

CHAPTER 1

THE FRAMEWORK FOR THE MARKET SUPERVISION OF AUSTRALIA'S STOCK EXCHANGES

Introduction

1.1 The Committee is conscious that many readers of this report are well acquainted with how stock exchange activity in Australia is supervised and regulated. This first Chapter of the Committee's report provides a brief overview for those readers less familiar with the detail of how this institution operates, its objectives, structures, rules, philosophy and underlying legislative foundation.

1.2 Stock exchanges perform two important roles within the economy, namely:

- a fundamental role in capital formation; and
- the allocation of savings to their most productive uses.¹

1.3 As such, stock market activity is an important driver of overall economic activity.

1.4 Competition for capital is global and investors are sensitive to a range of factors that determine whether they will invest in this country or elsewhere. High on their agenda is confidence that markets are conducted with integrity and fairness and in a manner that provides confidence in the security of the transaction. Investors are also cost sensitive and accordingly markets also have to focus on providing their services efficiently while not compromising on integrity. Lastly, investors require access to reliable and timely information.

1.5 The framework for Australia's market supervision of its stock exchanges has developed around these requirements for integrity, fairness and efficiency and is underpinned by Corporations Law, which gives legislative effect to these broad objectives.

1.6 The remainder of this Chapter provides the reader with a brief outline of Australia's stock exchanges, including the recent significant developments of demutualisation and listing of the ASX and the underlying regulatory methodology incorporated in the co-regulatory model. The Chapter then provides an overview of the legislative framework in Corporations Law that underpins market supervision and how the ASX goes about its day to day business of providing an orderly market through its various rules. The Chapter concludes with a description of further changes to the legislative framework made by the Government in the Financial Services Reform Act that has recently passed the Senate.

¹ The Treasury, Submission No. 5, p. 1.

1.7 In the Chapters that follow, the Committee comes to grips with the terms of reference for the inquiry, in Chapter 2 examining the advantages of the current framework. Chapter 3 looks at the disadvantages, including the important issue of possible conflicts of interest arising from the supervisory structure. Chapter 4 scrutinises the ASX's major response to the conflicts of interest issue, the establishment of the subsidiary company ASX Supervisory Review (ASXSR). Chapter 5 analyses the implications of demutualisation and listing for possible alliances with overseas exchanges. Chapter 6 describes other possible structures for supervising market operations, and Chapter 7 examines the adequacy of trade practices law as it applies to Australian stock exchanges.

Australia's stock exchanges

1.8 Australia currently has three operational stock exchanges:

- the Australian Stock Exchange (ASX);
- the Stock Exchange of Newcastle Limited (NSX); and
- the Bendigo Stock Exchange Limited (BSX).

1.9 The Committee also notes the presence of the Sydney Futures Exchange Limited and the Australian Derivatives Exchange Limited.

1.10 The NSX first commenced trading in 1937 but was inactive for many years. It recommenced trading in December 2000. Expected to provide an alternative and complementary market to the ASX, the NSX provides a specialised market for the securities of small to medium and regionally based enterprises.² At present, there are two companies listed with the NSX.³

1.11 Also directed towards small to medium enterprises, the BSX recommenced trading very recently, listing its first security on 15 August 2001. It is a fully Internet-based exchange which intends to specialise in emerging companies and rural based businesses.⁴

1.12 The Bendigo and Newcastle exchanges are however very small organisations. For all intents and purposes, ASX is Australia's only significant exchange and is the main focus of this inquiry.

Demutualisation and listing

1.13 Prior to 1998, the ASX was a mutual enterprise. A company limited by guarantee, it was owned collectively or mutually by its members and run on behalf of its members under its own constitution and operating rules. Its members were the

² NSX CALLS, eNewsletter Number 5, 11 December 2000 at www.newsx.com.au/wnews.

³ www.newsx.com.au/nsx.html.

⁴ Information obtained from the BSX web site at www.bsx.com.au.

brokers who used the facilities of the exchange to deal in securities.⁵ The mutual structure of exchange ownership is common internationally, although there is an increasing trend towards demutualisation.

