

ALTERNATIVE MODELS

ASX submission

1.1 The ASX submission to the inquiry identified four alternative models, as follows:¹

- current Corporations Law Model;
- dispense with co-regulatory model;
- create one overarching Self Regulating Organisation (SRO) for all markets; and
- hybrid model – that is, leave SRO function for Market Conduct Requirements but responsibility for internal business practices of market participants to reside with third party).

Option 1 - Current Corporations Law Model

1.2 Chapters 2 and 3 deal with the advantages and disadvantages of the current model. The ASX summarised the advantages of the current model as follows:

- preserves synergy between markets and market-specific oversight;
- allows expert regulation of markets;
- allows speed and flexibility of market regulatory responses;
- reduces cost to taxpayers of market related regulation and allows government to channel resources to activities outside the province of the market operator;
- allows market operator to manage business risks and exposures relative to provision of market platforms and services;
- fosters competition; and
- promotes public accountability of market operator.

1.3 Disadvantages associated with this model identified by ASX were as follows:

- does not completely eliminate potential for conflict; and
- costs imposed on market operators.

1 Submission No. 2, Appendix 5.

Option 2 - Dispense with co-regulatory model

1.4 The ASX summarised the advantages of this option as follows:

- eliminates conflicts of interest by market provider;
- potential to create uniformity of standards domestically if there are a number of market operators;
- may reduce compliance costs to the extent there is now overlap or additional requirements by different market operators.

1.5 The ASX summarised the disadvantages of the this option as follows:

- divorces markets and market-specific oversight;
- government agency would be slower to change regulatory framework to respond to financial marketplace developments;
- removal of ‘at coalface’ business expertise may adversely impact effectiveness of supervisory responses;
- funding issues;
- anti-competitive implications- Supervision is core business – brand value;
- loss of control by business of key risk management aspects of the business relationship;
- departure from overseas experience – may impact international linkages;
- will cause delays in information flow and impact ability to minimise market losses or adverse impacts;
- may lose benefit of ‘soft line’ supervision – role of education and persuasion performed by SRO (who can be viewed as business partner);
- need for government regulator to recognise impact on one or more markets and to share information to enable market integrity impacts to be addressed by relevant market operator or clearing house;
- need to skill up and resource a government agency; and
- may still be conflicting priorities due to resourcing limitations and political issues.

Option 3 - Create one overarching Self Regulating Organisation (SRO) for all markets;

1.6 The ASX summarised the advantages of this option as follows:

- eliminates conflicts of interest by market provider;

- potential to create uniformity of standards domestically if there are a number of market operators; and
- may reduce compliance costs of a variety of market rules and codes.

1.7 The ASX summarised the disadvantages of this option as follows:

- divorces markets and market specific oversight;
- centralised SRO may be slower to change regulatory framework to respond to financial marketplace developments and have difficulty reconciling developments in a particular market within common framework;
- loss of ‘at coalface’ business expertise may impact effectiveness of supervisory responses;
- funding issues;
- will cause delays in information flows and impact ability to minimise market losses or adverse impacts;
- may lose benefits of ‘soft line’ supervision – role of education and persuasion performed by SRO (who can be viewed as business partner);
- need for SRO to recognise impact on one or more markets and to share information to enable market integrity impacts to be addressed by relevant market operator or clearing house (eg pull the plug on a market participant);
- anti-competitive implications – Supervision is core business – brand value of market operator;
- loss of control by business of key aspects of risk management relationship with customers;
- need to skill up and resource central body; and
- may still be conflicting priorities due to resourcing limitations or relationships with particular markets.

Option 4 - Hybrid Model – that is, leave SRO function for Market Conduct Requirements but responsibility for internal business practices of market participants to reside with third party)

1.8 The ASX summarised the advantages of this option as follows:

- removes scope for potential conflict of interest where it will most likely arise;
- potential to create uniform standards for business conduct and client relationship matters if there are a number of market operators;

- may reduce compliance costs where there are a variety of markets rules and codes.

1.9 The ASX summarised the disadvantages of this option as follows:

- may be difficult to carve-up market specific and non-market specific territories;
- may be slower response to financial marketplace developments;
- to extent, these matters impact on the integrity of a particular market - the issues noted as disadvantages for previous models, apply; and
- funding issues.

US Securities Industry Association (SIA) white paper²

1.10 The US SIA White paper provides an analysis of alternative market supervision frameworks in the United States, although not unexpectedly it shares much in common with considerations of the issue in Australia and elsewhere.

