Parliament of the Commonwealth of Australia

SENATE ECONOMICS REFERENCES COMMITTEE

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

February 2002

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TERMS OF REFERENCE

On 5 December 2000 the Senate referred to the Senate Economics References Committee the matter of the framework for the market supervision of Australia's stock exchanges for inquiry and report by 30 April 2001, with particular reference to:

> The framework for the market supervision of Australia's stock exchanges, with particular reference to:

(a) the advantages and disadvantages (if any) of the current framework;

(b) the implications (if any) of the demutualisation and listing of an exchange and any proposed alliance between Australian exchanges and other exchanges;

(c) other frameworks or structures for market supervision, including frameworks or structures of, or examined by, overseas exchanges; and

(d) whether trade practices law is deficient in ensuring a competitive stock exchange market.

The Committee sought and received from the Senate an extension to the reporting date of 23 August 2001.

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ABBREVIATIONS

AASE	Australian Associated Stock Exchanges
ACCC	Australian Competition and Consumer Commission
AIS	ASX International Services
ASA	Australian Shareholders' Association
ASIC	Australian Securities and Investment Commission
ASTC	ASX Settlement and Transfer Corporation
ASX	Australian Stock Exchange
ASXSR	Australian Stock Exchange Supervisory Review
BSX	Bendigo Stock Exchange Ltd
CHESS	Clearing House Electronic Subregister System
CSA	Chartered Secretaries Australia
FSR Act	Financial Services Reform Act
IFSA	Investment and Financial Services Association
IOSCO	International Organization of Securities Commissions
MOU	Memorandum of Understanding
NGF	National Guarantee Fund
NSX	Stock Exchange of Newcastle Ltd
S&P	Standard and Poor's
SCH	Securities Clearing House
SEATS	Stock Exchange Automated Trading System
SFE	Sydney Futures Exchange
SGX	Singapore Stock Exchange
SROs	self-regulating organisations
TPA	Trade Practices Act

PREFACE

On 5 December 2000 the Senate referred to the Senate Economics References Committee the matter of the framework for the market supervision of Australia's stock exchanges for inquiry and report by 30 April 2001.

The inquiry was advertised in the national press and on the internet, and interested parties were invited to make submissions to the Committee.

The Senate extended the reporting date for this inquiry on several occasions, most recently setting the reporting date as the last day of the 39th Parliament - 11 February 2002.

The Committee received 12 submissions, as well as several supplementary submissions, particularly from the Australian Stock Exchange. These are listed at Appendix I.

The Committee held the following public hearings:

- 9 April 2001, Sydney;
- 3 May 2001, Canberra; and
- 31 January 2002, Sydney.

The Hansard transcripts are published on the Committee's webpage.

The Committee wishes to thank everyone who contributed to the inquiry by making submissions, providing other information or appearing before the Committee at public hearings.

EXECUTIVE SUMMARY AND FINDINGS

Advantages and disadvantages

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Demutualisation and alliances

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

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

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

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

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

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

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

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

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

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

Effectiveness of trade practices law

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

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

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

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

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

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.

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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

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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:

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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;

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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 CHESS);
- 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.

CHESS

1.30 CHESS 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

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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 CHESS 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]

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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.

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

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

CHAPTER 2

ADVANTAGES OF THE CURRENT FRAMEWORK

Introduction

2.1 This Chapter explores the Committee's first term of reference and sets out the advantages of the current framework, as identified in the evidence presented. The Chapter also briefly canvasses witnesses' and submittors' views about how well the framework functions.

2.2 A small number of submissions viewed the framework as flawed and in need of major change. However, the majority of organisations that made submissions, while not hesitating to make critical comment in some areas, generally supported the current supervisory framework and expressed the view that the ASX operates efficiently and with integrity. The predominant view was that the regulatory framework is generally appropriate.

Advantages of the current framework

2.3 A range of submissions and evidence identified advantages associated with the current framework. A major theme repeated on a number of occasions was that the market is well served by having as its front line supervisor an operator that is familiar with the day to day operations of the market and is able to respond quickly to developments in the market itself.

2.4 Advantages identified by ASIC and Treasury represent a fair cross section of those identified in other submissions. These included:

- the cost of market regulation is borne by market participants and users[1];
- the proximity of exchanges to market trading, activity and participants means that exchanges are well placed to supervise operations, transmit information and respond rapidly to irregularities in trading;
- the exchange's ability to adapt elements of supervisory arrangements through changes to operating rules to reflect the needs of the market and its users and cater for developments in business practices;
- the ability of exchanges to monitor market movements and respond quickly limits the potential for market abuse and aids the market as a reliable price discovery mechanism; and

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1 See Australian Securities and Investments Commission, Submission No. 8, p. 6.

- the framework bestows a commercial incentive on exchanges to ensure that they discharge their supervisory responsibilities effectively as they have a vested interest in maintaining reputation and attracting investment.[2]

2.5 The final point, the exchange having a commercial incentive to maintain standards, is particularly important. Because the ASX has a commercial incentive to maintain integrity, this may reasonably be expected to exert a counter to commercial pressures that might otherwise provide inducements to compromise integrity. In theory, this should result in the exchange being largely self policing. The ASX's key business asset is its reputation for integrity and efficiency and not one that it could compromise without threatening the value of its own business.

2.6 The ASX itself identified the advantages of the current framework as follows:

- in its detailed prescription of the activities of securities exchanges, its powers of intervention and calling to account, the framework promotes a high integrity environment; and
- in its strong self-regulatory emphasis, there is the ability to provide efficient market responsive rules and flexible and effective enforcement of them in a cost effective way for government.[3]

2.7 The ASX's submission summed up its own view of how well the current framework operates:

> ASX believes that the co-regulatory model has served financial markets very well. Market operators like ASX have a strong vested interest in the efficient and robust regulation of the markets they provide. They are also better placed to respond quickly to develop best practice and to strive for improvements in the efficiency and transparency of market activity. The proximity of the market operator to the market and its participants allows it to respond quickly and cost effectively to changes in the market dynamic and indeed, to anticipate them. A change to the rules governing market activity – the contractual arrangements between the market operator and its customers, is a more expedient process than legislative change.[4]

2.8 The ASX's assessments of the advantages of the framework in which it operates are not disinterested. However, it is significant that a number of the other submissions and evidence received by the Committee during the inquiry also supported the co-regulatory model and supervisory framework and identified advantages flowing from them. For example, in its submission the Securities Institute of Australia said:

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2 See The Treasury, Submission No. 5, p. 4.

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

4 ASX, Submission No. 2, p. 5.

> There are considerable advantages with the current supervisory framework of Australia's stock exchanges. These advantages revolve around having experienced, well-funded, independent experts who currently perform the role rather than regulators with little or no practical experience. Being close to the market is essential to this important function.[5]

2.9 The Chartered Secretaries Australia (CSA) also expressed confidence in the current arrangements:

> Chartered Secretaries Australia is not aware of any major concerns among its members with respect to the present regulatory framework for Australia's stock exchanges…Chartered Secretaries Australia also believes that the current framework is appropriate for supervision of the activities of ASX.[6]

2.10 A possibility that major changes in the regulatory structure might be contemplated also appeared to concern the CSA, leading them to warn about the consequences of imposing additional regulation:

> …CSA is concerned that any additional layers of regulation would increase costs that would ultimately be passed on to companies through listing fees. The ASX, and Australian companies, must remain competitive in worldwide terms. Any increase in the cost of doing business should be avoided.[7]

2.11 Representing Australia's institutional investment managers, the Investment and Financial Services Association (IFSA) also expressed general support for current arrangements, despite holding reservations about some aspects, as elaborated later in this report. Ms Lynn Ralph, Chief Executive Officer, told the Committee that:

> I have to say that probably in general our view would be that the market works pretty well here in Australia, people have reasonable confidence in it. That is not to say that it is perfect by any sense of the imagination. Do we think that there needs to be a shift in response to some problems, concerns or lack of confidence? I would be surprised if my members felt that there should be some sort of conscious shift in the balance between listing and regulation and legislation at this time without some evidence that there was some serious problem and/or serious breach in the perceptions that people had about how the market was operating.[8]

2.12 The Australian Shareholders' Association (ASA), representing the individual investors who comprise 26 per cent of the Australian equities market,[9] while expressing reservations about some aspects of the framework, (in particular the

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5 Securities Institute of Australia, Submission No. 1, p. 1.