1.14 The initiative to demutualise came from within the exchange itself. The ASX advised the Committee that in 1996, ASX members were asked to vote on a proposal to mandate the ASX Board to seek Commonwealth Parliament legislation authorising and facilitating demutualisation. In return for ceding mutual membership and any control of ASX that mutual membership may bestow, each relevant member would be allocated shares in ASX.

1.15 The major considerations that drove demutualisation were the prospect of competition for ASX business and services, divergence of members' interests from each other and the exchange itself, and a proposition that in the longer term, it is undesirable for control of an entity to reside with one group of its customers.⁶

1.16 ASX members endorsed the proposal in October 1996 and the Government subsequently introduced the necessary legislation, which came into force on 16 December 1997.

1.17 The exchange subsequently demutualised and listed its shares on the exchange in October 1998.

1.18 The ASX advised the Committee that it anticipated debate that a change in the organisational form of ASX would give rise to conflicts of interest or obsession with generation of profit that might compromise supervisory activities or expenditure on them. Indeed, the evidence received during this inquiry showed that this debate is still going on.

The co-regulatory model of market supervision

1.19 Stock market regulation in Australia is based on what is generally known as a co-regulatory model, a combination of statutory and 'self' regulation. At its essence, this model is a collaboration between a government regulator, ASIC, and the self-regulating organisation that operates the exchange, the ASX. A legislative framework provided under Chapter 7 of the Corporations Act provides the legal foundation for securities industry regulation. In addition, the ASX itself has a detailed set of rules and practices that apply to market participants which are supported both by Contracts Law and the Corporations Law.

Corporations Act

1.20 Chapter 7 of the Corporations Act deals with the following issues:

⁵ *Self regulation and the demutualisation of the Australian Stock Exchange*, Australian Journal of Corporate Law, March 1999, Vol 10 (1), pp. 5-6.

⁶ ASX, Submission No. 2, pp. 10-11.

- markets, exchanges and associations (Part 7.2);
- the securities clearing house (Part 7.2A);
- participants in the industry (such as brokers and advisers) (Part 7.3);
- the conduct of participants' businesses (Parts 7.4 – 7.7);
- fidelity funds for the protection of investors from default by participants (Parts 7.9 – 7.10); and
- misconduct in the industry (Part 7.11).⁷

ASX rules and practices

1.21 The ASX supervises the market of the exchange on a day to day basis with the objective of ensuring the market is fair and orderly. It does this through a series of contractual arrangements with market participants whereby they agree to comply with rules for admission to and continued participation in trading activity. They fall into three broad areas:

- Listing Rules;
- ASX Business Rules; and
- Securities Clearing House (SCH) Business Rules.

1.22 The ASX Listing Rules govern the procedures and behaviour of all ASX listed companies and listed trusts.⁸ In addition to prescribing pre-requisites for listing, the Listing Rules require that listed companies and trusts report announcements to ASX to keep the market informed of their activities and report profit results and other financial information within specific deadlines.

1.23 ASX Business Rules govern the operations and behaviour of participating organisations of ASX and affiliates.

1.24 The SCH Business Rules govern the operation of CHESS, the Clearing House Electronic Subregister System, which provides an electronic transfer and settlement system and the CHESS subregister.⁹

1.25 The ASX's day to day activities in providing market supervision are extensive and include:

- surveillance, review and reporting of market activity;

⁷ ASX, Submission No. 2, p. 4.

⁸ Only public companies and public trusts are permitted to be listed on ASX. A public company or trust is one in which any member of the general public can acquire shares or units and there are no restrictions on the maximum number of shareholders or unitholders.

⁹ Information obtained from the glossary of sharemarket terms on the ASX web site, www.asx.com.au.

- investigation of market participant and listed company behaviour;
- enforcement of market participant behaviour;
- trading halts, suspensions and de-listing;
- assistance to ASIC;
- support, education and guidance to market participants and listed companies designed to encourage and facilitate compliance with rules; and
- review and appeal mechanisms for market participants and listed companies.¹⁰

1.26 In addition, ASX provides a number of services that facilitate market operations including:

- automated trading and clearing platforms (SEATS and CHES);
- guarantees of trade completion and risk management; and
- information (for example, company announcements via Signal G).