1.11 The SIA prepared the paper in the context of significant change in the US Securities Industry driven largely by technological innovation. The paper notes that technological developments have challenged many of the fundamental assumptions of how markets work and facilitated the creation of new competitive structures. The proliferation of alternative trading systems (ATs) and electronic communication networks (ECNs) in the US securities market presents substantial competition to the traditional exchanges. In response, the New York Stock Exchange (NYSE) announced that it intended to demutualise and the National Association of Securities Dealers decided to spin off and privatise the NASDAQ.

1.12 As in Australia, these developments gave rise to concerns about possible conflicts between supervisory and commercial responsibilities and brought into question the continued viability of this organisation as self-regulatory organisations. (SROs).

1.13 Accordingly, the SIA formed an ad hoc Committee to analyse these issues. The resulting paper examines the advantages and disadvantages of the current self-regulatory structure and evaluates a range of possible alternatives.

1.14 The SIA Subcommittee identified seven factors for evaluating the appropriateness of regulatory structures:

- foster investor protection;
- preserve fair competition;

2 United States Securities Industry Association, *Reinventing self regulation*, White paper for the SIA's Ad hoc Committee on Regulatory Implications of de-mutualisation, January 2000.

- eliminate inefficiencies;
- encourage expert regulation;
- promote reasonable and fair costs of regulation;
- foster due process; and
- encourage industry participation and self-regulation.

1.15 It is important to note that in the SIA's evaluation, there was a clear preference for the continuation of self-regulation. The following quotation is indicative of the prevailing view:

The genius of self-regulation is that it puts regulatory decisions in the hands of people intimately familiar with the relevant facts. Any regulatory change should not abandon this valuable asset in favour of a distant, generalist regulator that is ignorant of the markets it regulates.³

1.16 The paper evaluated six potential regulatory models, as follows:

- retain status quo;
- multiple exchanges with separate boards and information barriers for their regulatory arms (NASDR model);
- multiple SROs with firms designated to a single SRO for examination purposes (DEA model);
- one SRO for member firms; markets regulate their own trading (Hybrid model);
- all purpose single SRO (Single SRO model); and
- single regulatory model (SEC only model).

1.17 One difficulty that the SIA's analysis presents is its relevance to the Australian market, there being several large competing exchanges in the US compared to the dominant status of the ASX in Australia. Nonetheless there are enough similarities to make cautious comparisons worthwhile.

Option 1 - Retain Status quo

1.18 In the US there are 8 national securities exchanges and one national securities association (NASD) registered with the American regulatory equivalent of ASIC, the Securities Exchange Commission (SEC). The number of exchanges is expected to increase. The basis functions of these SROs are not dissimilar to ASX - they operate and promote a marketplace; and perform a regulatory function of the market and participants. The White paper identifies the following advantages of this structure:

3 White paper, p.3.

- current model has a history of serving securities industry and investors well - has a tradition of excellence;
- sufficient flexibility to encourage innovation while protecting from fraud and abuse;
- conflicts of interest may be more a problem of perception than reality, and the regulator (SEC) has sufficient experience to recognise and address them;
- the regulator is familiar with the market - blending of market and oversight responsibilities may enhance regulatory process because of the first hand experience of the operator; and
- no significant change to rules or legislation required.

1.19 Disadvantages identified with maintaining the status quo were as follows:

- conflicts of interest between regulatory and market roles, potential misuse of regulatory power for own commercial advantage;
- duplicative and inconsistent regulation - this is more a problem in the US where brokers are operating in several exchanges with different and inconsistent rules and examinations and different enforcement and discipline procedures;
- a potential for regulatory competition between SROs, may lead to a "race to the bottom" - (again, more a US problem although may occur in Australia if exchange is competing for listings against international exchanges);
- limited feasibility - SEC head believes that demutualised exchanges will need to create a separate corporate entity for regulatory operations; and
- impact of Financial Modernisation Law - impact unclear (again, a uniquely US problem).

