



ASIC

Australian Securities & Investments Commission

MARKET DEMUTUALISATION AND PRIVATISATION: THE AUSTRALIAN EXPERIENCE

Jillian Segal

Deputy Chair

Australian Securities and Investments Commission

IOSCO Conference - June 2001

When trading began in shares in ASX Limited on 14 October 1998, history of a sort was made. Other market operators – such as the OM market – operated as listed, for-profit entities, but this was the first time as far as I am aware that exchange shares traded on a market operated by the exchange. Now, in 2001, Australia has four exchange markets: The Australian Stock Exchange (ASX); the Sydney Futures Exchange (SFE); and two smaller regional equity markets. They all have one thing in common – none has a mutual structure. For Australia, at least, the era of not-for-profit, mutual ownership of financial markets has passed.

My purpose today is to share with you some of the experiences we have had in the transition to this new world: to touch on some of the issues we have had to deal with as the market regulator; and to highlight what we are now focussing on. I will also attempt to discuss some of the lessons we have learnt and indicate where work that for us began as "demutualisation work" is now leading. Most of my remarks will be about our experience with ASX. That is because it is Australia's premier capital market, and because ASX first raised the complex set of issues we have been working through. Nevertheless, the ASX experience has close parallels in our other major market, the SFE.

Let me begin, as they say, at the beginning, with the story of the demutualisation process of ASX.

DEMUTUALISATION – THE AUSTRALIAN STORY

In the beginning ...

ASX is more than the operator of a regulated securities exchange. It operates markets in options, warrants and interest rate securities. It also provides clearing and settlement services for all its markets. ASX has front line responsibility for surveillance of its markets, supervising the participants in its markets, admitting entities to its official list and monitoring and enforcing compliance by listed entities of its listing rules. ASX also sells market data, runs an extensive investor education program and has a 50% interest in a registry services business. Recently ASX made an application for authorisation of a futures market and the provision of clearing house services for that market. In September 1996, more than 96% of ASX members voted in favour of demutualising the exchange. Of the 619 members that voted, 87 were corporations, 10 were partnerships and the remainder were individuals. The corporations and partnerships accounted for virtually all the trading that took place on ASX's markets. The vote was the culmination of 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 detailed analysis ASX prepared in support of this argument stressed that ASX needed to become a more flexible, responsive and commercially focussed entity, capable of quickly taking up emerging commercial opportunities. Access to capital raising through the offer of shares was an important, but by no means dominant, consideration. In the view of the experts who advised ASX, the mutual structure of ASX, including at least 500 individual members as well as the large institutional participants, inhibited ASX's ability to make rapid commercial decisions to change the shape of the business to meet emerging opportunities and threats.

When ASX in those times referred to business opportunities, it no doubt had in mind some domestic opportunities. Above all, however, it was focussed on the challenges posed by the global nature of financial market activity. From ASX's perspective - as an exchange market that is small by world scale – a critical capability ASX needed was to be able to engage with the global market, whether this involved links, alliances or joint ventures. I will say more about this aspect shortly.

What were the hot issues during the process of conversion of ASX to a demutualised, self-listed entity?

Demutualisation could not occur without changing the Australian law. The reasons were technical and I need not go into them¹, but the need for facilitative

¹ The Australian law used to assume that exchange markets have "members" who are both members of the market (and therefore bound by its rules) and also members of the corporation that operates the market in a

legislative change gave ASIC and the legislators a chance to deal with some of the new issues ASX's proposals raised. The legislation enacted in December 1997 was not a complete rewrite of the market provisions of the law (that is happening now as part of the financial services reform legislation). However, it did contain some new concepts, the most important of which were:

