

CHAPTER 4

ASX SUPERVISORY REVIEW PTY LTD

4.1 As discussed earlier in this report, the ASX is widely acknowledged as having a commercial interest in ensuring that it maintains market integrity. If customers perceive the exchange as operating other than fairly, for example failing to supervise competitors impartially, it follows that ASX could threaten the reputation for impartiality that it clearly values and regards as a business asset. Consequences for both liquidity and its business are potentially severe. Features of both Corporations and Trade Practices Law give further protection.

4.2 Nonetheless, the ASX is clearly conscious that some market participants will perceive a potential for conflicts of interest between supervisory and commercial roles. In response, the ASX has established a subsidiary company, ASX Supervisory Review Pty Ltd (ASXSR), to provide a further level of assurance that it is directing appropriate resources to supervisory functions and maintaining standards.

Role and functions of ASXSR

4.3 ASX explained that ASXSR will:

- review the policies and procedures of areas in the ASX Group which have supervisory functions. This will include a review of the level of funding and resources for supervisory functions;
- provide reports and express opinions to the ASX Board on whether appropriate standards are being met and whether the level of funding and resources for supervisory activities are adequate;
- as a result of these activities, provide assurance that the ASX Group adequately complies with its ongoing responsibilities as a market and clearing house operator, is conducting its supervisory activities ethically and responsibly and is maintaining appropriate controls against employee conflict of interest; and
- oversee supervision of listed entities with special identified conflicts that select ASXSR supervision (the 'Review Group': see para 4.5). The oversight function will involve consultation on each supervisory decision concerning the exercise of discretion.¹

4.4 The ASX advised that ASXSR reports would be used to assist in the preparation of the exchange's annual regulatory report to the Minister and will be made available to ASIC.

¹ ASX, Submission No. 2, p. 14.

4.5 ASXSR's function in supervising some listed entities will operate on an 'opt in' basis. That is, the 'Review group',² will have the option of seeking the extra level of protection offered by ASXSR scrutiny. However, as explained by Ms Karen Hamilton, Executive General Manager, Issuers and Market Integrity, ASX, companies that are in dispute with the ASX still have the option of seeking a completely external review:

If they have a complaint and they are not satisfied with a decision taken by management, there is an external review tribunal already set up. The ASX listing appeal committee is a group of external industry practitioners who review management decisions when the listed entity is unhappy with those decisions.³

4.6 ASXSR is not independent of ASX, although it is clearly expected that it will operate at arms length. In evidence to the Committee, Mr Humphry described the ASXSR as an 'internal review mechanism'.⁴

4.7 The ASXSR Board is comprised of a majority of independent directors chosen from a panel nominated by ASX, although ASIC retains a power to veto any proposed members and also to veto their removal prior to their term expiring. The Minister is also to be informed of proposed appointments, removals and retirements. The organisation is also dependent on ASX for funding its operations.

4.8 ASX notified the Committee of the appointment of the last director on 10 July 2001 and the organisation has now commenced full operations. The board has met monthly since its formation and has commenced reviewing the policies and procedures of individual units within ASX. The Committee was advised that ASXSR's first report, which will be a public document, would be released at the end of the 2001-02 financial year.⁵

4.9 Mr Humphry acknowledged that the ASXSR structure established was not the only possible approach to the issue. However, he believed that it has a number of advantages over alternatives, most of which are closely related to the major advantages of having a market operator that is also the market supervisor, as discussed previously. Mr Humphry explained:

² The 'Review Group' will comprise entities which satisfy one of the following criteria:

- (a) their business is in direct competition with our business in a material way for ASX;
- (b) they hold a substantial shareholding interest in ASX;
- (c) we hold a substantial shareholding interest in them;
- (d) the entity 'controls' an entity falling with paragraphs (a), (b) or (c). For this purpose 'control' means the direct or indirect capacity to dominate decision making in accordance with AASB 1017: Related Party Disclosure; or
- (e) it is otherwise desirable for the entity to fall within the Group because of the potential for significant conflict of interest. [from ASX, Submission No. 2, p. 15]

³ Evidence, p. 26.

⁴ Evidence, p. 19.

⁵ Evidence, p. 143.