Option 2 - Multiple exchanges with separate boards and information barriers for their regulatory arms (NASDR model)

1.20 In this option, the SIA considers essentially the same structure as option 1, with the important distinction that exchanges undergo an internal corporate restructuring segregating the market and regulatory roles of demutualised SROs. The SIA envisaged at least two subsidiaries within the SRO, one dealing with rules and related matters, and the other containing the market centre. Advantages are:

- reduced conflicts of interest;
- prior experience with NASDR model - which evolved as a result of criticisms aimed at NASD. Chairman of the SEC has noted 'since SEC's

historic enforcement action...the NASD has adopted an unprecedented number of changes to improve the fairness and efficiency of its operations';

- minimally disruptive change - does not require divestment.

1.21 Disadvantages identified are:

- conflicts may persist - the entity as a whole still has an interest in promoting its own functions;
- only addresses conflicts, fails to address other problems such as duplication and inconsistency.

Option 3 - Multiple SROs with firms designated to a single SRO for examination purposes (DEA model)

1.22 Under this option, inspection responsibilities are allocated amongst the SROs. The option also introduces the concept of a Designated Examining Authority (DEA). Under the model, the SEC allocates responsibility for overseeing broker/dealers who operate in more than one market to one SRO only that becomes the DEA for that group of brokers. The objective is to avoid duplicate examinations of brokers, something that has not been raised as a problem in the Australian context. It is difficult to see how this model could be applied in Australia because of the presence of only one SRO of major significance, the ASX. The advantage of this option is that it eliminates duplicate examinations of brokers - an efficiency measure.

1.23 Disadvantages identified are:

- improvement limited to the single issue identified in advantages;
- issues arise where an SRO has to interpret another SRO's rules - may aggravate conflicts of interest by creating an incentive for one SRO to interpret another's rules in an anti-competitive fashion; and
- fails to address the conflicts of interest issues arising from demutualisation.

Option 4 - One SRO for member firms; markets regulate their own trading (Hybrid model)

1.24 Under Option 4, the SIA contemplates self regulation on the basis of function rather than on the basis of firm membership. The model breaks regulation into two streams – one relating to trading and the other to firm operation and capital requirements. All non-market related self-regulatory functions would be combined into a single organisation which would function irrespective of markets. Hence, each market would undertake its own regulatory and surveillance functions, but matters such as member regulation, sales practices and all other aspects of inter-market trading would be overseen by a single SRO.

1.25 Like Option 3, it is difficult to see how this model could be applied in an Australian market context. However, it is apparently a favoured model in the US context. It is a complex model and received the most attention in the SIA paper.

1.26 The SIA sees the following advantages:

- minimises duplicate and inconsistent regulation;
- reduces regulatory competition (the race to the bottom scenario);
- reduces conflicts of interest;
- regulation is seen as functional - supervisory duties are linked to expertise;
- operationally and legally feasible to implement;
- regulatory expertise centralised;
- more effective liaison with SEC, Government agencies etc.

1.27 Identified disadvantages are:

- separates market and surveillance - may degrade self regulation by lessening familiarity with the market;
- bureaucratic tendencies;
- difficulty in determining boundary between oversight and trading issues;
- still some conflicts of interest regarding trading.

Option 5 - All purpose single SRO (Single SRO model)

1.28 Under Option 5, the SIA would move trading regulation and non-market-related regulation into a single, all purpose SRO. This organisation would then be responsible for all rule making, surveillance and enforcement responsibility for all areas of regulation. The exchanges would be divested of all their self-regulatory authority, leaving each functioning as a simple marketplace, similar to an alternative trading system. This model appears to be based on a concept requiring a private organisation to function as a regulator, with no other purpose.

1.29 The model is possibly feasible in an Australian context but may be impractical. The SIA sees the following advantages:

- decreases duplicative and inconsistent regulation (not an Australian problem);
- centralises regulatory experience (already present in ASX);
- acts as a more effective liaison to other organisations;
- is legally and practically feasible;
- eliminates regulatory competition and conflicts of interest (the market is equivalent in function to its ATS competitors);
- eliminates jurisdictional overlap (not an Australian problem);

- creates a level playing field among markets; and
- broad knowledge of regulated entities, having a comprehensive perspective of the securities industry.

1.30 Identified disadvantages include the following:

- effectiveness of self regulation may be degraded because the regulators are less familiar with market processes;
- possibility of bureaucratic tendencies because of absence of peer competition;
- boundary issues – the line between firm oversight issues and trading issues may be hard to draw
- the SRO could add a superfluous layer of regulation that adds little to that already provided by the SEC; and
- no synergy with new business systems – as exchanges and other market participants implement innovations, the regulatory SRO could become less effective as the SRO would not be involved in the shaping of the new systems and could encounter difficulties in monitoring them effectively.