6 Chartered Secretaries Australia Limited, Submission No. 6, p. 2.

7 Chartered Secretaries Australia Limited, Submission No. 6, p. 2.

8 Evidence, p. 38.

9 Australian Shareholders' Association, Submission No. 12, p. 1.

perception of conflicts between ASX supervisory and commercial roles) also appeared to generally support the current framework:

> Subject to the following comments we agree with ASIC in supporting the continuance of the current legislative model as modified by the changes which we understand are proposed by the Financial Services Reform Bill.[10]

2.13 The ASA continued:

> While we support the present co-regulatory framework involving ASX, ASIC and the Minister we agree with the Securities Institute that a disadvantage of the current framework is the possibility of a perceived conflict between the role of the ASX as a profit making company and its supervisory role.[11]

IOSCO view

2.14 The self-regulatory model is also viewed favourably by the International Organization of Securities Commissions (IOSCO). In a recent review of self-regulation, IOSCO was of the view that self regulatory models have a number of advantages resulting from their familiarity with the industry and can be efficient and cost effective:

> Overall, self-regulation fosters integrity in the marketplace and among participants. Moreover, it is an effective method of regulation because self-regulatory organizations are familiar with the increasingly complex nature of the industry as well as the products developed and marketed by members and member organizations. SROs [self regulating organisations], therefore, have the specific knowledge and ability to effectively implement and conduct efficient and cost-effective regulatory programs.

2.15 IOSCO emphasised that there is a need to subject SROs to appropriate accountability mechanisms 'to ensure that regulatory responsibilities are discharged properly and that the regulated markets operate in accordance with general performance standards in the public interest'. IOSCO noted that properly implemented self-regulatory regimes can produce 'efficient rules, wide compliance with and acceptance of those rules, timely adjustment of rules to meet changing conditions, and flexible and effective enforcement'.[12]

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10 Australian Shareholders' Association, Submission No. 12, p. 3.

11 Australian Shareholders' Association, Submission No. 12, p. 5.

12 Model for Effective Regulation – Report of the SRO Consultative Committee of the International Organization of Securities Commissions, May 2000.

CHAPTER 3

DISADVANTAGES AND SHORTCOMINGS

Introduction

3.1 This Chapter examines disadvantages or perceived disadvantages identified in the evidence and submissions. It also looks at the ASX's response to the major issue, namely the perception of possible conflict of interest arising from the ASX supervising organisations against which it also competes.

3.2 While many submissions and witnesses supported the current framework for market supervision, several criticised the framework. Some, while supportive of the overall approach, identified shortcomings in limited areas. The ASX itself falls into this category, as does IFSA.

3.3 Other submissions were far more critical, identifying what they saw as major disadvantages. Dr Shann Turnbull, for example, contended that the market supervisory framework is fundamentally flawed because of what Dr Turnbull identified as a lack of transparency in trading, permitting market manipulation.

3.4 The submissions and evidence of Computershare, IFSA, Mr Ross Catts, the Australian Shareholders' Association and Boardroom Partners addressed the major issue of the inquiry, namely conflicts of interest between ASX's supervisory and commercial objectives. Computershare contended that the ASX's continued supervision of listed companies that are also commercial competitors gives rise to what Computershare argued is an irreconcilable conflict of interest that cannot be addressed within the current framework. Computershare argued that the ASX's expansion of its activities into areas occupied by other companies created potentially unfair competition.

3.5 IFSA's submission and evidence addresses an issue that relates to the balance ASX must strike between meeting commercial and supervisory obligations, operating a market dependent on information flows. IFSA expressed concern about the implications of ASX charging for information previously provided free. Mr Catts and the ASA also had concerns about the availability of information in a post demutualisation commercial environment.

3.6 In the following sections of this Chapter, the Committee examines the disadvantages of the current framework, which fall into the following broad categories:

- shortcomings identified by the ASX itself, predominantly related to rigidities, duplication and costs;
- transparency of trading issues;

- perceptions of conflict between supervisory and commercial objectives; (for example, through new charges imposed for the provision of information and restrictions on the availability of information); and
- potential conflicts of interest relating to market supervision of ASX competitors arising from ASX expansion of commercial activity.

3.7 The latter two points are identified separately for the purposes of this discussion but in reality, the two are closely related. Both originate from the ASX's demutualisation and expansion into new commercial territory through the vertical integration of related services.

Shortcomings identified by the ASX

3.8 As noted above, the ASX argued forcefully for the retention of a supervisory framework based on the co-regulatory model. Clearly, the ASX believes that this is the best approach to market supervision. Nonetheless, the ASX expressed concern about a number of aspects of the current arrangements. Predominantly, these concerns related to the direct costs to the exchange of implementing the supervisory framework, and indirect costs associated with a perceived lack of flexibility and management of authorisation and approval processes.[1]

3.9 The ASX drew a distinction between shortcomings in the regulatory framework and those in its own supervisory framework. Within the regulatory framework the exchange identified what it sees as the following shortcomings:

- the detailed prescription that applies to market supervision;
- a lack of flexibility in the current legislative framework for the National Guarantee Fund (NGF), rendering it incapable of accommodating future needs and general industry developments; and
- rigidities with the current structure in the context of ASX's international alliance proposals.[2]

3.10 The ASX expected that the FSR bill would address some of these shortcomings:

> One of the great benefits of the FSR Bill will be to allow us to separate the NGF's clearing support function from the NGF's function of protecting investors/consumers from 'improper' conduct by Participating Organisations. This will be consistent with overseas models…
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> …

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

2 ASX, Submission No. 2, pp. 7-8.

> The Bill…provides long overdue harmonisation of regulatory treatment of securities and futures. It also moves towards a more principles based, flexible regime.

3.11 However, the ASX remained of the view that despite the changes to be introduced by the Bill, shortcomings in the framework would remain:

> …it does not diminish the level of regulation and thus of regulatory costs faced by securities exchanges. Nor does it change the fundamental approach to the supervision of securities exchanges.[3]

3.12 The ASX sees these alleged shortcomings as important because of the costs that flow from them. These costs are both direct, adding to transaction costs, thereby decreasing the ASX's ability to compete for liquidity on a global capital market; and opportunity costs incurred by the exchange itself, handicapping its efforts to expand its range of products and services. At a primary level, these opportunity costs limit the ASX's opportunities for generating revenue. This might be thought to be of concern only to the ASX's shareholders, but the ASX argues that there are wider ramifications, as the range of services and thus efficiencies it can offer potential clients contributes to its ability to compete for liquidity on a global market.

3.13 The exchange reminded the Committee that Australia's share of the global capital market is very small, pointing out that in the MSCI World Index, which is widely used as the basis of asset allocation by international fund managers, Australia accounts for approximately 1.43 per cent of the global market. It argued that investors would be cautious about investing in the Australian market instead of foreign markets if they are not confident they can liquidate their investments readily and at low cost. The factors identified by the exchange as having influence over liquidity were information, transaction costs and market security and integrity.[4]

3.14 The ASX's efforts to remind the Committee of these issues appear to be based on what can be distilled to a fairly simple message: regulators (and by implication, legislators) should be mindful of the flow-on effects of regulatory compliance costs on Australia's ability to compete for capital on a global capital market. Investors and the issuers of financial products will seek the security offered by a high integrity market but will also be influenced by efficiencies in and costs of transacting business in that market. As such, operating a successful and globally competitive market requires careful balancing of market integrity measures (supervision and regulation) against the cost associated with achieving that integrity. Both over-regulation and inadequate regulation have the potential to be damaging.