We set up this body because we believed that we needed an internal review mechanism. The difficulty arises from the fact that you cannot separate the supervision of the market from the ongoing operation of the market – the two are integrated ... It all has to happen in real time. We wanted to have a body that was at least at arms-length but could report on activities and, particularly, how we might improve our procedures.⁶

4.10 The ASX also expressed a desire to ensure that ASIC has adequate powers to audit ASXSR's operations:

We have indicated that all of those reports will go to ASIC so that ASIC has access to them. But, to complement that, ASIC needs to have the proper authority to be able to carry out any external review. I do not believe it has that adequate provision in the legislation at the moment.⁷

4.11 The Committee notes that the FSR Act contains provisions that 'give ASIC powers to audit compliance by a market with its obligations under the Corporations Law'.⁸ ASIC is obliged to audit the ASX at least once a year, although Mr Humphry expressed a preference for more frequent ASIC activity. He confirmed that the exchange had invited ASIC to scrutinise ASX's operations at any time:

Yes, because it is not about us trying to hide anything; we do it all now. The difficulty is that a mystery surrounds supervision. We would prefer to see it as transparent as possible.⁹

Adequacy of the ASXSR initiative

4.12 The reaction to the ASX's initiative has been mixed, although the predominant view put to the Committee was that it is appropriate in the circumstances. A number of witnesses advised the Committee that they preferred to see how well the ASXSR initiative worked in practice before passing judgment.

4.13 ASIC representatives told the Committee that they viewed the establishment of ASXSR as 'a positive step' and together with the additional oversight responsibilities and powers to undertake active surveillance proposed for ASIC in the then FSR Bill, 'appropriate to this marketplace at this point in time'.

4.14 Ms Segal advised however that ASIC would be carefully monitoring how the arrangement works in practice:

We will keep it under quite close monitoring to understand how it is working and if it is delivering not only the independence that we think is

⁶ Evidence, p. 26.

⁷ Evidence, p. 27.

⁸ Media Release by Minister for Financial Services, 9 November 2000.

⁹ Evidence, p. 27.

important but also the perception. I do think that confidence in the marketplace is not only reality but also perception.¹⁰

4.15 Computershare did not consider the ASXSR initiative an appropriate approach to the problem. In evidence, Mr Chamberlain advised the Committee that what they had been seeking was a more objective assessment of whether ASX behaviour is anti-competitive, whereas the ASXSR approach, as viewed by Computershare, is that the ASX itself decides if a potential conflict exists.¹¹ Mr Chamberlain's concerns appear to be based on a perception that ASXSR will not be independent of ASX.

4.16 The Australian Shareholders' Association shared similar concerns. The Chairman, Mr Ted Rofe, reminded the Committee that the ASX itself describes ASXSR as 'an internal review mechanism'. Mr Rofe thought that it would be preferable to have an external body that could monitor all the securities exchanges:

...we are not just talking about the ASX. We have already got the Newcastle Stock Exchange, the derivative exchanges, and so on. Rather than having separate supervisory bodies for each of these things, perhaps an overall independent supervisory body may be a worthwhile idea. I think it is a question of whether we need some extra body. I do not really think ASXSR satisfies that.¹²

4.17 Mr Rofe acknowledged that ASIC does have such a monitoring role, noting that in his observation, ASIC had been playing a 'more active role in monitoring and supervising the operations of various industry organisations' in the last 12 months.¹³

4.18 Other witnesses were, however, much more supportive of the ASXSR initiative. IFSA, for example, said that the initiative should be given 'a chance to work'. Ms Lynn Ralph, the CEO, told the Committee that she believed that the ASX had sufficient at stake to ensure ASXSR worked as intended, discounting the importance of absolute independence as a determinant of how well ASXSR might function:

We would think that there is enough at stake here for the Stock Exchange, in terms of brand confidence in their business, for them to do their best to appoint very competent people who can act independently. We would like to believe that can actually happen. I would be loath to think that anyone taking on an appointment – whether it is an appointment by the Stock Exchange or anyone else – was not prepared to act independently on such a serious body.

¹⁰ Evidence, p. 12.

¹¹ Evidence, p. 56.

¹² Evidence, p. 63.

¹³ Evidence, p. 63.

