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ASIC

Australian Securities & Investments Commission

Market Demutualisation and Privatisation: The Australian Experience

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Good afternoon ladies and gentlemen. Thank you for inviting me to contribute to this discussion today.

The topic of capital market demutualisation and privatisation is an interesting one and is one in which, we in Australia, have considerable experience. I would like to share that experience with you today.

In particular, I would like to begin with a brief description of the Australian market structure and its regulation, and then explain the demutualisation road that we have travelled. Finally, I will discuss with you our observations and thoughts on market demutualisation from a regulatory perspective, given the Australian experience.

Our own capital market demutualisation experience has been an evolutionary one, with the Australian legislation today, providing a clearer picture of the division of responsibilities between market operator and regulator (ASIC).

Fundamentally, "front-line" regulatory responsibilities in Australia sit with the market operator. Our structure is underpinned by the view that there are real advantages to having a market operator with public regulatory responsibilities that is able to use its closeness to the market to monitor broker activity and intervene quickly as required.

1. Features of the Australian Scene

The Australian Markets

Most of my remarks today will be about our experience with the Australian Stock Exchange (ASX) as Australia's premier capital market, which first raised the complex set of demutualisation-related issues that we have had to work through. The ASX experience, however, has close parallels to our other major market, the Sydney Futures Exchange (SFE).

To give you a picture of the Australian capital market landscape, let me quickly cover a few of the major features of each of the ASX and SFE.

ASX operates Australia's primary national stock exchange for equities, options and fixed interest securities. In the past 10 years, the volume of equities trade on ASX has risen by approximately 665% (ie. over six times) so that the market capitalisation of domestic equities listed in the Australian Stock Exchange in December 2003, was approximately A\$770 billion.¹

SFE on the other hand provides futures and options on the four most actively traded markets - interest rates, equities, currencies and commodities, and is the 10th largest financial futures and options exchange in the world by volume turnover.²

Both ASX and SFE are demutualised markets, with the ASX demutualising in 1998, and the SFE in 2000. Now, both the ASX and SFE are public companies with shares trading on ASX's market. Both ASX and SFE operate and manage their own clearing and settlement facilities. And, they both have significant global links. However neither ASX nor SFE have ownership links with other exchanges.

Market Intermediaries

Participation in the Australian marketplace also exhibits some interesting and unique characteristics.

While ASX obviously has some locally-based market participants, for example Macquarie Bank and Commonwealth Securities (ComSec), ASX market participants predominantly comprise large global players. These global participants are generally large US, UK or European conglomerate entities (for example: Merrill Lynch, JB Were, Morgan Stanley etc) that operate on the Australian market through separately incorporated vehicles.

¹ http://asx.com.au/shareholder/13/MarketOverview_AS3.shtm: 13/05/2004

² <http://www.sfe.com.au/index.html?content/sfe/intro.htm>: 13/05/2004

Interestingly though, many participants in the Australian market are not specialist stockbrokers. They are also generally involved in significant other business in the Australian financial services industry including corporate advisory, corporate finance, bond market, OTC derivatives trading and proprietary trading (ie. on its own account).

The result is that specific exchange related business remains only a small percentage of the overall business of Australian market participants. ASX's front-line supervision role is therefore limited to only part of the participant's business, with ASIC regulating non-market business.

Indeed, there is no market participant based Self Regulatory Organisation (SRO) in Australia as you may see in other jurisdictions. Rather, it is ASX itself that is responsible for supervision of the market, market participants and market disclosures.

- o I will speak more of this issue shortly.

2. Demutualisation – the ASX story

Let me now turn to the ASX demutualisation story.

When trading began in ASX shares on 14 October 1998, history was made. This was the first time, anywhere in the world, that exchange shares were traded on a market operated *by the exchange*.

96% of ASX members had voted in favour of demutualising the exchange following a campaign to persuade members that demutualisation was needed if ASX was to survive as a long-term commercial entity, and, on a larger scale, if Australia was to retain a viable domestic market for securities trading.

The analysis supporting demutualisation stressed that ASX needed to become more flexible, responsive and commercially focussed, capable of quickly taking up emerging commercial opportunities. The mutual structure of ASX, including at least 500 individual members as well as the large global institutional participants, was

seen to inhibit its ability to make rapid commercial decisions to meet emerging business opportunities and threats.

ASX was also focussed on the challenges posed by the global nature of financial market activity and saw that it needed to engage with the global market. However, this could not occur without changing the Australian laws.

1st Legislative Response

The first wave of legislative response was relatively limited. It was not a complete re-write of the market provisions of the old law, however it did contain some new concepts, the most important of which were:

- Detail on the exchange's obligation for market supervision including an express power to require it to do specified things to ensure it complies with supervisory obligations;
- Requirements that the exchange at least annually prepare and give to the regulator (ASIC) reports about compliance with their supervisory obligations; and
- Processes to require ASIC to act as the listing authority for ASX – ie. the role that ASX plays in relation to all other listed entities, to ensure that the ASX as a listed company complies with its disclosure obligations.