3.15 The ASX separately identified what it described as inadequacies in its own rules, focussing on the degree of detail and prescription, duplication of requirements embodied in law and corporate governance requirements:

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[3] ASX, Submission No. 2, pp. 7-8.

[4] ASX, Submission No. 2, p.7.

> Our rules tend to be very detailed and prescriptive. In the business conduct and client relationship areas, rules often duplicate or supplement Corporations Law requirements or common law principles. Our listing rules include corporate governance rules concerning management of a listed entity and its daily operations which do not have a directly evident effect on the market.

3.16 The exchange expressed concern about the resulting compliance costs and how these might affect its customers, observing that the situation may be exacerbated over time.

3.17 The ASX expressed a desire to divest itself of the responsibility for aspects of the business conduct and client relationship rule framework, suggesting that either ASIC or an appropriate industry body regulate and enforce these aspects of market supervision. The exchange did not think that this would compromise the market but rather would 'allow us to concentrate our supervisory efforts on matters which are essential to the maintenance of market integrity and efficiency'.[5]

3.18 In this regard, the Committee also notes the evidence from Mr Richard Humphry, Managing Director and Chief Executive Officer, ASX, that the ASX has:

> …no powers of regulation. We have listing rules and we have business rules…We are not resiling from our responsibilities here, but we are trying to point out that we are not an extension of government, we are not a government agency. We are running a market as a market operator and we are licensed.[6]

3.19 The Committee accepts the validity of some of the exchange's arguments, particularly in relation to the responsibility that rests on both the operator and regulatory authorities to operate as efficiently as practicable. The Committee also accepts that the ASX wishes to maintain the integrity of the market and has a strong vested interest in doing so. However, the exchange's views about the level of regulatory safeguards required to maintain market integrity cannot be regarded as disinterested. The Committee considers that ASIC and the Minister should consult with all stakeholders before making the changes to the regulatory framework sought by the ASX itself.

Transparency issues

3.20 In his submission, Dr Shann Turnbull argued that the present framework is fundamentally flawed because of what he considers to be a lack of transparency in trading. Dr Turnbull identified the following issues as shortcomings:

- investors are not allowed to know the identity of the counter party when they are buying or selling securities;

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

6 Evidence, pp. 21-22.

- those who control the trading of securities can hide their identity through nominee companies; and
- the relationship between the beneficiaries of securities and the controllers is hidden.[7]

3.21 Dr Turnbull argued that the existing framework, by not disclosing identities and relationships between persons trading securities, provides opportunities for market manipulation, necessitating complex and costly regulatory activity to control it. He said:

> The existing framework facilitates, protects and so promotes opportunities for unethical activities. It creates markets that are both inefficient and unequitable. It introduces the need for extensive, intrusive and costly prescriptive laws, regulation and official monitoring of market activities.[8]

3.22 Dr Turnbull advocated a trading regime described as 'sunlight trading', under which the identity of buyers and sellers of securities must be fully disclosed before trading takes place, and continuous disclosure requirements re-directed from corporations to individuals. Dr Turnbull contended that under this system, market leading or manipulation as a result of access to privileged information would be impossible. He considered that a sunlight trading regime would enable exchanges to be essentially self-regulating. He concluded that under such a regime, market manipulation through insider dealing and price manipulation would be made much more difficult:

> The existing system of trading securities is inconsistent with transparency and the introduction of self-regulation. As a result it has produced extensive intrusive regulation and costly monitoring with inadequate and dubious benefits. Full transparency to facilitate self-regulation would significantly reduce the need for complex prescriptive laws, regulation and monitoring. To obtain the privilege of obtaining negotiability of their investments, shareholders must forgo the right to privacy and anonymity. Concerns for privacy and anonymity are inconsistent with the public interest in establishing both a fair and efficient public market in securities.[9]

3.23 Dr Turnbull's recommendations for achieving the required transparency in the market's operations were as follows:

> (i) [As] a condition for <u>any</u> company being allowed to remain registered is that it be required to provide on a web page for public inspection without charge all the information which it must make publicly available by law or by <u>any</u> regulator;

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7 Dr Shann Turnbull, Submission No. 3, p. 1.

8 Dr Shann Turnbull, Submission No. 3, p. 1.

9 Dr Shann Turnbull, Submission No. 3, p. 3.

> (ii) Only allow corporations and other types of issuers to have their securities publicly traded on condition that legal title will only be recognised by the issuer if:
>
> > (a) The vendor discloses the parties who directly or indirectly control the authority to dispose of the security to the purchaser before execution of a trade;
> >
> > (b) Any change in the parties who directly or indirectly control the authority to dispose of the security is reported to the issuer who at the same time makes this information publicly available through a web page linked to the parties executing the trade; and
> >
> > (c) The holder of a security reports to the issuer the relationship between parties who control directly or indirectly the trading of the security and the beneficiaries of the securities.[10]

3.24 The ASX rejected Dr Turnbulls's proposals:

> …we believe that the platform, which you saw a demonstration of today, is at the transparent end of the global spectrum in relation to markets. We do not believe that the kinds of sentiments expressed in the Turnbull submission have any basis in fact.[11]

3.25 While sympathetic to Dr Turnbull's commendable aim of promoting integrity within the market, the Committee is unconvinced of either the need for or practicality of his proposal. While examples of attempts at market manipulation and companies failing to comply adequately with their continuous disclosure obligations can always be found, the Committee has received little evidence to suggest that problems in the market are widespread, or that the supervisory framework is inadequate in performing its task. The Committee considers that the continuous disclosure requirements imposed on companies traded on the ASX also provide much of the transparency sought by Dr Turnbull. Other laws dealing with the disclosure of directors' interests and changes in significant holdings also add to the transparency of the market.

3.26 Most other commentators, including those with much to lose if the market were operating other than with integrity, have also supported the current system.

3.27 Further, from what the Committee has seen of the ASX's sophisticated monitoring program, there is reason to believe the market is being monitored effectively, minimising opportunities for manipulation.

3.28 The Committee would be concerned at any proposal to unilaterally introduce the system proposed by Dr Turnbull as it would place the Australian market at odds with practice in most other markets and may open up opportunities for arbitrage.

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[10] Dr Shann Turnbull, Submission No. 3, p. 3.

[11] Evidence, p. 28.

Potential conflict between supervisory and commercial objectives

3.29 Several submissions identified a possible conflict for the ASX between its post demutualisation and listing obligations to return a profit to shareholders by engaging in commercial activity, and its continuing obligations to supervise market operations.

3.30 The Treasury submission defined the nature of the problem:

> …demutualisation and changes to exchange ownership and organisation have the potential to expose tensions between exchanges' supervisory obligations and their commercial objectives to maximise profits for the benefit of shareholders. While the operation of proper supervisory practices is likely to be seen by exchanges as consistent with profit maximising objectives over time, the tension that is created by demutualisation could manifest itself, or just as importantly for market integrity, be perceived by market participants to manifest itself in a number of ways – for example, insufficient devotion of resources by an SRO to its regulatory function, or the calling into question of its capacity to supervise a listed entity with whom it was in direct competition.[12]

3.31 The Treasury advised the Committee that because of these potential conflicts, one of the Government's key policy objectives must be to ensure that the board and management of an exchange pay sufficient attention, and devote sufficient resources, to the task of maintaining a well functioning market.

3.32 This issue manifested itself during this inquiry not so much in terms of the amount of resources that the ASX devotes to supervisory responsibilities, but rather the ASX's maximising revenue through the imposition of fees and charges for information formerly provided free. Submissions on this subject appear to have been provoked by several different but related issues, including:

- the availability and commercialisation of information; and
- standards of listed companies.