Option 6 - Single regulatory model (SEC only model).

1.31 This option is seen as a drastic solution under which the concept of self-regulation would be abolished entirely. The ASIC equivalent, the SEC, would have its duties expanded to cover all the oversight responsibilities currently undertaken by the SROs. Listed advantages include:

- any concerns associated with self regulation are eliminated;
- duplicative and inconsistent regulation ends; and
- regulatory expertise – the increased power of the SEC would augment its status, allowing it to attract and keep talented staff, rather than competing with other regulators for that expertise.

1.32 The option is seen as likely to introduce a host of new problems. Disadvantages include:

- minimal industry input – the regulator loses the expertise of a market operator who is on intimate terms with the market – a loss of expertise, loss of direct input by the market into regulation;
- expensive and bureaucratic; and
- history of failure in similar programs.

1.33 This option does not appear to be seriously contemplated by the SIA.

IOSCO examination of recent international developments

1.34 The mid to late 1990's has been a period of dramatic change among many of the world's exchanges. A manifestation of this change has been the increasing number of exchanges opting to demutualise and in some cases, float.

1.35 This rapid change has been addressed by international organisations such as IOSCO. The issues that are canvassed in this chapter are based on the IOSCO paper titled; 'Issues Paper on Exchange Demutualization' of June 2001. This final section of the chapter examines a number of the world's exchanges and briefly summarises, in point form, the more relevant aspects relating to demutualisation. The section highlights the methods that have been implemented to deal with some of the issue that arise when an exchange demutualises and or floats.

1.36 A similar bundle of issues confront all exchanges when they choose to demutualise. The key issues are the problems which arise in relation to conflicts of interest and self regulation. The way in which these issues are managed bear similarities to the systems put in place by the ASX. Solutions generally require the assistance of the relevant countries supervising body in the form of increased monitoring. However, there is no universal plan, each situation requires solutions catering to the specific environments of each exchange. Issues that are common to all exchanges include:

- conflicts which create or exacerbate supervisory difficulties when a for-profit exchange performs a regulatory function;
- limits on levels of individual ownership;
- protecting the financial viability of a for-profit exchange which also performs an important regulation function;
- ensuring the supply of an appropriate level of resourcing for non-profit core activities such as supervisory roles;
- the expansion of exchanges into other areas of the industry, such as takeovers or mergers with clearing and settlement companies;
- the managing of any monopolies which the exchange may have; and
- demutualisation creating a new and separate conflict of an exchange floating and then self-listing, the result being an exchange becoming responsible for its own regulation.

1.37 Some of these issues, even before demutualisation, have confronted all exchanges to some degree. This is evidenced by the fact that many exchanges have been self-regulating since inception. In such an environment exchanges have been required to manage conflict in relation to:

- the setting of rules for the exchange that may have a negative impact on individual interest; and

- the monitoring and enforcement of these rules for themselves.

1.38 The response to potential conflicts from stock exchanges around the world has been to point to controls such as:

- self regulation producing better rules due to the market having the relevant expertise and knowledge;
- market participants are more likely to follow rules they have participated in shaping; and
- the protection of the industry reputation is incentive to maintain a fair and equitable exchange.

Hong Kong

- In 1999, following shareholder and court approval, Hong Kong's Exchanges and Clearing Houses were merged to form the Hong Kong Exchanges and Clearing Houses (HKEx).
- In 2000 HKEx was listed on the Stock Exchange of Hong Kong, in effect HKEx was listed on its wholly owned subsidiary.
- HKEx is self-regulating in regard to its exchanges and clearing house activities. However, the Securities and Futures Commission (SFC) regulates the HKEx and any other listed companies/persons which have an identified conflict which prevents the HKEx company from doing so.
- SFC also monitors and has authority over fees charged in relation to goods and services over which the HKEx has an effective monopoly.
- Risk management practices are also monitored by the SFC and a statutory risk management committee of HKEx. The aim of this is to monitor the soundness of practices put in place by HKEx.
- There is a 5 per cent limit on shareholding by individual or individuals acting in concert to prevent control.