1.27 The ASX maintains that providing these services in addition to trading facilities enhances the integrity, reliability and efficiency of trading activity.¹¹

SEATS

1.28 SEATS is the acronym for the Stock Exchange Automated Trading System. It is a computerised trading system, which provides an efficient, fair and secure trading method. Installed on PCs in brokers' offices, it enables brokers to type orders into their PCs and the orders are passed to ASX computers where they may be traded.

1.29 The system enables matching buy and sell orders to be automatically traded by the system, with the best-priced orders taking priority. 'Best price' means the lowest priced sell order and the highest priced buy order. If there is more than one order at the same price, the order that was placed first takes precedence. Large orders have no priority over small orders.

CHES

1.30 CHES is the acronym for the Clearing House Electronic Subregister System which is operated by the ASX Settlement and Transfer Corporation (ASTC), a wholly owned subsidiary of the ASX. The system serves two major functions:

- as a clearing house, a system to facilitate the settlement or clearing of trades in securities; and

¹⁰ ASX, Submission No. 2, p. 6.

¹¹ ASX, Submission No. 2, p. 6.

- as an electronic subregister for securities in ASX listed companies.

1.31 As a clearing house, the system enables the transfer of title or legal ownership of securities between sellers and buyers and facilitates the transfer of money for these securities. This process is referred to as ‘settlement’ and CHESSE allows the transfer of both securities and money to occur simultaneously in a process referred to as Delivery versus Payment (DvP).

1.32 As a subregister, the system registers ownership of securities.

Financial Services Reform Act 2001

1.33 The *Financial Services Reform Act 2001* (FSR Act), passed by the Parliament in August 2001, made a number of changes to the legislative framework governing the ASX. This Act did not pass the Parliament until after the Committee had received evidence and submissions on this inquiry.

1.34 The Treasury advised the Committee that the then Bill would maintain the current basic framework for regulatory oversight of the stock exchanges but would make significant changes to licensing requirements and ongoing obligations of markets.¹²

1.35 The FSR Act made a wide range of regulatory amendments that affect how the ASX and market participants are regulated. The Act created a single licensing regime for financial sales, advice and dealings in relation to financial products and more uniform regulation. It also removed what the Government considered were unnecessary distinctions between products. The regulatory requirements of the Act apply to the activities of existing financial intermediaries such as insurance agents and brokers, securities advisers and dealers, and futures brokers, as well as any other person carrying on a financial services business.¹³

1.36 In relation to markets and clearing and settlement facilities, the FSR Act:

- ends the current distinction between securities exchanges and futures exchanges by introducing a single licensing regime for ‘financial markets’;
- enhances competition in respect of clearing and settlement facilities by extending the ability to carry out electronic transfers of trades to all prescribed facilities, ending the Securities Clearing House competitive advantage;
- harmonises the legislation relating to securities and futures contracts; and
- facilitates the participation of overseas markets and facilities in Australia.¹⁴

¹² The Treasury, Submission No. 5, p. 1.

¹³ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 1.

¹⁴ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 14.

1.37 Of particular interest was the lifting of the previous 5 per cent shareholding limitation that applied to the ASX at the time of demutualisation to 15 per cent, or higher if the Minister decides that a higher percentage would be in the national interest.¹⁵ The Minister can lift the limit by tabling a regulation subject to disallowance. In a departure from normal practice, the regulation cannot take effect until after the period for disallowance has expired. The Act also introduced a ‘fit and proper person’ test, designed to ensure that only appropriate people are associated with the management, ownership and control of all financial markets and clearing and settlement facilities.¹⁶

1.38 The Act also introduced stronger measures intended to enhance ASIC’s ability to safeguard the integrity of Australian financial markets in the areas of market misconduct and insider trading.

1.39 Commenting on the Act before its passage, the ASX expressed support for several of the changes, noting that the then bill did not change the fundamental approach to the supervision of securities exchanges. Positive features identified by ASX include harmonisation of regulatory treatment of securities and futures and moves towards a more principles based, flexible regime.

¹⁵ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 14.

¹⁶ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 87.