Availability and commercialisation of information

3.33 Several witnesses pointed to apparent changes in the ASX's policy of charging for information that was previously free as one aspect of commercial imperatives affecting the exchange's ability to run a fair and orderly market.

3.34 The availability of information is accepted as essential to market integrity and indeed, continuous disclosure requirements are central. However, investors also use a range of other information produced by the exchange, a proportion of which they regard as constituting a 'public good', a necessary part of the exchange's operations. One of these items of information is market indexes.

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

3.35 Historically, the ASX produced a range of indexes, such as the all-ordinaries index, which tracked market movements. The ASX has, however, sold its index business to Standard and Poor's (S&P). IFSA advised the Committee that S&P have now sought to licence the use of the indexes:

> What was essentially a public good and not charged for under the old demutualisation structure subsequently became a revenue generating item as a demutualised company.

3.36 IFSA told the Committee that demutualisation has called into question many of the assumptions market participants have held in relation to the services provided by the ASX. IFSA questioned whether ASX had struck an appropriate balance between its market operator and commercial roles in this case:

> We consider that the public interest nature of the services provided by ASX must be balanced against the need to promote the interests of shareholders…
>
> I guess the issue really comes down to the fact that, on the one hand, the ASX see things like market information as an asset which they can generate a return from. On the other hand, as investors we see that information as something that makes the wheels of the marketplace move.[13]

3.37 IFSA acknowledged that the payment of fees for information was not a major issue for most of its members. However, it pointed out that for small shareholders, the issue was more important due to their more limited resources. Two other submissions, those of the ASA and Mr Ross Catts, elaborated on this theme.

3.38 Mr Catts, an individual investor, complained about what he saw as 'the expense and cumbersome nature of comprehensive access to information disclosed by ASX listed entities'. He claimed that as a result, 'the benefits for the efficient allocation of capital in the economy that can flow from a well informed investing public are not being realised'. In Mr Catts's view, this also leads to an inequity between institutional and private investors, institutional investors having a comparative advantage.[14]

3.39 Mr Catts identified September 1996 as a turning point in the quality of information available to individual investors, a time when the ASX was contemplating demutualisation. Up until that time, all disclosures were available on microfiche but subsequently, only on computer database. According to Mr Catts, costs to the small investor of obtaining detailed market information, beyond that available via signal G, have escalated to the point that they are prohibitive:

> Printouts from ASX's MAPS database, obtained via telephone or fax requests, then post or fax dissemination, cost $5.50 file access fee plus $0.44

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13 IFSA, Submission No. 10, p. 4.

14 Mr Ross Catts, Submission No. 9, p. 9.

> per page plus postage. Many disclosure documents are over 100 pages and are expensive items to the point where many investors are deterred.[15]

3.40 Signal G also incorporates a 20 minute delay from the time of announcement, whereas institutional investors can have access to real-time data via systems such as Bloombergs, which also provide (for a fee) the detailed information of the kind sought by Mr Catts. This also places the small investor at a disadvantage to the larger investor, although it must be acknowledged that this would probably only make a difference for that very small number of individual investors who were operating as day traders.

3.41 Nonetheless, there is a perception in some areas that the ASX's practices in respect of information provision create two classes of investor. Mr Dudley Chamberlain, Senior Executive, Computershare, drew the Committee's attention to an article written by Stephen Bartholomeusz which, he maintained, identified the nub of the problem:

> The basic problem, however, is that even after improving access to corporate information, by editing company announcements and by charging those who want immediate access to the full unedited version of those announcements, the ASX creates two classes of investor – those who can afford to pay for instant and complete information and those who can't.[16]

3.42 Mr Ted Rofe, Chairman, ASA, supported a number of the views put forward by Mr Catts. Mr Rofe advised that the ASA's recommended approach to addressing the availability of data is to require listed companies to post it on their websites:

> Our current approach is that, as a condition of listing, all listed companies should be required to maintain a web site on which they publish statutory information – annual reports, continuous disclosure information – as soon as it is released to the ASX. As more than two-thirds of companies are already doing it, there is no good reason why all listed companies should not have a web site.[17]

ASX response

3.43 The ASX rebutted suggestions that there has been a drop in the access and quality of information since demutualisation, arguing that the reverse is true. In a supplementary submission, the ASX contented that since demutualisation, it had substantially reduced the cost of access to real time market data and continuous disclosure information.

3.44 Addressing the issue of the 20 minute Signal G delay, Mr Humphry advised the Committee that this was in accordance with international general practice. The

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15 Mr Ross Catts, Submission No. 9, pp. 2-3.

16 Quoted in Evidence, p. 55.

17 Evidence, p. 66.

exchange also claimed that prior to demutualisation the delay was 8 hours. Summing up its response to Mr Catts, the ASX asserted that:

> These changes, combined with the continuing growth in on-line access by private investors, has meant that the average investor now has more information concerning ASX markets available to them than at any time before ASX demutualised.[18]

3.45 The ASX also addressed the cost of information issue raised by Mr Catts and others, pointing out that there are costs associated with receiving, storing, processing and disseminating continuous disclosure documents. Mr Humphry explained:

> [But] I think it is a mistake to think that the ASX somehow gathers information in a costless way and then sends it out and somehow clips the ticket. We have to reorganise that information and compile it in a way so that it is a signal which is going out in a coherent manner. The cost of actually gathering all that information, coordinating it and streaming it - we have about a dozen signals that we send out - is not something which is costless.[19]

3.46 The exchange maintained that the fees charged are to recoup these costs and are in line with similar fees charged by ASIC.[20] Mr Humphry argued that if there were a requirement that all information had to be provided free, the costs of this would have to be recovered elsewhere:

> If the community says we will have that information for nothing, what that will tend to mean is that the total cost of all of that provision of information will simply arise through some other mechanisms, through trading figures or whatever.[21]

3.47 The ASX also point to technical difficulties associated with supplying complete continuous disclosure information in the quantity and detail sought by Mr Catts and others. Mr Humphry told the Committee that limitations on internet technology complicated the task of getting information out more quickly. An example of this is that it would take up to 2 hours 42 minutes for an average internet connection to download a disclosure document made up of 35 megabytes.[22] In Mr Humphry's assessment, the ASX is 'getting it about as fast as we could probably serve it to them'.[23]

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18 ASX, Submission No. 2B, p. 9.

19 Evidence, pp. 23-4.

20 ASX, Submission No. 2B, p. 10.

21 Evidence, p. 23.

22 ASX, Submission No.2B, p. 9.

23 Evidence, p. 24.

3.48 A possible solution to the obstacles faced by smaller investors in obtaining information is the reintroduction of the ASX library system, offering access to computer terminals. This would give individual investors access to these documents but would only assist investors in major cities. A further solution would be to encourage listed companies to make better use of web pages. This would involve companies posting information on their websites at the same time as they release it to the ASX. This would eliminate the 20 minute Signal G delay. The time to download large documents is likely however to remain a problem for the average internet connection.

3.49 The Committee sought ASIC's view about the provision of information to the market by the ASX and whether it is reasonable to charge to disseminate information. ASIC's Deputy Chairman, Ms Jillian Segal, affirmed the importance of the dissemination of market information, noting that a number of other markets have previously charged a fee for information and are now moving away from charging.[24]

Standards of listed companies

3.50 A further possible manifestation of commercial objectives clashing with supervisory requirements was identified by Boardroom Partners, a 'boutique consultancy formed to provide corporate governance advice to a wide range of enterprises',[25] who questioned how the need to satisfy the income requirements of ASX shareholders fits with the equally important need to regulate the market for shares in listed companies. Boardroom Partners pointed out that 'surveillance, investigation and enforcement is a drain upon profits'. They acknowledged that without expenditure on these items the ASX's reputation would suffer, but maintained that 'there is little financial incentive for the ASX to maximise its expenditure and involvement in this important activity'.[26]

3.51 Boardroom Partners maintained that the collapse of a number of companies illustrates its point. Boardroom Partners contended that many of these companies should not have been allowed to list because of past failures of directors and inadequate capital. They also implied that both the ASX and ASIC had failed in their monitoring of the continuous disclosure requirements. The conclusion that Boardroom Partners appeared to be drawing was that investors may believe that the ASX is reluctant to regulate listed companies to the fullest because of the cost of doing so.[27]

3.52 The Committee also sought information from ASX about the same matter, asking about media allegations that the ASX had reduced listing standards in order to attract listings. The ASX responded to these issues by denying that it had dropped listing standards since demutualisation. It pointed out that ASX's market admission

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24 Evidence, p. 10.