4.19 Ms Ralph also thought that the market would ‘judge quite harshly’ if ASXSR failed to meet expectations.¹⁴

4.20 Ms Ralph saw ASXSR as not just addressing the conflicts of interest problem but also demonstrating to the market that despite being a money making organisation, ASX is still an effective and fair market supervisor:

...from our point of view, the primary benefit of the supervisory review board is not to deal with three potential competitors’ conflicts of interest with the Stock Exchange...but more broadly to give confidence to the broad market that even in a profit-making environment stock exchanges are filling their regulatory functions adequately across the entire market place. For those companies which do have direct commercial conflicts with the ASX, at the end of the day they are best placed to say why they feel the way they feel and why they feel potentially that there is a final umpire, called the ASIC, which they can actually talk to.¹⁵

4.21 However, Mr Mark O’Brien, Investment Board Committee Member, IFSA, did indicate that it was important that the ASXSR be transparent in its activities and accountable to the public. He saw issues of resourcing and reporting structures as being at least as important as who was on the board of ASXSR.

It is in the best interests of the ASX to make sure this thing has a degree of public accountability associated with it. I am not so concerned about who may be on the supervisory board, but I think it needs to be capable of managing clearly and openly the potential conflicts of interest that are perceived to exist.

...

At the end of the day it has a great opportunity to promote the model the ASX has embarked on of having a commercial entity operating closely with the actual market regulator through an organisation in the middle which essentially reflects and represents the interests of all market users. Then I think you have to ask what is the appropriate resourcing, what are the reporting structures and all those sorts of things.

...

At the end of the day, if they have a problem with the resources or getting to the systems or the data that they need to fulfil their job, you would expect them to say so.¹⁶

4.22 The Securities Institute also thought ASXSR represented a ‘pragmatic solution’:

¹⁴ Evidence, p. 39.

¹⁵ Evidence, p. 42.

¹⁶ Evidence, pp. 41-42.

There is a perception of conflict of interest that needs to be addressed, and we believe that this is a reasonable approach to it.¹⁷

4.23 Like IFSA, the Securities Institute proposed that the ASX be allowed to demonstrate that its proposed initiative was a sufficient response before considering other options.

4.24 The Chartered Secretaries of Australia also considered ASXSR to be an effective solution, equating the functions and reporting requirements of the ASXSR to that of a company's internal audit function:

It is not independent, but in terms of the way it operates the internal audit function has a pretty strong role in many companies. Although not independent, it is sort of regarded that way by having direct reporting relationships to a very high level.

4.25 The Chartered Secretaries also drew the Committee's attention to the appointment of Mr David Hoare as Chairman of ASXSR, noting his standing in the financial community:

We note that the board is chaired by Mr David Hoare, a person who has the highest respect and standing in the Australian financial community ... We talk a lot about a state of mind but someone like David Hoare, as chairman, is not a pushover when it comes to these matters. I do not think people would take on that job thinking they are just going to be a puppet of ASX.¹⁸

The supervisory structure in the future

4.26 The ASX has indicated that they are interested in pursuing alliances with other exchanges and have in the past considered mergers, most recently with the New Zealand Stock Exchange. The next chapter discusses some of the issues surrounding exchange alliances and mergers, but the Committee received evidence that the ASXSR, and the supervisory structure more generally, may not be appropriate in the future, especially if the ASX does enter into alliances with other exchanges.¹⁹

4.27 The ASX itself indicated that the environment is dynamic and future developments may necessitate change in the supervisory framework. Mr Humphry told the Committee:

The best way I can answer that is to say I think there will be continuing developments. I do not believe that it is going to be possible for us to say, 'That sets us up for the next four to five years'. The environment is so

¹⁷ Evidence, p. 109.

¹⁸ Evidence, pp. 69-70.

¹⁹ Since this evidence was taken, the ASX has established an alliance with the Singapore Stock Exchange. The exchanges opened the trading link on 20 December 2001. This issue is discussed in the following Chapter.

dynamic and so volatile that it is difficult to nail anything down. So when we made our statement announcing that David Hoare would be chairing the ASXSR we made the point that this was in a sense the first step along the way. There is no consensus internationally on this development. A whole lot of experimentation was being tried. All of us were interested in all of our developments. What we are trying to do over time is to develop some form of harmonised approach which will be best practice. I think that is going to be a fair while in coming.²⁰

4.28 ASIC also gave evidence to the Committee regarding the effect of possible future events on the supervisory framework. ASIC indicated that the formation of the ASXSR was an ‘appropriate package of arrangements for dealing with the situation as it applies today’.²¹ However, ASIC raised a number of questions which will need to be examined if the ASX enters into alliances, mergers or global linkages with other exchanges. Ms Segal said:

