CHAPTER 5

DEMUTUALISATION, LISTING AND ALLIANCES

Introduction

5.1 The Committee's second term of reference asks 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.

5.2 The connection between these concepts is not immediately obvious. Treasury explained in its submission that a demutualised structure enables exchanges to more easily enter into business arrangements with other exchanges.[1] The reasoning behind this proposition is that shares in a demutualised exchange can be traded readily, facilitating the process of establishing alliances between exchanges by allowing cross-share ownership. This is considered desirable because of the increasing trend towards integration of world capital markets and global competition for capital.

5.3 When Parliament passed legislation facilitating the ASX demutualisation and listing, it included provisions limiting persons and their associates to owning or controlling no more than 5 per cent of the shares in ASX.

5.4 The ASX, however, saw this provision as inequitable and likely to impede alliance proposals:

> Unlike other provisions inserted in the Law to accommodate demutualisation of securities exchanges, the ownership limitation was confined to ASX. ASX has submitted that this is inequitable and the restriction may, absent modification, serve to impede our international alliance proposals. [2]

5.5 The FSR Act lifted the ownership limit from 5 to 15 per cent. This limit applies to all exchanges and clearing and settlement facilities considered to be of national significance. The Act also contains regulation-making powers that allow the Minister to permit holdings in excess of 15 per cent consistent with the national interest. However, the regulation is disallowable by the Parliament and cannot come into effect until the disallowance period has expired. The Act also incorporates a 'fit and proper person' test, intended to ensure that only 'appropriate people' are associated with managing, owning and controlling exchanges.[3]

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

2 ASX, Submission No. 2, p. 15.

3 The Treasury, Submission No. 5, pp. 5-6.

5.6 This Chapter explores the reasons for forming exchange alliances, considers the relevance of ownership limits and also looks at obstacles to their formation.

Why form alliances?

5.7 The evidence provided to this Committee indicates that the major driving force behind the ASX's pursuit of alliances with overseas exchanges is the need to maximise the amount of liquidity available to Australian companies. Alliances have the potential to add depth and liquidity to the Australian share market by facilitating the entry of overseas investors into the Australian market. Theoretically, this could offset some of the incentive faced by Australian companies to list in overseas markets rather than in this country because of a lack of depth in the local market. As noted in the ASX submission:

> By market capitalisation (of stocks listed), ASX is currently the 13th largest national stock exchange. Given its relative size, ASX recognised some time ago that becoming part of global securities markets would be essential for longer term growth.[4]

5.8 Alliances also have the potential to facilitate overseas investment by local investors. Providing such assistance helps the ASX and local exchanges to remain relevant in a world where Australian investors, institutional and private, are increasingly conscious of investment opportunities elsewhere and can use non-traditional trading methods to meet their requirements.

5.9 Technological change has greatly reduced physical barriers to cross border trading. For example, there is little to prevent Australian or international investors from buying shares in other countries by dealing directly with sharebrokers in the country in question. However, international trading may entail higher risks for investors than trading on a national market. Mr Humphry explained the greater protections for investors that can flow from alliances, using the example of the ASX's alliance with the Singapore exchange:

> We are putting this proposition together because we think we can provide greater protection for investors. We can provide streamlining for trading, and we can also give effect to settlement…We are seeking to create a regime which actually provides a far greater certainty of their trade being executed. What we are setting about is something which is actually in the interests of protection of the investors.[5]

5.10 The World Link service is an ASX initiative to facilitate international securities trade. The ASX explained that the World Link service 'aims to provide significant benefits to brokers and Australian investors by allowing investors to cost effectively invest in companies listed on foreign exchanges and to maintain and

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4 ASX, Submission No. 2, p.18.

5 Evidence, p.31.

improve liquidity for companies listed on ASX'. At this point there are two initiatives within this service:

- a trading link to the United States securities market; and
- a reciprocal trading link with the Singapore market.

5.11 The US trading link offers a facility for trading in a foreign market and settlement of the foreign transaction by a wholly owned subsidiary of ASX, settlement in Australian currency through CHESS, and arrangements for holding the foreign securities as beneficial interests in CHESS broker sponsored holdings.