25 Boardroom Partners, Submission No. 11, p. 2.

26 Boardroom Partners, Submission No. 11, p. 5.

27 Boardroom Partners, Submission No. 11, p.5.

criteria require companies wishing to be listed to satisfy minimum standards of 'quality, size, operations and disclosure' and sufficient investor interest demonstrated. The exchange concluded that neither it nor ASIC make judgements about the investment worthiness of a company. The disclosure and transparency requirements assist investors to make their own decisions about this matter.[28]

3.53 The Committee also notes that Boardroom Partners' assertions about a lack of incentive to maintain integrity are directly contrary to the ASX's evidence and that of a number of other significant commentators who argue that the contrary is true – that ASX does have a strong vested interest in maintaining integrity. The Committee also notes that in 2001 the ASX commenced posting its proposed listing rule changes on its website and inviting comments on proposed changes.[29] The Committee encourages the ASX to continue with this practice in order to ensure that all interested people can participate in the rule-making process and to ensure transparency in the process. The Committee was also advised by Treasury that the Minister for Financial Services and Regulation has a power to disallow listing rule changes.

3.54 The ASX also has a power to waive listing rules and maintains a public register of listing rule decisions.[30] Treasury advised the Committee that ASIC is advised of listing rule waivers and monitors the circumstances in which such waivers are granted.

3.55 The Committee believes it is essential that the Minister and ASIC exercise their responsibilities diligently in order to ensure accountability in, and transparency of, changes in operating rules and any waivers from those rules. The Committee also recommends that the register of listing rules decisions include reasons for those decisions – subject to considerations of commercial confidentiality – and be available on the ASX website.

Potential supervisory conflicts of interest

3.56 The ASX is in the process of expanding beyond its core listing and trading services into other areas such as registry and information services. For example the ASX has acquired interests in Bridge DFS, a company providing desktop information services to the investment industry; Orient Capital, a strategic investor relations group; and a share registry organisation now known as ASX – Perpetual Registrars. The ASX's commercial activity brings it into possible competition with other established

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28 ASX, Submission No. 2B, p. 1.

29 This change follows controversy in mid 2000 when the ASX relaxed listing rule requirements applying to shareholder approval of employee incentive schemes. Under the listing rule change, which press reports suggested took many within the industry by surprise, approval requirements were reduced from 75% of shareholders to 50%. IFSA subsequently disagreed with the change, urging company compliance with its Corporate Governance guidance notes instead of the lower ASX requirement. A major reason for controversy surrounding the change appears to be that it came into effect before many within the industry were even aware of it. ASX's initiative to list proposed changes on its website should avoid future controversy of this nature.

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

providers of these services. For example, Computershare is a large international company that competes with the ASX for business in several of these areas.

3.57 While competing with these other service providers, the ASX nonetheless has a continuing responsibility to supervise its competitors, giving rise to perceptions that conflicts of interest may arise. A similar issue exists in respect of the demutualised exchange supervising itself as a self listed entity, although this issue is comprehensively covered in a Memorandum of Understanding (MOU) between ASX and ASIC.

3.58 Computershare Ltd's submission was one of the more prominent that raised the issue of conflicts of interest arising from the ASX's moves into new spheres of activity. However, a number of other submissions also commented about the same matter. Boardroom Partners also considered that the potential for conflict of interest was an inevitable consequence of a demutualised ASX diversifying into new commercial activities. They questioned whether the supervisor of the listing rules could monitor its own activities.

3.59 Computershare explained that it considered the ASX's power to set and apply trading rules could give it the opportunity to use this power to further its own interests at the expense of competitors, creating a major and untenable conflict of interest. Computershare illustrated its point in the following terms:

> We are now in a situation where a publicly listed company, the ASX, is able to make rules that may well supplement the law but are potentially capable of being anti-competitive in nature. By having the power to make and implement business rules and prescribe technical processes, the ASX have the potential to create actual commercial benefits for the ASX and rules that could favour the technical platforms of their commercial adjacent businesses, such as APRL – which is the share registration service – Orient Capital and Bridge.[31]

3.60 Computershare also questioned the transparency of the rule making process, contending that 'there is much less scope for transparency and review in the rule making process':

> Computershare's argument is that the ASX is in a position to exploit the advantages it gains from being the market operator to compete unfairly, use information about companies, proposed rule changes and proposed future changes to technology to create commercial advantage for itself.[32]

3.61 Computershare used the example of a seminar conducted by the ASX which was allegedly used as a vehicle for promoting Orient Capital to illustrate how the market can easily perceive a conflict of interest between the ASX's commercial

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31 Evidence, pp. 52-3.

32 Evidence, p. 53.

objectives and its supervisory activities. In response, the ASX strongly denied any improper behaviour but did acknowledge in evidence that adverse perceptions might mean that such events should be more clearly separated in future.[33]

3.62 Computershare's proposed solution to the perceived problem was essentially to break up the ASX's vertically integrated operation. They proposed the 'ring fencing' of ASX's commercial activities from its supervisory roles through the establishment of separate companies with separate ownership and governance to undertake these roles, and separating the management and supervisory function of ASX, SEGC and ASTC from ASX management of commercial business operations.

3.63 Computershare also proposed regulation to control anti-competitive activities covering areas such as:

- price control on monopoly areas to stop monopoly rents being extracted, at least while the monopoly exists; and
- prohibiting cross-subsidisation from monopoly areas to contestable areas.

3.64 Perhaps the most significant change proposed was the removal of the regulatory and rule making power from ASX, this function to be performed instead by ASIC.[34]

3.65 The ASX defended itself vigorously against Computershare's assertions. While acknowledging that diversification can create the potential for conflicts of interest, the ASX reminded the Committee that it is subject to legislative requirements (for example, s46 of the Trade Practices Act) that prevent abuse of market power. Further, it has introduced new measures (in particular ASXSR) to address the issue.

3.66 The exchange told the Committee that the concerns about conflicts of interest were based on perceptions and fears, not reality:

> Commentators who are critical of ASX tend to talk in generalities about perceptions and fears – tangible examples of actual conflict having compromised ASX's supervisory effort are not cited. That is because ASX's supervisory conduct is and continues to be diligent, professional and even-handed.[35]
>
> …
>
> The Computershare submission does not present a single example of misuse of ASX supervisory power in this area. Nor could it. The Computershare

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33 See discussion between Senator Conroy and Mr Humphry at Evidence, p. 22.

34 Computershare, Submission No. 4, p. 13.

35 ASX, Submission No. 2A, p. 2.

> submission, as conceded in evidence [at page E59-60] is motivated by self-interest.[36]

3.67 The Committee also notes that in evidence Mr Humphry said the ASX would not extend into commercial activities 'which would really inhibit our supervisory role'.[37] Nevertheless, the Committee is conscious that the ASX needs to be careful to balance its supervisory functions with its commercial interests. Mr Shane Tregillis, National Director, Policy and Markets Regulation, ASIC, best summed up the issues faced by ASX in this regard:

> There is the potential for a conflict of interest between their role as the market operator and regulator and the commercial interests. ASX performs, as it has set out in the submission, a whole range of important regulatory functions – its listing and business rules. So for important regulatory purposes, its infrastructure has important regulatory aspects to it. I think I would agree that it needs to be very careful that when it is dealing with its participating organisations or listing companies on regulatory matters that it, as far as possible, seeks to separate out commercial ventures that it might be dealing with.[38]

Addressing the conflicts of interest issue - ASX Supervisory Review

3.68 The ASX's major initiative in response to the perceptions about possible conflicts of interest is the establishment of the new subsidiary company, ASX Supervisory Review. The next Chapter deals with this body.