- (a) provisions embodying a public policy that no person (or group of associated persons) should be able to own more than 5% of the share capital of ASX. This put ASX in the same conceptual category as major Australian financial institutions such as banks, which are subject to shareholding limitations of 15%. From a regulatory perspective, this low limit on shareholding also acted as a substitute for a statutory "fit and proper" test for exchange owners and controllers. It also placed ASX in a category of institutions, including banks, which are seen as so central to the Australian economy that they require limits on the concentration of ownership.
- (b) mechanisms designed to deal more explicitly with an exchange's supervision obligations especially where these obligations might conflict with the exchange's role as a commercial entity. The main components were:
 - (i) a fuller articulation of the obligations of exchanges, especially for market monitoring and supervision;
 - (ii) requirements that exchanges at least annually prepare and give to the regulator reports about compliance with their supervisory obligations, and a power to require reports to be audited;
 - (iii) an express power to require an exchange to do specified things to ensure it complies with its supervisory obligations;
- (c) processes to require ASIC to act as the listing authority for ASX (the role ASX plays in relation to all other listed entities). These provisions gave ASIC the power to query ASX about its share price movements and also allowed it to charge ASX fees for carrying out this supervisory function.

These were therefore the elements of the regulatory regime that applied to ASX on demutualisation.

Not much later ...

Not long into the life of the demutualised ASX, we discovered that October 1998 really marked the beginning of an adventurous journey, not the end.

As a matter of interest, ASIC's regulatory role in this process did not include setting the price of the shares – this was a matter for ASX and the market.

traditional, corporations law, sense. Legislation was also needed at that time to allow ASX to change from one type of corporation to another.

ASIC's role did include making sure that those receiving shares had the benefit of a prospectus-standard disclosure document. In fact the share price rose dramatically on listing – from \$4.25 at the close of the first day of trading in October 1998 to more than \$16 in March 1999. (The price now is around \$13).

Soon after listing, other issues claimed our attention. The leash the ASX Board and management had said was holding them back was gone, and ASX surged forward on a number of commercial initiatives. In December 1998, only a couple of months after demutualisation, it announced a proposal to merge the Sydney Futures Exchange into ASX, and later in that first year it announced a strategic alliance with the NASDAQ market.

For ASIC, these and later developments meant having to deal with a range of conflict issues the enabling legislation had not explicitly envisaged. Let me give a couple of examples:

The First Commercial Venture

ASX announced a bid for the SFE in December 1998. In May 1999, Computershare announced a rival bid for SFE. Computershare is a public company listed on ASX, which has a major business in supplying market technologies, and a substantial part of the share registration business in Australia and elsewhere. The sharp question for us was: what arrangements needed to be put in place to ensure that the supervision of Computershare as a listed entity was not seen as tainted by the obvious conflict between ASX's role as a market supervisor and its interests as a potential commercial competitor?

The legislation had not dealt with this situation - the only conflict the law dealt with was about ASX itself as a listed entity, not as a commercial rival of another listed entity. What we did in the end was persuade both parties to enter into an agreement with us which provided that, until the issue of the rival bids was resolved, ASX as the market operator would not make any substantive decision about Computershare without first consulting with ASIC and acting in accordance with advice provided by ASIC. This purely contractual arrangement was made public and details released to the market. (As it turned out, neither ASX nor Computershare succeeded in their bids, and SFE remains independent today.)

Two particular things to note from this particular incident are:

- conflicts of this kind arise very quickly (our example was a takeover) without any prior warning from any of the parties;
- they need to be dealt with quickly because the conflict arises immediately and must be dealt with as close to instantly as regulators can manage. In our case, the very announcement of the bid was a first test as it had to be released to the market over the companies' announcement platform managed by ASX.

Other Commercial Initiatives

ASX has pursued a number of other business opportunities in the three years since demutualisation. They illustrate the broad scope for there to be conflict between an exchange's role as a market regulator and its role as a commercialised entity able to pursue business initiatives in many directions. I mention a few examples:

- ASX purchased a 50% share in a joint venture vehicle with a major trustee with a strong business in share registry facilities. ASX has representatives on the board of the joint venture vehicle. The joint venture competes with Computershare for registry business, including for companies proposing to list on ASX;
- ASX has taken a significant (15%) shareholding in a listed company whose businesses include order routing and information vending;
- ASX has a 50% stake in an unlisted investor relations firm;
- ASX has sought approval for a subsidiary to be authorised as a futures exchange, with another subsidiary seeking approval as the clearing house for the futures market. If approved, this will enable ASX to compete directly with SFE. SFE proposes to become a listed ASX entity some time in 2002.