5.12 The Singapore link commenced operation on 20 December 2001. The ASX advised the Committee that the intention is to allow access to a number of Singapore securities on the SGX market via a new ASX software application and an inter-exchange communications link. The ASX explained that under the arrangements, transactions take place in accordance with the rules and procedures of the securities' home exchange. For Australian investors, the service enables settlement to occur in Australian dollars. As with the US link ASX has put in place, record of beneficial ownership of Singapore securities by Australian investors is held on CHESS. For holdings of ASX listed shares held by Singaporean investors, the beneficial ownership is recorded in SGX's Central Depository (Pte) Limited.[6]

5.13 Ms Karen Hamilton advised the Committee that the ASX-SGX link is 'the first co-trading link of its type to be created by stock exchanges anywhere'.[7]

5.14 This arrangement appears to have a number of advantages. Settlement takes place in the investors' home market, in local currency. Procedures for recording ownership are well established and secure. Importantly, the model has the advantage of maintaining the sovereignty of each market while facilitating order flows between them.[8]

5.15 The arrangement with the Singapore market relies on market integrity measures in the home exchange to provide the primary level of security to investors. Ms Hamilton explained that a memorandum of understanding governs the process:

> In the case of the link with Singapore, there is a memorandum of understanding between the two exchanges which helps to formalise the process for exchange of information and requests for investigative or enforcement action. Each exchange has added a section to its rules to protect the integrity of the other's market. It is a disciplinary offence for a Singapore exchange broker using the link to engage in conduct that would adversely affect the ASX market and vice versa. The result is that, for

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6 ASX, Submission No. 2B, p. 8.

7 Evidence, p. 136.

8 ASX, Submission No. 2B, p. 8.

> inbound trades, the regime of cross-border cooperation forming part of the co-trading link arrangements results in enhanced market protection.[9]

5.16 While the ASX has successfully established the two-way link with SGX, it remains true that the path to establishing alliances remains difficult and there are a number of obstacles that must be overcome before successful alliances can proceed.

Obstacles to alliances

5.17 An examination of the available evidence suggests that the obstacles to implementing alliances (which at essence are links between two exchanges facilitating trade in securities) are far less to those associated with mergers (where two entities become one) but are nonetheless still an issue. In particular, there are regulatory and enforcement issues that need to be addressed. The Committee notes that in relation to the ASX's alliance with Singapore, ASIC and the Monetary Authority of Singapore have been closely cooperating on these two issues.[10]

5.18 In evidence to the Committee, the Treasury confirmed that the regulatory implications associated with mergers can be very complex. Treasury noted however that the regulatory implications of alliance proposals are somewhat less severe.

5.19 ASX evidence confirmed that mergers face obstacles that it regards as insurmountable at the present time. According to Mr Humphry, mergers face great difficulties because of the problems associated with agreeing on a single regulatory regime applicable in two countries:

> At this point in time, my view is that they are show-stoppers. I just do not see stock exchanges being able to merge, for that very reason. However, you can link markets and still achieve the combined depth and liquidity in a market.[11]

5.20 The ASX identified the regulatory issues that arise where exchanges in different countries attempt to merge:

- whether the operator(s) of the market require a licence to conduct that market in both jurisdictions;
- whether participants in the new (combined) market require licensing and accreditation in both jurisdictions;
- the compatibility of rules governing operation of the markets in each jurisdiction including capital adequacy, licensing and accreditation requirements;

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9 Evidence, p. 136.

10 Address by Ms Jillian Segal, Deputy Chair, ASIC to IOSCO conference, June 2001.

11 Evidence, p. 31.

- how information can be shared between jurisdictions at SRO and government regulator levels, particularly in view of the statutory immunities conferred or privacy regimes in operation, in particular jurisdictions;
- the compatibility of the market offences provisions in each relevant jurisdiction;
- the compatibility of the disclosure regimes in each relevant jurisdiction;
- the compatibility of the fund raising (prospectus) regimes in each relevant jurisdiction;
- the compatibility of the takeover regimes in each relevant jurisdiction;
- the requirement for clearing house licences in each relevant jurisdiction;
- the extraterritorial reach of legislation in each jurisdiction;
- the compatibility of fidelity fund and risk management arrangements;
- the compatibility of transfer and holding requirements (in particular whether electronic transfer and uncertificated holdings are available);
- the compatibility of clearing guarantees and clearing house structures;
- how surveillance and enforcement activities will be effectively co-ordinated; and
- the effectiveness of cross-border enforcement at both SRO disciplinary and legislative offence levels.[12]

5.21 While alliances appear more achievable, the ASX advised the Committee in its second submission (February 2001) that the current legislative framework is itself an obstacle and does not contemplate exchange to exchange links:

> It provides limited opportunity to recognise the home regulation of exchanges, their supervisory infrastructure (including information sharing arrangements) and the limited broker role, in a traditional sense, that is performed by the exchange in facilitating the link. The issues are of duplication and wrong fit. For example, the activity of a regulated exchange in displaying information from a foreign regulated market should not of itself require a market licence, and the dealer capital, reporting and performance bond requirements are not well suited to the representative role and structure of exchanges.