Toronto

- In 1999 permission was granted by the Ontario Securities Commission (OSC) to allow the Toronto Stock Exchange to become a company known as the Toronto Stock Exchange Inc (TSE).
- The OSC monitors and enforces all fees charged by the TSE. In addition the OSC ensures that the TSE is equitable and does not create barriers to access.
- The TSE self-regulates via the establishment of a separate division in the TSE, known as TSE RS. Market regulation has been separated and the TSE RS has a certain amount of financial autonomy as a result of it charging fees at the rate to meet cost recovery.

- There is a 5 per cent limit on ownership. However, this can be increased with the consent of the OSC.

Singapore

- In 1999 the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange (SIMEX) were demutualised and merged to form the Singapore Exchange Limited (SGX).
- SGX has retained all the self-regulating activities held by SES and SIMEX. Trading and clearing house activities are managed by separate subsidiaries.
- SGX auditors are required to report any breaches of the relevant legislation or any irregularities to the Monetary Authority of Singapore (MAS).
- The MAS has supervisory power over SGX and its subsidiaries in relation to the maintenance of a fair and orderly market. It has authority to issue directives regarding rules, corporate governance, and SGX's management of matters relating to securities and futures.
- MAS also is required to approve the appointment of SGX's Chairman and CEO, additionally the SGX is required to set up a Nominating Committee with the function of nominating Board members and senior management positions.
- A 5 per cent limit is set for individual shareholding. This limit may be exceeded on the authority of the MAS.
- It is expected that the SGX will be floated on itself publicly and that the MAS will then take over the supervision of the listing rules for the SGX.

Sweden

- In 1993 the Stockholm Stock Exchange (SSE) was demutualised and the following year the shares became freely available with no restrictions.
- The Exchange was not permitted to float its own shares.
- By 1998 OM Gruppen AB (OM), a firm established in 1985, also carrying on business in exchange like activities had bought all the shares in SSE. OM then merged its activities into the SSE. This merge created OM Stockholmborsen AB.
- The reaction to the takeover and merger was the passing of legislation which increased the supervision of the newly merged exchange via the Swedish Finansinspektionen (SFI). The main points to the legislation are:
 - the exchange is not permitted to list its own securities, but it is able to list those of companies that hold shares in it.
 - a fit and proper person test was put in place to assess any proposal to purchase more than a 10 per cent stake.

- the SFI has the power to control the voting rights of a qualified owner and also the power to force a qualified owner to divest themselves of shares to under 10 per cent.
- power to bring qualified owners before the Disciplinary Committee of the exchange.

United Kingdom

- In 2000 the London Stock Exchange became a public company known as London Stock Exchange plc (LSE).
- As a result of the LSE's restructuring to become a for-profit entity, the Treasury and the LSE agreed to move the role of Primary Market regulator to the Financial Services Authority (FSA).
- The Secondary Market ie the of day to day trading in securities is still regulated by the LSE.
- The Articles of Association, which govern the behaviour of the LSE as a company, prevent other entity's or persons from obtaining more than 4.9 per cent of shares in the LSE.
- The LSE is looking to remove the 4.9 per cent ownership limit by amending the Articles of Association. However, any change to the Article of Association will require support from more than 75 per cent of shareholders.
- There has been some interest in the LSE by Swedish company OM Gruppen (discussed above)

1.39 The Committee notes that since the date of the IOSCO publication, the 4.9 percent ownership limit applying to the LSE has been removed.

Comparison between Australian and overseas developments

1.40 As part of or soon after their demutualisation processes, the Hong Kong, Singapore and Swedish stock exchanges have been merged with their respective futures markets or clearing and settlement houses. It can be assumed that such arrangements offer more depth and security to the market. The ASX has become involved in clearing and settlement activities via the CHES and SEATS systems. However, the ASX has not been permitted to takeover the SFE due to an ACCC decision based on potential loss of competition.

1.41 All the monitoring responsibilities of Hong Kong's HKEx falls to the Securities and Futures Commission (SFC). The SFC monitors and manages the HKEx in terms of conflicts of interest. In addition the SFC also has powers associated with trade practices law in matters such as those pertaining to monopolies. The Australian model has split the two roles between the ACCC and ASIC.

1.42 The Toronto Stock Exchange (TSE) has proposed the establishment of the TSE RS. Its role would be the responsible management of market regulation. This

model bears some similarity to that of the ASX, which has established the ASXSR. However, the TSE RS charges for its services on a cost recovery basis. The ASXSR is totally funded by the ASX. The TSE RS model offers a perception of independence by charging for its services. However, charging will lead to an increase in costs when conducting business on the TSE.