As can be seen simply from listing these examples, the larger the range of business activities an exchange undertakes, the broader the scope for conflicts.

Today ...

As well as pursuing domestic business opportunities, ASX has actively been forging links with the global financial market.

It has established a link with the NASDAQ and NYSE markets – at this stage indirectly through an intermediary (Bloomberg), but with the possibility at a later stage of a more direct link. It is important to note that the service is marketed domestically as an ASX service, ASX World Link, with ASX resources and the reputation of ASX as the focus of the service.

Major work is also being done for a proposed linkage between ASX and the Singapore Stock Exchange (SGX) that will facilitate Australian investors buying and selling stock listed on SGX and vice versa for Singaporean investors. The preferred model is what the exchanges describe as a "reciprocal portal linkage" under which the exchanges (or other companies in the exchange group) carry on their markets in the usual way, but also act as intermediaries for transmitting orders across jurisdictions, and participate in their own markets as executing brokers. This plan has seen the two regulators - ASIC and the Monetary Authority of Singapore – closely cooperating to identify and solve regulatory and enforcement issues.

ASIC is increasingly viewing initiatives of this kind as natural products of the demutualisation process. ASX is seeking to secure its future as an Australian capital market by ensuring it is linked effectively to, and part of, global capital markets. Demutualisation was a necessary foundation for this focus.

Tomorrow ...

What does the future hold? The pace and uncertainty of events of the last few years make me doubt anyone can answer that with any confidence. However, some directions are clear. The links between exchanges located across the globe open up continuous (24 hour trading) possibilities. Another possibility is that some initiatives could lead to mergers or acquisitions which involve cross border ownership, as well as trading, links. We briefly had exposure to the issues this might give rise to during a period when ASX and the New Zealand Stock Exchange were discussing a possible merger of the two businesses, either under a common holding company or as single, cross-jurisdictional, market.

At the same time as these international initiatives are being developed, there are continuing concerns about ASX's dual role as market supervisor and commercial entity. ASX competes with financial service providers generally, and potentially with the intermediaries who trade on its markets. It has commercial interests which may result in conflict with entities listed on its markets. It no longer has the close ties of ownership and membership with those who trade directly on its markets, for example, ASX has been active in encouraging the emergence of a stockbrokers association to represent stockbroking interests, to ASX as well as to government and ASIC. Legislators are also showing an active interest in how conflict and other issues are being dealt with, and ASIC Commissioners and staff have appeared before a variety of Parliamentary committees interested in the question.²

ASX has responded to concerns about the conflicts issue by forming a special purpose subsidiary, ASX Supervisory Review (ASXSR). This is best characterised as a corporate governance solution to conflict issues. However, it is not a model which separates market and regulatory roles (such as the NASDR model). Rather, it has been presented as an additional, internal "audit" structure.

The entity's purpose is to provide assurance that the ASX group adequately complies with its obligations as market operator and clearing house operator. It is not intended to be a direct supervisor so much as to develop best practice policies and practices for ASX's supervisory functions, and to monitor and report to ASIC and the Government on compliance by the ASX group with its

² A special hearing into the ASX and issues of its role and conflict has not yet reported but is expected to do so in the near future.

supervisory obligations. It will also play a role where actual or perceived conflicts might require an extra layer of scrutiny of ASX's supervisory activity.

ASXSR has a board of five, the majority of whom are to be independent of ASX. In effect they must have had no material connection with ASX for at least two years before their appointment. ASIC has a limited role in vetting a panel from which board members are selected. A director may be removed from office only if ASIC does not object and the Minister must be notified by ASX of any proposal it may have to remove a director.

