework was inadequate in performing

that task. Evidence was presented of a potential for conflicts to occur which may impinge on ASX's supervisory responsibilities, but there is also clear evidence that the ASX and regulators are conscious of the potential problems associated with the current model and are acting to address them. However, should there be a significant material change in ASX operations or should the ASX merge with another exchange, or enter into an alliance which differs significantly from the ASX-SGX [Singapore Stock Exchange] link, the Committee should again review the market supervision framework.

The Committee considers that the ASX should be given a period of time to demonstrate that initiatives such as ASXSR are sufficient to address the conflicts of interest issues, and that it is capable of continuing to uphold high standards while facing commercial challenges as well.

Much of the value of the ASXSR will be in the degree of transparency it can bring to the process of market supervision by the ASX. As this inquiry has confirmed, there is a large degree of interest in the activities of the ASX by both market participants and other listed companies, and they must be assured that the market is functioning efficiently and with integrity. The Committee considers it important that the activities, and in particular, the findings of the ASXSR be as open as possible. The ASXSR should also ensure that in its deliberations, regard is had to the interests of all market participants.

The Committee also considers it important that ASIC regularly audit ASX's compliance with its supervisory obligations and provide regular reports to the Minister and to Parliament. The Committee acknowledges that the ASX has indicated that it believes ASIC should have the power to undertake active surveillance or compliance assessments of all market operators.

The Committee wishes to stress the importance of the transparency of the supervisory arrangements. This is to be achieved by, among other things, ensuring that the ASXSR is properly resourced and has appropriate reporting structures, that the findings of the ASXSR are as open as possible, that ASIC audits ASX compliance with its supervisory obligations, that the ASX continues with the practice of publicly consulting on rule changes, and that the Trade Practices Act (TPA) continues to apply to the ASX. The Committee also notes that the ASX maintains a public register of Listing Rules waiver decisions, but recommends that that register include reasons for the waiver decision – subject to considerations of commercial confidentiality – and be available on the ASX website.

Demutualisation and alliances

The Committee's second term of reference asked it to examine the implications (if any) of the demutualisation and listing of an exchange and any proposed alliance between Australian exchanges and other exchanges.

The major issue in this area was whether the ownership limits that apply to the exchange impeded its ability to strike alliances with other exchanges.

The Committee accepts that there are sound arguments for encouraging alliances between markets. In particular, the Committee notes the benefits that can flow to the Australian economy through improved market depth and liquidity as a result of opening up opportunities for a larger pool of investors.

Whether mergers are desirable is more questionable. The Committee notes that an attempted merger between the ASX and the New Zealand Stock Exchange was abandoned and that mergers are not currently considered feasible in this region. To that extent, the issue of the desirability of mergers does not arise.

The ASX considered that alliances may be facilitated by exchanges taking a stake in each other's shareholdings and to this end sought an increase in the previous ownership limit from 5 to 15 per cent, a change implemented in the FSR Act. The Committee is of the view that there is no evidence to suggest raising the ownership limit to 15 per cent will have any major detrimental outcomes. Further, raising the limit to 15 per cent brings exchanges into line with other major financial institutions such as banks. Finally, the introduction of a 'fit and proper person test' in the FSR Act adds a level of protection that compensates for the change in ownership limits.

The second issue in this area was whether the existing supervisory framework would be appropriate if any alliances or mergers were effected. The Committee notes that ASX has recently concluded an alliance with the Singapore Stock Exchange, establishing a two-way trading link in December 2001.

The Committee heard evidence that the ASX encountered difficulties in establishing the Singapore link within the current legal framework, the dealing and market operating provisions being 'tortured and stretched'. It is too early to determine whether the existing provisions of the law will prove entirely adequate to accommodate the alliance's operations. This is a matter that ASIC will need to monitor carefully.

The Committee also notes the significant regulatory differences between Singapore and Australia and that the ASX and ASIC have attempted to address these differences by relying on market operating rules. Nonetheless, investors need to be aware that regulatory differences do exist and the Committee suggests that the ASX introduce a 'health warning' for potential investors, reminding them of these issues.

The Committee also notes that ASX and ASIC have instituted a trial of arrangements for handling conflict and perceptions of conflict in relation to the supervision of ASX International Services. Details of this arrangement appear at Appendix 4.

As noted above, the Committee is of the view that it should again review the market supervision framework if the ASX merges with another exchange or enters an alliance that differs significantly from the SGX-ASX link.

Effectiveness of trade practices law

The Committee notes that the ASX's motivation to expand its range of services relates to it being a relatively minor player in terms of international financial markets. The small size of the ASX in those terms places pressure to continually stay relevant and competitive internationally. The success of such a strategy is assisted by flexibility in trade practices law by allowing certain concessions in respect of the TPA.

The Committee considers that the ASX's need to continue with a global perspective will be ongoing. As such the TPA will have to be applied with a view to international trends. However, the development of ASX's ability to compete globally will always have to be carefully balanced against the need to maintain competition in Australian financial markets. The past benefits of maintaining competitive pressures in this sector are clear.

The Committee finds that the application of the trade practices law is addressing the needs of the ASX in a manner which offers flexibility via its system of authorisations, section 87B undertakings and the appeals system. These tools offer flexibility while also maintaining a competitive environment, with the final arbiter in any situation regarding the TPA being the courts.

However, the Committee is mindful that as the ASX expands its activities into other commercial areas, it is causing concern to some of its competitors. The ASX is aware of these concerns. The Committee believes that moves to increase the transparency of the supervisory framework – including the establishment of the ASXSR – and the application of the Trade Practices Act to the ASX will assist in addressing those concerns.

The Committee also notes that in the majority of submissions and evidence received, the adequacy of trade practices law in ensuring a competitive stock exchange market was not questioned.