5.22 The ASX noted that the (then) FSR Bill provides 'more flexibility generally'. However the exchange was of the view that the improvements provided by the Bill are

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12 ASX, Submission No. 2, p. 9.

limited and '[do] not easily accommodate two-way links between regulated exchanges that seek to leverage existing regulation and reduce unnecessary duplication'.[13]

5.23 The ASX's most recent evidence to the Committee (January 2002) confirms its earlier view about the difficulties of establishing an alliance within the current framework. Ms Karen Hamilton and Ms Christine Jones (General Counsel, ASX) explained the difficulties encountered in establishing the SGX link:

> **Mrs Hamilton:** I think it is true to say, essentially to facilitate the linkage between two authorised markets in their jurisdictions, we have tortured and stretched the existing dealing and market operating provisions to facilitate that form of technology. That has been a fairly tortured path to get us to where we want to be.
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> **Ms Jones**: It has been a difficult process too to comply with existing law while doing something which is quite different.[14]

5.24 The Committee sought Mr Humphry's views about the fundamental issues in relation to the protection of shareholders that arise in respect of alliances with other markets. He responded that from his perspective 'the continuous disclosure is critical, and a lot revolves around that particular requirement'.[15]

5.25 The ASIC also advised the Committee of regulatory issues which would need to be overcome in order to protect Australian shareholders. The issues to be resolved in relation to alliances were not however, regarded as insurmountable. Mr Tregallis told the Committee:

> There are a number of mechanisms that you could put in place to reassure yourself. Firstly, I think we would always look at the quality of home jurisdiction regulation. Secondly, we would certainly think about information sharing provisions and make sure they are in place. Thirdly, you would have to look at trying to establish potentially common standards in some key areas. It will be quite a difficult issue if you take the step beyond trading alliances, which I think we can deal with under the current regime and current mechanisms.[16]

5.26 There are, nonetheless, significant regulatory differences between Singapore and Australia. For example, the Australian legislative prohibition on short selling does not have a counterpart in the Singapore legislation or in the laws of many other countries. However, in the case of the Singapore link, the issue of differing standards has been addressed through the introduction of operating rules within SGX, instead of attempting to change the Singapore legislation. Mr Malcolm Rodgers, Executive

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13 ASX, Submission No. 2, p. 19.

14 Evidence, p. 138.

15 Evidence, p. 31.

16 Evidence, p. 6.

Director, Policy and Markets Regulation, ASIC, explained the strategy for overcoming this obstacle:

> It would not be an offence in Singapore to short sell on ASX, but it is not permitted under this arrangement by a mechanism that effectively requires that through the business rules of the Singapore exchange, so there has been some adjustment. That was a clear case where there was simply no prohibition on one side and there was on the other. The compromise position at an administrative level is to say, 'We have a responsibility to enforce the Australian law. There is a risk of noncompliance by the Singapore brokers because they would not be complying with Australian law if that happened in Australia. We want that risk dealt with.' And it was dealt with by the mechanism of creating an express prohibition, albeit at the rule level, so that it is a disciplinary offence in Singapore to short sell an ASX listed security, as well as an Australian offence.[17]

5.27 A final and important issue that can present a possible obstacle to the introduction of alliances is a perception of a conflict of interest arising from ASX's market supervision of its own subsidiary that operates the link with other exchanges, ASX International Services (AIS). The Committee notes that ASX and ASIC are conscious of this issue and have introduced arrangements for handling such conflict, to be trialed over a three month period. The details of these arrangements are incorporated at Appendix 4 at the end of this report. An alternative strategy for dealing with this issue would be to shift responsibility for the establishment and supervision of operating rules away from the ASX if an alliance or merger was to proceed.