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36 ASX, Submission No. 2B, p. 5.

37 Evidence, p. 30.

38 Evidence, p. 10.

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.

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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:

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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

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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.

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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':

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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

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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 Chatper.

> 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 cetra. 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

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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]

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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.

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[28] Evidence, p. 27.

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.
>
> **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.

CHAPTER 6

OTHER FRAMEWORKS FOR MARKET SUPERVISION

Introduction

6.1 The Committee's third term of reference requires it to examine other frameworks or structures for market supervision, including frameworks or structures of, or examined by, overseas exchanges.

6.2 Demutualisation has been a global trend and many stock exchanges around the world have either demutualised, have taken steps towards demutualising or are contemplating this step. Almost universally, this has led to a discussion about market supervision, including alternative supervisory arrangements.

6.3 A difficulty faced by the Committee is that few submissions responded to the term of reference in any detail. As noted in Chapter 2, most submissions expressed satisfaction with the current model and expressed no desire to change it. The only notable exceptions were the Computershare submission and that of Dr Shann Turnbull, both of which have been discussed elsewhere in this report. There was very little detailed discussion of the issue at the three public hearings held.

6.4 Accordingly, the Committee has identifed a number of alternative models and their relative advantages and disadvantages.

6.5 The Committee has relied on three sources of information:

- the ASX submission;
- a white paper published by the United States of America's Securities Industry Association entitled "Reinventing self regulation" and
- papers published by the International Organisation of Securities Commissions (IOSCO).

6.6 The Committee has collated the information about alternative models in Appendix 3.

CHAPTER 7

EFFECTIVENESS OF TRADE PRACTICES LAW

How does trade practices law apply to ASX?

7.1 This Chapter focuses on the elements of Part IV of the *Trade Practices Act 1974* (TPA) which deal with anti-competitive behaviour. The majority of evidence in relation to this aspect of the terms of reference supports the current approach to applying the trade practices law to the ASX.

7.2 The Australian Competition and Consumer Commission is the independent government body which is responsible for ensuring compliance with Part IV of the TPA. The ACCC has jurisdiction to apply the sections of Part IV of the Act across all sectors of the Australian economy, including the ASX. The TPA is applied through a series of authorisations and court enforceable undertakings, examples of which are discussed later in this Chapter.

7.3 Part IV of the TPA prohibits the following anti-competitive behaviour:

- anti-competitive agreements and exclusionary provisions, including primary or secondary boycotts (section 45);
- misuse of market power (section 46);
- exclusive dealing (section 47);
- resale price maintenance (sections 48, 96-100); and
- mergers which would have the effect or likely effect of substantially lessening competition in a substantial market (sections 50, 50A).[1]

7.4 The purpose of Part IV in relation to the structure of the ASX is to deliver a market place which avoids monopolies and maintains competition, where practical. Monopolies are recognised as being detrimental to consumers because they can lead to higher prices, reduce innovation and deliver sub-standard services.[2] In addition, the application of Part IV encourages fair competition which in turn is aimed at generating lower transaction costs.

Exceptions and authorisations

7.5 In its submission, the ACCC outlined numerous examples of the role Part IV has played in ensuring a competitive stock exchange. It has achieved this by applying a flexible system of authorisations and court enforceable undertakings in relation to

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1 ACCC, Submission No. 7, p. 2.

2 ACCC, Submission No. 7, p. 3.

anti-competitive behaviour. Anti-competitive conduct which leads to possible breaches of the TPA can be exempted by the ACCC from legal proceedings. This is achieved by the application of an authorisation under section 88 of the TPA.[3] The Committee notes that rulings made by the ACCC are appellable via the Australian Competition Tribunal. This tribunal is an independent body headed by a judge of the Federal Court who is assisted by two lay persons such as an economist and a business person.[4]

7.6 The ACCC has applied this system to the ASX since the introduction of the TPA in 1974. The ACCC has made rulings in a variety of areas including acquisitions, proposed changes to the ASX listing rules and the introduction of new technologies such as the SEATS and CHESS systems.

7.7 When considering applications which seek to pursue actions that may breach Part IV of the TPA, the ACCC applies a public benefit test. The test requires that the applicant show that the results of the proposed activity, if approved, would lead to a public benefit outweighing the anti-competitive detriment.[5]

7.8 The concept of public benefit is determined, amongst other factors, as including such benefits as economic development and fostering business efficiency which improves international competitiveness.[6]

7.9 The 1992 decision in relation to SEATS is an example of the ACCC sanctioning an application which would lead to anti-competitive behaviour, on the grounds of a public benefit.

7.10 SEATS is a computer-screen based system which removes the need for floor trading. The SEATS system offers added efficiency and security for people trading in the market. The benefits gained by the use of SEATS contributes to the ASX becoming more competitive in the international market. The ACCC held that such advantages outweighed the possible breach of the TPA.

7.11 However, before approving the implementation of SEATS the ACCC required the ASX to agree to two points. Firstly, the ASX is required to supply market information to persons on reasonable commercial terms. Secondly, any restrictions in relation to intellectual property only apply in respect of where the law currently applies and to the extent necessary to protect the property.

7.12 By contrast, a notable example of an ACCC refusal of authorisation for an application from the ASX was in relation to the 1999 ASX bid for the Sydney Futures

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3 ACCC, Submission No. 7, p. 4.

4 ACCC, Submission No. 7, p. 5.

5 ACCC, Submission No. 7, p. 29.

6 Miller's Annotated Trade Practices Act 2000/21st Edition, Russell V Miller, LBC, Sydney, 2000, p. 637.

Exchange (SFE). In this case the ACCC decided not to grant permission for the purchase.

7.13 The ACCC determined that the bid would substantially reduce competition and so breach section 50 of the TPA. In evidence to the Committee the ACCC elaborated on this matter:

> Again, I think it was expressed pretty strongly in our decision on SFE-ASX that we considered the risk to innovation, development of new products, pricing for users and so forth. We really saw those as being at risk - the whole development - as the SFE and ASX...We always have a concern with monopolies if there is no external discipline or import discipline.[7]

7.14 On the day of the ACCC's decision, the ASX withdrew its offer for the SFE.[8]

7.15 As an alternative to either accepting or rejecting applications outright, the ACCC may exercise a third option, namely to seek and accept enforceable undertakings from entities under section 87B of the TPA. Such undertakings create court enforceable agreements in relation to arrangements into which entities enter. The use of 87B allows some manoeuvring amongst the parties and the ACCC when considering a proposal.

7.16 In relation to the ASX, the joint venture between the ASX and Perpetual Registrars Australia forming ASX Perpetual Registrars made use of the 87B provisions by creating an agreement which aimed to ensure the separation of the commercial and regulatory functions of the ASX. The agreement also ensured that the ASX would not discriminate between parties utilising the ASX's CHESS system.[9]

7.17 The ability of the ACCC to apply enforceable undertakings offers an element of flexibility to the management of the trade practices law in regard to the ASX. The Committee notes that this facility allows the ACCC to maintain competition in the majority of the proposals put to it.

Effects on competition

7.18 The ASX has made a number of submissions in the past proposing the removal of the ASX from ACCC jurisdiction in favour of regulation under the Corporations Law.[10] However, the Committee notes the important function the ACCC has performed, in terms of maintaining competition, with specific reference to the ASX.

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7 Evidence, p. 91.