Importantly however, at this time there was no legislative basis for regulating conflicts between ASX's commercial interests and its obligations as market supervisor. The only conflict issue the law dealt with related to the ASX itself as a listed entity, not as a commercial rival of another listed entity.

Early market experience

Soon after ASX listing it became clear that Australia had indeed embarked on an adventurous journey as ASX surged forward with a number of commercial initiatives that gave rise to regulatory challenges. In December 1998 ASX announced a takeover bid for the SFE.

In May 1999 Computershare, a public company listed on the ASX, announced a rival bid for the SFE. Computershare has a major business in supplying market technologies, and a substantial part of the share registry business in Australia and elsewhere.

A major conflict of interest had arisen, and the sharp question for us as regulator was: "What arrangements can we put in place to ensure that the supervision of Computershare as a listed entity is not seen as tainted by the obvious conflict between ASX's role as a market supervisor and its interests as a potential commercial competitor?"

As I stated previously, the legislation had not dealt with this potential situation and a regulatory response was required. Accordingly, both parties entered into an agreement with ASIC which provided that, until the issue of the rival bids was resolved, ASX would not make any substantive decision about Computershare without first consulting ASIC and acting in accordance with the advice provided by ASIC.

This purely contractual arrangement was made public and details released to the market. Incidentally, neither ASX nor Computershare succeeded in their bids and SFE remains independent today.

In the three and a half years since demutualisation, ASX also pursued a number of other domestic business opportunities which could give rise to conflict, including:

- ASX acquired a 50% interest in a share registry business that competed for registry business with another company listed on ASX (Computershare) including competing for registry business of companies proposing to list on ASX;
- ASX acquired a 100% stake in an investor relations firm;
- An ASX subsidiary, ASX International Services, began operating as a licensed broker listed on the ASX (this is the vehicle through which ASX facilitates its links into the Singapore and US markets); and
- An ASX subsidiary – ASX Futures – was authorised as a futures exchange in direct competition with the SFE (also listed on the ASX).

As you can see, the potential for conflict was significant. And, it had become quite clear to both ASIC and the Government, that prompt legislative reform was required.

Market Response

ASX recognised the Government's concerns. It also recognised the importance of maintaining integrity in its own market, structure and supervisory obligations, and so in November 2000 created ASX Supervisory Review Pty Ltd.

ASX Supervisory Review is an ASX subsidiary that essentially operates as an arms length "process monitor" and "internal regulatory auditor". Its role is to ensure the integrity, efficiency and transparency of ASX's supervision of its markets.

ASX Supervisory Review distinguishes itself as a supervisory body that is separate from ASX, by having:

- independent directors;
- a mandate approved by the regulator (ASIC); and
- reporting on supervision to the regulator.

However, until recently there was no systemic structural separation of commercial and regulatory functions of the ASX.

2nd Legislative Response

On 11 March 2002, a clearer regulatory environment emerged with the introduction of the *Financial Services Reform Act 2001*. While the first legislative response made assumptions about the activities of exchanges in Australia, the current legislation makes it a statutory obligation that market operators do all things necessary to ensure that the market is operated in a "fair, orderly and transparent" manner.

The new Australian legislation is still based on a model where the market operator has 'front line' regulatory responsibility. However, it also prescribes that:

- ASIC will undertake an annual assessment of ASX supervision, including by way of public reports;

- Market operators must have in place adequate conflict management arrangements to deal with conflicts between commercial interests and ensuring the market operates fairly and transparently; and
- Single ownership of ASX shares is limited to 15%.

Corporations Regulation 7.2.16 was also enacted. This regulation is important as it allows ASIC to intervene, at the request of a commercial competitor of ASX, and to take a supervisory role where there is a specific and significant conflict, or potential conflict, between the commercial interests of ASX (or a subsidiary of ASX) and its market supervision obligations in dealing with a listed entity that is a competitor.

Interestingly, the new legislation has also removed the concept of “exchange” in Australia, such that the key concepts are now of:

- Market operator – being the ASX;
- Clearing and settlement facility provider – in the ASX case, the Australian Settlement and Transfer Corporation (ASTC) which provides settlement services through CHESS and the Australian Clearing House; and
- Financial services provider – the market participants.

3. Observations and Issues

Let me now briefly outline our observations of the demutualisation process.

As I stated previously, Australia's experience has been an evolutionary one where demutualisation-related issues have been quickly responded to by legislative reform. This has, in turn, seen changes to market supervisory arrangements aimed at maintaining market integrity and improving conflict handling arrangements.

It is clear from the Australian story, that in an environment of market demutualisation, regulators need to be prepared to quickly respond to conflict and other issues that might arise from the demutualised entity pursuing its own commercial objectives. These issues will not always be obvious in advance and may arise very quickly without prior warning from any of the parties, simply through the pursuit of legitimate commercial opportunities.