5.28 The Committee obtained almost no evidence that the establishment and supervision of listing rules should not remain with the ASX at the current time. It was generally agreed that there were benefits in having the listing rules with the market operator; these benefits stemmed from the market operator having the 'front-line, day-to-day interface with listed entities'.[18]

5.29 However, ASIC could not unequivocally rule out that the listing rules should remain forever with the ASX. Ms Segal indicated that the specifics of an alliance may require that the listing rules be transferred from the ASX:

> It would be hard to say there were no circumstances. I think that international comity in coming to a workable framework for mergers and alliances would mean that we would have to be very open as to what was the most appropriate regime to discuss.[19]

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17 Evidence, p. 161.

18 Evidence, p.14.

19 Evidence, p.15.

Potential pitfalls

5.30 At the outset, it should be noted that most of the industry submissions and evidence received by the inquiry favoured the development of alliances. The Securities Institute, for example, saw the alliances program as 'extremely important' for two reasons:

- it exposes ASX to world best practice in their industry; and
- it involves ASX in discussions and negotiations in changing technologies and liquidity patterns within global stock exchanges.

5.31 The Securities Institute argued that without an alliance program, Australia could encounter the same problems as the New Zealand Stock Exchange and liquidity may not be maintained, at considerable cost to business. They contended that:

> ASX should be encouraged and facilitated in seeking to give our market a role in global arrangements. This includes ensuring that a flexible approach is taken to regulatory issues that may arise so that ASX can enter alliances and/or mergers as necessary.[20]

5.32 Chartered Secretaries Australia made similar comments:

> Australia needs a vibrant capital market to foster economic growth. Alliances with other exchanges will have a positive influence on this.[21]

5.33 Dr Shann Turnbull's submission was, however, less supportive. Dr Turnbull considered that alliances or mergers were neither in the interest of investors and issuers, nor in the national interest. In particular, he thought such a proposition could 'subjugate Australian companies to standards set by alien officials', 'allow a third party exchange greater power to extract higher listing fees' and 'reduce choice'. He also believed that technological change, particularly international internet trading, could soon overtake the issue, making exchanges irrelevant.[22]

5.34 The ASX was dismissive of Dr Turnbull's arguments. In a supplementary submission, ASX compared Dr Turnbull's proposition about alien officials setting regulatory standards for Australian companies to arguing that adopting international accounting standards is detrimental to Australian companies:

> Such propositions seem to reflect a belief that Australians will be satisfied with a level of prosperity that they can attain in a 'fortress Australia' which turns its back on the forces of globalisation. ASX takes a contrary view.

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20 Securities Institute, Submission No. 1, p. 2.

21 Evidence, p. 69.

22 Dr Shann Turnbull, Submission No. 3, pp. 3-4.

5.35 ASX acknowledged that mergers between exchanges 'ought to be subject to a regulatory discipline that ensures that standards are not compromised.' It advised that in some situations the benefits of mergers may outweigh the detriments. However, the Australian and Asian regions have more severe cross border jurisdictional issues than are found in the European Union. For that reason, ASX believes that alliances are more likely in this region 'over the next few years at least'.[23] The Committee agrees with this assessment.

Ownership limits

5.36 The process of forming alliances may include the participating markets taking cross share ownership - that is, buying a stake in each other's companies. However, the extent of such cross share ownership in an ASX alliance was originally limited to not more than a 5 per cent holding. The Treasury explained the reason for introducing the 5 per cent ownership limit:

> In light of the demutualisation…the Law was further amended to impose a share ownership limitation on the exchange to address the potential danger that the operations of the exchange may be compromised to suit the vested interests of large shareholders. As a consequence, currently, no one person is permitted to own more than five per cent of the voting shares in the ASX.[24]

5.37 The Treasury advised the Committee that the Government decided to remove the 5 per cent limitation 'in recognition that the current limit does not achieve a level playing field' and because it limits the ASX's ability to 'enter into arrangements which may require higher levels of equity participation, especially in the context of the increasing integration of world capital markets'.[25]

5.38 The Government, at the request of the ASX, raised this limit to 15 per cent, with a provision for the Minister to allow a higher limit if judged to be in the national interest.

5.39 Treasury advised that a 15 per cent ownership limitation will 'allow markets and clearing and settlement facilities to structure their operations in a way which responds to commercial pressures and ensure diversified ownership.' They advised that a 15 per cent limitation is consistent with the current thresholds in the *Financial Sector (Shareholding) Act 1998* and the *Foreign Acquisitions and Takeovers Act 1975*.[26]

5.40 The ASX offered a similar line of reasoning to that of Treasury in support of lifting the ownership limit, advising the Committee that it considered the use of

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23 ASX, Submission No. 2A, p. 19.