8 ACCC, Submission No. 7, p. 20.

9 Evidence, p. 92.

10 ACCC, Submission No. 7, p. 3.

7.19 For example, the Australian Associated Stock Exchanges (AASE) has sought, in the past to introduce conditions on trading and entry as a broker into the ASX. The ACCC ruled that such conditions would be substantially anti-competitive and did not have the requisite public benefit.

7.20 In the current environment, the Committee considers that the role which the ACCC performs has taken on an even greater importance. The evolution of the ASX into a 'for profit' organisation has attracted criticisms in relation to trade practices issues, such as the potential for the ASX to misuse its market power.

7.21 Some of the fears relating to possible anti-competitive behaviour were expressed by Mr Chamberlain, a senior executive with Computershare:

> ASX's moves to vertically integrate its practical monopolies into areas where there has traditionally been competition, such as share registration and information distribution, are likely to have the effect of significantly reducing competition in those markets, with inevitable costs to consumers and reductions in levels of service and innovation.[11]

7.22 In its submission, Computershare pointed out the advantages the ASX has in the marketplace. Such advantages include the tendency for buyers of equity shares to gravitate to the market that has the most sellers and vice versa. The result is that the majority of market participants in equity shares direct their business to the largest market, the ASX.

7.23 Another example of ASX's advantage is its monopoly ownership of the CHESS system. Computershare pointed out that, currently, the CHESS system is the only electronic method authorised to transfer the legal title of shares of a company formed under the Corporations Law.[12] Although, under the FSR Act, other bodies may apply for a licence to operate a clearing and settlement (CS) facility, no applications have been received to date.[13] Computershare claimed that it is commercially impracticable to establish a competing CS facility due to the head start the ASX has enjoyed to this point:

> [I]n a situation where ASX dominates trading in equities in Australia it is not possible as a practical matter for a competing clearing and settlement service to be offered. This is because clearance and settlement of any market transaction needs both parties to the transaction to participate in the same system. Otherwise, the system cannot match the purchaser's payment with the delivery of securities by the seller.[14]

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11 Evidence, p. 52.

12 Computershare, Submission No. 4, p. 9.

13 *Financial Services Reform Act 2001*, s824A - s824C.

14 Computershare, Submission No. 4, p. 9.

7.24 The ASX did not agree that it was able to misuse its position in the market for its own commercial advantage, pointing out that the TPA prevents this:

> Legislative sanctions are available for misuse of position. ASX cannot take advantage of its market power for the purpose of eliminating or substantially damaging a competitor in any market, preventing new entrants to any market. To do so would constitute a breach of section 46 of the Trade Practices Act.[15]

Global competition issues

7.25 The changing global market places pressure on small markets such as the ASX. The Committee acknowledges that this issue is best dealt with by the application of new technology, more efficient practices and market depth. In addition to this, the ASX has also expanded its traditional core services. Such expansion is squarely aimed at staying in touch with international trends, as more exchanges become 'for profit' organisations.

7.26 The development of additional services and products through vertical integration also reflects the ASX's desire to maximise profits. The development of a larger, deeper market leads to a more stable environment, which in turn creates a more attractive investment environment.

7.27 Increasingly vertical integration and the expansion of commercial activity by an already strong organisation like ASX does have the potential to reduce competition. However, some witnesses to this inquiry expressed the view that strengthening the local operator's ability to compete on a global market is more important than ensuring a competitive market.

7.28 For example, the Chartered Secretaries of Australia expressed their disappointment with the rejection by the ACCC of the ASX takeover of the SFE. They argued that the SFE takeover would have been an efficient and effective way to add depth to the market, which would have helped better to position Australia in the international context.[16]

7.29 In a similar vein, the ASX argued that it operates in an environment of global competition,[17] and that an isolationist application of the TPA is out of step in that context. In response, however, the ACCC noted that, as part of the public benefit test, it does factor in the international perspective.[18]

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15 ASX, Submission No. 2B, p. 4.

16 Chartered Secretaries of Australia Limited, Submission No. 6, p. 3.

17 ASX, Submission No. 2B, p. 21.

18 Evidence, p. 94.

Cross subsidisation and the TPA

7.30 The Committee received some evidence arguing that there is a potential for the ASX to derive an unfair competitive advantage by using profits generated through its market supervision role to cross subsidise less profitable activities. Computershare argued in its submission that the only viable solution would be for the ASX to 'ring fence' its regulatory and monopoly infrastructure businesses from its commercial activities. Senator Conroy explored this potential problem during a public hearing at which the ACCC gave evidence:

> The argument is that there is a cross-subsidy taking place of the monopoly profits that are being generated in the regulatory function and then used to subsidise a commercial business against, say, Computershare or some other companies…Unless they are segregating their business so that they have no capacity to pass the money backwards and forwards, it is not possible to prove that they are not because you just have to assume that they are.[19]

7.31 The ACCC gave evidence that this could potentially constitute a breach of section 46 of the TPA. Mr Davey, Director of Mergers and Asset Sales explained:

> I think that particular conduct of leveraging of market power from one market into another would certainly raise issues under section 46 of the Trades Practices Act, which prohibits misuse of market power. There are mechanisms under the law to deal with these types of problems.[20]

7.32 The Committee is aware that the ACCC investigated the relationship between Bridge DFS and ASX, which holds 15 per cent equity in Bridge DFS, following a complaint made against the ASX in regard to a possible breach of section 46 of the TPA along these lines.[21] The complaint alleged that the accounting procedures used by Bridge DFS were inappropriate when calculating the fees owed to the ASX for the provision of real-time share market data. However, the ACCC found that the complaint could not be substantiated.

Conclusions

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

7.34 This flexibility was reflected in the 1986 application made to the ACCC in relation to the restructuring of stock exchanges to form the ASX.

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19 Evidence, p. 88.

20 Evidence, p. 89.

21 Additional information supplied by the ACCC.

7.35 In dealing with this application the ACCC considered advantages such as the efficiency of the market and the added security to investors of the creation of a larger market with more depth.[22] These advantages were considered to outweigh any anti-competitive results.

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

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

7.38 The Committee also notes that in the majority of submissions and evidence received, the adequacy of trade practices law in ensuring a competitive stock exchange market was not questioned. However, the Committee is mindful that as the ASX expands its activities into other commercial areas, it is causing concern to some of its competitors. The ASX is aware of these concerns. The Committee believes that moves to increase the transparency of the supervisory framework – including the establishment of the ASXSR – and the continued application of the Trade Practices Act to the ASX will assist in addressing those concerns.

Senator the Hon Brian Gibson
Acting Chairman

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22 ACCC, Submission No. 7, p. 8.

APPENDIX 1

SUBMISSIONS RECEIVED

1	Securities Institute
2	Australian Stock Exchange Limited
2A	Australian Stock Exchange Limited
2B	Australian Stock Exchange Limited
3	Management and Investment Services
4	Computershare Limited
4A	Computershare Limited
5	The Treasury
6	Chartered Secretaries Australia Limited
7	Australian Competition and Consumer Commission
8	Australian Securities and Investments Commission
9	Mr Ross Catts
9A	Mr Ross Catts
9B	Mr Ross Catts
10	Investment & Financial Services Association
11	Boardroom Partners
12	Australian Shareholders' Association Ltd

APPENDIX 2

PUBLIC HEARINGS AND WITNESSES

Monday, 9 April 2001, Sydney

Australian Securities and Investments Commission (ASIC)
Ms Claire Grose
Ms Jillian Segal
Mr Shane Tregillis

Australian Stock Exchange (ASX)
Ms Karen Hamilton
Mr Richard Humphry

Investment & Financial Services Association Ltd (IFSA)
Ms Lynn Ralph

Management and Investment Services
Mr Shann Turnbull

Computershare Ltd
Mr Dudley Chamberlain
Mr Peter Griffin

Australian Shareholders' Association Limited
Mr Ted Rofe

Chartered Secretaries Australia Limited
Mr Tim Sheehy

Boardroom Partners
Mr Ian Horton

Thursday, 3 May 2001, Canberra

Australian Competition and Consumer Commission (ACCC)
Mr Richard Chadwick
Mr Alistair Davey
Mr Mark Pearson
Mr David Smith

Mr Ross Catts

Securities Institute
Mr Alex Fabbri
Mr John Jarrett

Treasury
Mr John Jepsen
Mr Nigel Ray

Thursday, 31 January 2002, Sydney

Australian Stock Exchange
Mrs Karen Hamilton
Ms Christine Anne Jones
Ms Erica Ebeling Simes

Australian Securities and Investments Commission
Miss Jennifer Gai O'Donnell
Mr Malcom James Rodgers

APPENDIX 3

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.