Indeed, even in Australia, where considerable efforts have been undertaken by ASIC, the legislators and the market itself, there remains a potential for conflict between the market operator's public role as front-line regulator and its role as a profit driven commercial enterprise seeking to maximise returns for its shareholders.

In its "Issues Paper on Exchange Demutualisation", the IOSCO Technical Committee stated that:

*"The commercial role of an exchange is to provide services to generate revenues from listing, trading services, settlement fees, fees for membership and charges for sale of market information."*³

Demutualisation may lessen some conflicts by separating ownership of the exchange from its participants. However all for-profit exchanges with public supervisory responsibilities face the potential for actual or perceived conflict, with the risk that it may be less willing to commit resources to enforcement, or to take action against market users and listed companies, who are a source of income for the exchange.⁴

Accordingly, in determining allocation of its resources, in setting its rules and in undertaking its supervision, a market operator must balance those commercial interests, and ensure that it continues to meet its supervisory obligations.

For its part, a market operator will assert that maintaining market reputation and integrity is a key objective to its own commercial success. And, that this commercial imperative complements its obligation to supervise the conduct of listed companies and participants on its market.

Mr Richard G Humphry AO, Managing Director & Chief Executive Officer of the ASX, distributed a paper last year at the World Federation of Stock Exchanges meeting wherein he stated:

³ Report of the Technical Committee of the International Organisation of Securities Commissions, "Issues Paper on Exchange Demutualisation", June 2001 (IOSCO 2001), p.6.

⁴ IOSCO 2001, p.6.

*"Our brand, that is to say our reputation and therefore our business and ultimately our very survival, depend on market integrity. Market integrity inspires confidence on the part of investors and listed companies, which in turn encourages further listing and trading activity, forming a virtuous and self-reinforcing cycle."*⁵

As regulator, we accept that ASX's reputation as a market of high integrity is imperative to its long term success, and note also that its commitment to maintaining market integrity must be supported by detailed processes to manage actual and potential conflicts of interest. All potential conflicts must be identified and adequate arrangements put in place to either avoid or manage those conflicts. Generally, these arrangements would also be subject to ongoing review for their effectiveness.

To this end, ASIC has welcomed the role of ASX Supervisory Review in managing ASX's potential conflicts of interest and reviewing internal policies and procedures for market supervision.

More generally then, we would make the following additional comments of a demutualised exchange that operates a dual role, as regulator and commercial enterprise.

Conflicts will arise. Conflict handling arrangements must therefore be embedded in the practices of the organisation's operational structure and must anticipate that conflicts will play out in different ways.

For instance, conflicts may arise between commercial business development considerations and the allocation of resources to supervisory activities. In such circumstances, allocation of resources to commercial activities must be matched by a corresponding focus on supervisory issues and resources.

If an exchange's brand is intrinsically linked to the integrity of the market, it will be in the exchange's business interests to maintain adequate resources for supervision. But in the real world it is easy to focus more on cost centres and

⁵ Richard G Humphry AO, Managing Director and CEO ASX, "Supervision: A Core Exchange Function", 14 October 2003, Annual Meeting of the World Federation of Exchanges.

direct profits, and such a focus is usually to the detriment of functions like compliance and supervision where the benefits are less direct.

Likewise, where emphasis is placed on customer relationship management by staff who also have a day-to-day responsibility for monitoring supervision (for example enforcing listing rules) it is crucial that such activities do not detract from staff ability or willingness to undertake that supervision appropriately.

Appropriate and robust governance arrangements are an extremely important part of ensuring that there are adequate accountability and control systems to make sure that the market continues to meet its supervisory obligations.

The Governance structure of a market needs to guarantee independent regulatory thinking and must have a structure that reflects and encourages this. Indeed, it is vital that an operator has in place appropriate formal structures for monitoring, testing and reviewing its own compliance with its obligations to supervise its market, including assessing how well it is delivering a fair, orderly and transparent market. And, it is important that senior management and ultimately the Board of such an organisation, is able to satisfy itself that it will comply with these supervisory obligations.

A structural separation of supervisory and commercial roles would further enhance supervisory independence and would generally be supported by:

- Quarantining information between commercial and supervisory areas;
- Use of internal management reports that identify incidents or exceptions to compliance with a market operator's obligations to supervise the market; and
- Recording supervisory decisions so as to facilitate scrutiny of all significant supervisory activity.

In this regard, I note that in January of this year, ASX has restructured its supervisory activities by creating a single division that is now responsible for managing and administering all of ASX's core supervisory activities. The effect is that there is now only overlap at the CEO / Board level.

Needless to say, we welcome these steps and will keenly watch and annually assess their effectiveness.

4. Conclusion

To conclude our discussion of the Australian experience, I'd like to reflect on the fact that capital market demutualisation was a path also trod by a number of other exchanges in the late 1990s and early this century.

And, while many in the regulatory community may have pondered the regulatory role of the exchange, I believe the Australian experience suggests that when the market operator recognises and safeguards the integrity of the market, 'front-line' public regulatory responsibilities can appropriately sit with the market operator.