It is a question of whether we are talking alliances, mergers, global linkages, et cetera. I think we are very conscious that Australia has its own framework and its own regime and is thought of very highly in the international marketplace...But we are conscious that, at the end of the day, our market is a very small piece of the world liquidity and so it will depend on what the arrangement is with the other players as to what would be appropriate – whether it is mutual recognition or whether other changes would need to be made. I am not sure that it could just be done by the exchange without looking at both the legislative framework and certainly the supervisory framework that it has at the moment.²²

4.29 ASIC did however provide to the Committee some principles, which would need to be observed in relation to any future developments. Ms Segal said:

We would expect there to be no less protection, obviously, to Australian listed companies, shareholders and market players, but how that would be achieved would very much be dependent on what the particular venture, alliance, linkage et cetera, are that the ASX or other market has in mind.²³

4.30 The Securities Institute also indicated that the future supervisory framework may well depend on the sort of alliance which is arranged and that ‘what is the appropriate mechanism will depend very much on the circumstances’.²⁴

4.31 IFSA also gave evidence in relation to the future supervisory framework. IFSA did not support adopting a formal legislative framework to deal with future

²⁰ Evidence, p. 28.

²¹ Evidence, p. 2.

²² Evidence, p. 13.

²³ Evidence, p. 13.

²⁴ Evidence, p. 110.

developments as it may preclude alliances which may otherwise be beneficial. Ms Ralph said:

We do not know the form that any of these particular alliances, virtual mergers or whatever will actually take and what sorts of activities the alliances will cover. I do think that is why we currently hold the view that this is an evolutionary process. The sort of oversight that the Stock Exchange will have five years from now probably will not look the same as it looks today, but we do not know the answer to the question because we really do not know where this is all heading. So what do you do in light of that? You can create a much more formalised legislative structure that locks on some sort of oversight which does not end up being suitable for the forms of alliances that they take down the track and we have to fix it all up five years from now, or you can do what the exchange is doing, which is trying to respond to the current position in consultation with the people in the marketplace.²⁵

Conclusions on ASXSR

4.32 The Committee notes that the weight of evidence heard indicates that the industry is currently satisfied with the way the ASX is managing the issue of conflicts and that the number of direct conflicts are few in number.

4.33 The industry's apparent confidence is predominantly based on the view that the market will not sustain a stock exchange that is not dealing with actual or perceived conflicts in an appropriate manner. This attitude is considered the main motivation for the ASX to protect its image and reputation.

4.34 Treasury reinforced the importance of the ASX's reputation in the market place:

The experience elsewhere in the world is that, once a market loses its reputation for integrity, it is very hard for it to get back. It is clearly the ASX's principal asset.²⁶

4.35 However, there is potential for the number of conflicts of interests (both direct and indirect) to increase as the ASX pursues its business activities. This is evidenced by the few limitations on future business activities that the ASX has set. Mr Humphry outlined the areas of business which may cause difficulty:

The only areas that I think I would be cautious about would be those which would really inhibit our supervisory role. It does not mean that we would not look at a structure which might allow us to still perform those types of duties.²⁷

²⁵ Evidence, p. 40.

²⁶ Evidence, p. 126.

²⁷ Evidence, p. 30.

4.36 The formation of alliances between ASX and foreign exchanges and possible mergers, as are discussed in the following chapter, will pose a number of challenges.

4.37 The Committee considers that the most effective way to deal with such issues is to have appropriate systems in place which offer a high degree of transparency to the market. The Committee notes that any systems put into place will also need to keep pace with the dynamic industry which the ASX operates and supervises. The creation of the ASXSR and the desire the ASX has for a bigger role for ASIC is a reflection of the systems and pro-active approach the ASX has taken to resolving these matters.²⁸

4.38 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's compliance with its supervisory obligations, that the ASX continues with the practice of publicly consulting on rule changes, and that the Trade Practices Act continues to apply to the ASX.

4.39 The Committee notes that the FSR Act requires ASIC to audit ASX's activities at least annually. The Committee believes that it would be appropriate in the circumstances for ASIC to be seen to undertake higher levels of activity than the minimum required by the Act and notes that Mr Humphry has undertaken to facilitate much greater ASIC activity. These measures should assist in allaying the perceptions that ASX is not addressing the conflicts of interest issues appropriately.

²⁸ Evidence, p. 27.