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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 paper[2]

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 (ATSs) 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;

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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:

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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 oversighting 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 know 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 CHESS 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.

APPENDIX 4

TRIAL ARRANGEMENTS BETWEEN BETWEEN ASIC AND ASX FOR HANDLING CONFLICT AND PERCEPTIONS OF CONFLICT IN RELATION TO THE SUPERVISION OF ASX INTERNATIONAL SERVICES (AIS) AS A PARTICIPATING ORGANISATION OF ASX.

INFORMATION SUPPLIED TO THE COMMITTEE BY THE ASX

4 FEBRUARY 2002.

ASX
AUSTRALIAN STOCK EXCHANGE

4 February 2002

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Mr Peter Hallahan
Committee Secretary
Senate Economics Reference Committee
Suite SG.64
Parliament House
CANBERRA ACT 2600

Dear Mr Hallahan,

Inquiry into the framework for the market supervision of Australia's stock exchanges

At the inquiry hearing on 31 January the Committee asked us to provide the interim arrangements for the supervision role which ASIC will play in relation to monitoring and enforcing compliance by ASX International Services Pty Ltd (AIS) with ASX business rules, in AIS' capacity as limited purpose participating organization.

Please see interim framework attached. As mentioned at the hearing, it is proposed that there be a 3 month trial period. We are continuing to work with ASIC to develop the framework, including operational procedures and protocols, for formal sign off by the Commission.

If you require any further information, please do not hesitate to contact me.

Yours sincerely,

Christine Jones
General Counsel and Company Secretary

Cc Mr Malcolm Rodgers
Ms Jennifer O'Donnell
Australian Securities and Investments Commission

TRIAL ARRANGEMENTS BETWEEN ASIC AND ASX FOR HANDLING CONFLICT AND PERCEPTIONS OF CONFLICT IN RELATION TO THE SUPERVISION OF ASX INTERNATIONAL SERVICES (AIS) AS A PARTICIPATING ORGANISATION OF ASX

The following provisional arrangement will be trialled for 3 months and will be reviewed not later than 30 April 2002.

Conflict

ASX and SCH have obligations to monitor and enforce compliance with their Business Rules. AIS is a limited purpose Participating Organisation and is therefore bound to comply with the relevant Business Rules of ASX. It is important that ASX and SCH are and are seen to be acting impartially in their oversight of AIS, and that no favourable treatment is given to AIS by virtue of its position as part of the ASX group.

In order to deal with issues or perceived issues of conflict, ASIC will have a role in the supervision of AIS as a Participating Organisation. It is a condition of the securities dealers licence issued to AIS on 12 November 2001 that AIS must at all times comply with all applicable rules of the ASX Business Rules, unless ASIC or its delegate consents otherwise in writing, and with any direction given to the licensee by ASIC or its delegate in respect of the administration or application of the ASX Business Rules to the licensee.

These arrangements are intended to supplement ASIC's powers to supervise AIS's compliance with its licence conditions.

Areas of Potential Conflict

Areas of significant potential for conflict or perception of conflict are:

- monitoring AIS' compliance with rules;
- administration of waivers and discretions in relation to AIS under the rules;
- investigating suspected breaches of rules by AIS; and
- taking disciplinary action in respect of suspected breaches of the Business Rules by AIS.

Exercise of Supervisory Powers

ASX's supervisory powers and duties are administered by various business units in ASX.

Supervisory powers in relation to ASX Participating Organisations are generally exercised by or monitored by the following business units within ASX:

- Compliance and Information;
- Risk Management;
- Investigations and Enforcement (***I&E***).

The Compliance Officer of AIS or the ASX World Link manager must notify Compliance and Information or Risk Management (in relation to financial matters) if he or she believes AIS has breached or is very likely to breach an ASX or SCH Business Rule. In addition to performing their ordinary supervisory functions, in relation to matters with respect to AIS, Compliance and Information or Risk Management will also act in accordance with the arrangements set out below.

Compliance and Information

Compliance and Information undertakes many categories of supervisory activity for all Participating Organisations and therefore AIS, including:

- recognition (in conjunction with Risk Management);
- self-assessment and inspection programs;
- monitoring ongoing compliance with the Business Rules (including granting of waivers);
- withdrawal/suspension of rights of Trading/Recognition;
- referral to I&E for potential breach;
- monitoring supervisory activity in relation to AIS across ASX.

Risk Management

Risk Management undertakes many categories of supervisory activity for all Participating Organisations and therefore AIS, including:

- recognition (in conjunction with Compliance and Information);
- monitoring capital returns (detailing liquid capital and risk requirements);
- approving repayment of subordinated debt;
- recommendation of withdrawal/suspension of rights of Trading/Recognition;
- monitoring ongoing compliance with the capital requirement regime (including the grant of waivers);
- fining for late returns;
- monitoring supervisory activity in relation to AIS' financial affairs (in accordance with the above proposal); and
- referral to I&E for potential breach.

In relation to each of the above, the arrangement is that:

- prior to a decision involving the possible suspension/withdrawal of trading rights/recognition, ASIC will be provided by ASX with all relevant documentation and be consulted in relation to any such decision. ASX agrees to act in accordance with any reasonable direction or instruction given by ASIC,;
- prior to Compliance and Information or Risk Management deciding whether or not to refer a matter to I&E, ASIC will be provided with all relevant documentation and be consulted in relation to any such decision. ASX agrees to act in accordance with any reasonable direction or instruction given by ASIC.
- prior to the exercise of any waiver, Compliance and Information or Risk Management will seek the consent of ASIC and will provide all such information and assistance as ASIC requires to decide whether to give that consent;

- in respect of all other supervisory activity, ASX will notify ASIC (with all relevant documentation) simultaneously with or as soon after the supervisory activity or trigger for this is possible.

Investigations and Enforcement

Investigations and Enforcement may undertake the following categories of supervisory activity in relation to AIS:

- consider referrals from other business units and whether to pursue an investigation;
- investigate a potential breach;
- formulate charges;
- bring disciplinary action for an alledged breach before the National Adjudicatory or SCH Disciplinary Tribunals.

The perception of conflict for ASX may be most acute at this stage of the supervisory process and therefore ASIC will have a consultation and direction role at all stages of this process:

- ASIC will be provided by ASX with all relevant documentation and be consulted in relation to any decision relating to a decision to pursue an investigation, the steps to be undertaken in the investigation and the formulation of the charges and the supporting evidence. ASIC will be provided with all relevant documentation on a timely basis and will be given timely oral or written updates by the investigating officer. ASX agrees to act in accordance with any reasonable direction or instruction by ASIC.
- if a matter is to be brought before a disciplinary tribunal, ASIC may nominate an officer to present the matter to the relevant tribunal, with all necessary and relevant support from ASX. It will be for ASIC to determine at what stage in the proceedings responsibility for control of those proceedings shall devolve to ASIC's nominated representative.

General

ASIC and ASX will agree detailed procedures for the efficient and effective implementation of the above arrangements, including the nomination of relevant ASIC and ASX officers in relation to each of the responsibilities outlined.