The board is responsible for putting together ASXSR's annual business plan and its budget, however, its funding and staffing are wholly dependent on ASX. It is planned that ASXSR have an agreement with ASX and the main operating entity within the group which will deal with matters such as the role ASXSR will play within the group, information flows between group members and ASXSR, assurances that staff providing services to ASXSR are responsible to the ASXSR board and are under a duty to act in the best interests of ASXSR, and the funding of ASXSR.

ASXSR is to report on its activities and financial position each year and is to provide ASIC with a copy of its annual reports. Commencing with the report for the year ending 30 June 2002, ASXSR may express opinions on whether ASX Group is meeting appropriate supervisory standards and on the adequacy of the level of funding and resources for ASX supervisory activities. The independent directors may also comment publicly in the report on the adequacy of the funding arrangements for ASXSR. The annual report is to be given to ASIC to facilitate an external audit by ASIC of ASX Group's supervisory policies and procedures under the new assessment of licensed market operators power that ASIC is given under the Financial Services Reform Bill.

ASIC awaits with more than a little interest the progress that this new body makes in dealing with the deep and difficult problem of ensuring that the conflict situations which are likely to arise are seen to be appropriately dealt with and that the costs of market supervision continue to be borne by those who use the market rather than the public purse, and at the same time that market integrity and consumer protection standards are maintained and enhanced.

At a more general level, the Australian Government is proceeding with the Financial Services Reform Bill 2001. This legislation provides a new regime for all financial products and services (particularly relating to disclosure of products and licensing of intermediaries), and overhauls the now outmoded provisions that apply to markets and clearing and settlement facilities. The legislation raises the ceiling on ownership of "public interest" exchanges such as ASX from 5% to 15% (with a power to approve holdings about the 15% limit), and at the same time introduces an explicit "fit and proper person" test for directors and executive officers and shareholders holding more than 15%. Interestingly, the legislation does not use the word "exchange" and all the assumptions of the old law relating to exchanges and their members have been replaced.

There are also further measures to strengthen the accountability of market operators for their market supervision obligations, including an obligation for ASIC to conduct annual "audit" reviews of a market operator's supervision responsibilities. The proposed new financial services legislation recognises that there is broad scope for conflicts to arise, beyond the market operator being a listed entity on its own market, so when conflicts arise – whatever their source – there must be adequate arrangements for dealing with them. When enacted, the new legislation will require all market operators to demonstrate that they have appropriate arrangements in place to deal with all conflicts between the commercial interests and operating the market in a fair, orderly and transparent manner as part of the licence approval process. This requirement will also become explicitly an ongoing obligation of the market operator and will therefore be one of the issues ASIC's periodic audits will need to examine and report upon (sections 795B (1)(d) (i) and 792A (c)(i)).

The new regime also contains a means for explicit recognition under the Australian regime of markets operating in Australia, but having their home base in other jurisdictions.

SOME LESSONS AND ISSUES FOR REGULATORS

Let me now try and draw together the threads from the Australian demutualisation story. I should say again that I have used ASX as the example, but the path trodden by the SFE is similar. SFE is now a demutualised entity proposing significant changes in its operations in Australia and with international links well into the planning stage. It plans to list on ASX's market some time next year.

I think of the lessons and issues under two broad headings - conflicts and corporate governance; and cross border activity. These are, for us in Australia at least, the particular areas that demutualisation has required us to confront.

Conflicts and corporate governance issues

There is clearly a need to deal comprehensively with the question of conflict of roles. This in turn raises the question of the future of private (exchange-based) supervision of markets, and the mechanisms that are needed to ensure accountability for regulatory outcomes. How market supervisory functions are paid for will inevitably be part of that debate.

In the Australian context, ASX maintains that strong supervision is key to its brand name. The new legislative regime will continue to allocate "front line" responsibility for general market oversight, disclosure by listed entities, and market participant supervision to the market operator. It is, however, inevitable that there will be some narrowing of the definition of the extent of these roles. For example, the time is passing when an exchange on which a major securities firm trades can be held responsible for supervising all of that firm's conduct – for example, on other markets or in relation to client dealings that do not involve market transactions.