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

25 The Treasury, Submission No. 5, pp. 5-6.

26 The Treasury, Submission No. 5, pp. 5-6.

shareholder limits to be 'an ineffective and inefficient means of achieving regulatory outcomes or objectives' and 'potentially limits the available mechanisms to form strategic alliances (taking an equity stake) without really advancing the central notion that a market operator must provide a fair and orderly market.'[27]

5.41 During the public hearing, the Committee asked Mr Humphry about how demutualisation had changed the ownership of the exchange. He advised that prior to demutualisation 606 brokers and organisations effectively owned the exchange, but following demutualisation and listing, ownership had expanded to 17 000 shareholders, all but 1000 of whom are individual members of the community. Mr Humphry expressed considerable satisfaction about this change:

> That has been a very satisfying and pleasing development, and I see it as a form of democratisation of the exchange. It is much more a stock exchange now owned by the community.[28]

5.42 As previously noted, the Committee considers that alliances between exchanges are desirable as they can facilitate the availability of liquidity for local companies. The Committee also understands that a 15 per cent limit is consistent with other legislation, for example, that applicable to banks. Finally, the Committee notes the proposal to introduce a 'fit and proper person' test. However, it does appear inescapable that if it is accepted that higher ownership limits for stock exchanges are required to facilitate alliances, then there must inevitably be some compromise of the 'democratisation of the exchange'.

5.43 Whether the 'fit and proper person' test will be sufficient to address the potential danger that the operations of the exchange may be compromised to suit the vested interests of large shareholders remains to be demonstrated. Would, for example, the 'fit and proper person' test be applied to a foreign stock exchange that was seeking to buy a stake in the ASX as part of an alliance arrangement and if so, how would it be applied? Nonetheless, the Committee considers that the introduction of a 'fit and proper person' test is appropriate for an organisation of the ASX's significance in the economy and is an essential precondition to higher ownership limits.

5.44 While not opposing the higher ownership limits, the Committee notes that the argument in favour of these limits was based more on assertion than demonstrated need. Indeed, comments by Mr Humphry seemed to downplay the importance of the higher ownership limits. Answering a question about whether the proposed increase in ownership limits from five to 15 per cent would materially help the ASX form alliances, Mr Humphry told the Committee that:

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27 ASX, Submission No. 2, p. 16.

28 Evidence, pp. 22-3.

> I think it will contribute to it, but the alliances or linkages that we have with other stock exchanges will come about because of the desire to trade orders. However, it will assist us in being able to take cross-share ownership.[29]

5.45 The Committee notes that Australia is not alone in regarding the ownership of key institutions, particularly those in the financial services sector, as important. Ownership restrictions and/or regulatory approval of significant shareholders are common. As noted in a recent technical paper on demutualisation published by IOSCO, public interest issues may warrant some regulatory oversight or restrictions on oversight.[30] The Committee finds itself in agreement with this statement of principle.

Conclusions

5.46 The Committee believes there was an element of confusion in some of the evidence received regarding alliances. It appears that a few witnesses may regard the two terms, merger and alliance, as interchangeable, when they are in reality quite different propositions.

5.47 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.

5.48 Whether mergers are desirable is more questionable. The Committee notes that mergers are not currently considered feasible in this region so the issue does not arise. However, should the ASX merge with another exchange, or enter into an alliance which differs significantly from the ASX-SGX link, the Committee should again review the market supervision framework.

5.49 The question of whether the ownership issue arising out of demutualisation and listing is significant in relation to forming alliances remains unclear. However, the Committee is of the view that there is no evidence to suggest raising the ownership limit to 15 per cent will be in any way detrimental.

5.50 Protection of investors who invest in foreign markets through portals supported by alliances is an important issue. The Committee notes that ASIC and ASX have implemented measures to address the legislative differences between Australia and Singapore. These measures, relying on market operating rules, do provide improved protection for investors. Nonetheless, investors need to be aware that regulatory differences do exist and ASIC cannot impose the standards integrated in the Australian legislative framework in other countries. The Committee suggests that ASX introduce a 'health warning' for potential investors, reminding them of these issues.

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29 Evidence, p. 20.

30 IOSCO Technical Committee on Demutualisation, Issues Paper, June 2001, p. 12.

5.51 Finally, the Committee 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. The Committee will await the results of this trial with interest.