Exchanges may also form subsidiaries to carry out regulated activities for which they have supervisory responsibility. It will be important for public and market confidence that these subsidiaries comply with relevant market rules such as capital rules and reporting rules. The impact of the activities of a market operator's group as a whole must increasingly be considered, especially the way in which the financial condition of the exchange and associated clearing houses may affect overall systemic risk.

One lesson from our experience is that it is essential to understand and prepare for the way in which a market operator's business might develop. There are many possible business strategies, not all involving the direct provision of market or clearing services. Regulators need to be equipped to deal with – for example – conflicts between an entity's role as a market, clearing and listing supervisor and its role as a provider of share registry services. These kinds of conflicts will not always be obvious in advance.

The way in which market operators deal with corporate governance issues is likely to play an increasingly important part in dealing with conflicts. Australia does not have a tradition of requiring exchange boards to have independent, "public interest" directors, nor has the ASX sought to separate its regulatory and commercial activities. Its initiative in forming ASXSR represents a different "review" approach to dealing with the issue.

Cross border activity

Demutualisation is an important gateway opening up domestic markets to the world. In Australia, it has been a major factor for markets in shifting the focus from domestic market regulation to cross border issues. In other jurisdictions, this connection might not be so strong, but I suspect for countries with domestically significant and sophisticated but relatively small markets in global terms the experience is likely to be similar.

Proposals for markets to operate across borders do not raise only market regulation issues. Regulation of cross border intermediary activity will often be involved, as will regulation of selling practices and disclosure. Beyond limited links for order transmission, "portal" arrangements and the like is the need for the development of full regulatory regimes that operate – at both the legislative and the administrative levels – effectively across national boundaries to protect consumers and ensure market integrity in all affected jurisdictions.

ASIC is equally conscious that cross border activity will be two-way, and new entrants will want to enter the Australian market place. This raises some interesting questions that I will not go into here – such as the extent to which global links will give rise to new forms of systemic risk, for example in global clearing and settlement arrangements.

ASIC has begun to tackle the need for a regulatory regime that works in a cross border environment by starting to develop a set of "principles" for the regulation of cross border activity. In our view, this is a necessary first step in articulating more fully the approach we will use to deal with securities market and other proposals involving offshore products and services being made available in

Australia, and, equally, Australian product and service providers operating in offshore jurisdictions. The framework we envisage will eventually deal with all aspects of these kinds of arrangements: how the Australian law applies; how offshore entities can comply with the Australian regime without being subject to duplicative or conflicting laws and rules; how Australian investors can seek and obtain redress; and how Australian market operators, clearing and settlement facilities, intermediaries and product issuers might use their regulation in Australia to assist them avoid similar risks in other jurisdictions. In this work, we aim to recognise the effects of home jurisdiction regulation, but in a way that does not result in lower standards of protection for Australian investors, or a lesser degree of integrity than is provided by the Australian regime we administer. As you can imagine, this is no small task.

Our work is at a very early stage. It will not surprise you to learn that the IOSCO principles are a strong point of reference for developing high-level principles. There are clearly going to be difficult questions to resolve – especially how to ensure there are effective enforcement arrangements; and that consumers in one jurisdiction have effective access to remedies when things go wrong. We have the great advantage of being able to test our thinking on principles against the practical examples of cross border activity that we are dealing with. I am happy to indicate our willingness to share the early results of this work with the relevant standing committees of IOSCO.

CONCLUSION

Our work on the demutualisation of exchanges has started a process that is a long way from finished. When we started, the link between demutualisation and globalisation was not nearly as obvious to us as it is now. Our focus is now both on some of the unresolved issues of demutualisation (the issue of conflicts and corporate governance) as well as on the need to build a framework that deals effectively with probably the most important consequence, that is, the connection between Australian markets and global markets.

The securities industry has long been global in its outlook. Perhaps the most enduring aspect of demutualisation, from a regulatory perspective, is that it has brought the regulatory issues posed by a global securities marketplace into focus.