



ASIC

Australian Securities & Investments Commission

**MARKET DEMUTUALISATION AND CROSS BORDER
ALLIANCES:
THE AUSTRALIAN EXPERIENCE**

Jillian Segal

Deputy Chair

Australian Securities and Investments Commission

Fourth Roundtable on Capital Market Reform in Asia – April 2002¹

¹

I would like to thank Ceyda Ozsayin in particular for her assistance in the preparation of this paper.

Thank you for inviting me to join you for the Fourth Roundtable on Capital Market Reform in Asia. I am delighted to be here.

I propose to share with you the Australian experience in relation to market demutualisation and cross border alliances. Although we have an exchange market that is small by world scale – with only 1.59% of the global capital market² – we have experienced a number of interesting, and I believe, internationally relevant developments. I will cover some of these developments and the issues we have had to deal with as the market regulator. I will also touch on some of the lessons we have learned and indicate where work that for us began as "demutualisation work" is now leading.

Most of my remarks will be about our experience with the Australian Stock Exchange (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 Sydney Futures Exchange (SFE).

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

² Australia is ranked 10th in the Morgan Stanley Capital International (MSCI) World Index, representing 1.59% of that Index.

Demutualisation – The ASX Story

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 were traded on a market operated *by the exchange*.

Australia now has six licensed Australian market operators – ASX, ASX Futures, SFE Group (which holds two licences), 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.

ASX is more than the operator of a regulated securities market. It operates markets in options, warrants and interest rate securities. Its subsidiary, ASX Futures, operates a licensed derivatives market. ASX also provides clearing and settlement services for all its markets. ASX has front line responsibility for surveillance of its markets, supervising participants, admitting entities to its official list, and monitoring and enforcing compliance by listed entities with its listing rules.

In September 1996, more than 96% of ASX members voted in favour of demutualising the exchange. 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 demutualisation stressed that ASX needed to become more flexible, responsive and commercially focussed,

capable of quickly taking up emerging commercial opportunities. Access to capital raising through the offer of shares was important, but by no means the 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 meet emerging business 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, it needed 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 them³, but the need for facilitative legislative change gave ASIC and the legislators a chance to deal with some of the new issues raised by the proposals of ASX. The legislation enacted in December 1997 was not a complete rewrite of the market provisions of the law. (This has now happened by way of amendments to the *Corporations Act 2001* made by the *Financial Services Reform Act 2001*, which commenced on 11 March this year.) However, it did contain some new concepts, the most important of which were:

³ 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 traditional, Corporations law, sense. Legislation was also needed at that time to allow ASX to change from one type of corporation to another.

- (a) provisions embodying a public policy that no one person (or group of associated persons) should be able to own more than 5% of the share capital of ASX. Now, the ownership limit (which applies to both ASX and SFE) has increased to 15%. This puts ASX and SFE in the same conceptual category as major Australian financial institutions such as banks, which are also subject to shareholding limitations of 15% under the *Financial Sector (Shareholding) Act 1998*. Other measures in the Corporations Act will also now allow ASIC to apply a "fit and proper" person test to controllers and senior managers of Australian financial markets and clearing facilities.

- (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) more detail in the legislation on 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 for the regulator to require reports to be audited; and
 - (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 that 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.

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. ASIC's role did, however, include making sure that those receiving shares had the benefit of a prospectus-standard disclosure document.

ASX's Commercial Initiatives – Post Demutualisation

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

The leash the ASX Board and management had said was holding them back had been cut and, soon after listing, ASX surged forward with a number of commercial initiatives. In December 1998, only a couple of months after demutualisation, ASX announced a takeover bid for the SFE. Later in that first year it announced a strategic alliance with NASDAQ – I will talk more about the alliances a little later. In the three and a half years since demutualisation, ASX has also pursued a number of other domestic business opportunities. These include:

- ASX purchased a 50% share in a joint venture vehicle with a significant trustee company, which had a major business in share registry facilities. ASX has representatives on the board of the joint venture vehicle. The joint venture competes for registry business with a company listed on the ASX – Computershare – including for the registry business of companies proposing to list, or listed, 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; and
- An ASX subsidiary – ASX Futures – has been authorised as a futures exchange, and another subsidiary approved as the clearing house for the futures market. This enables ASX to compete directly with SFE.

For ASIC, these and later developments meant having to deal with a range of conflict issues the enabling legislation had not explicitly envisaged. So, what lessons can we extract from the Australian demutualisation story ?

Conflicts and Corporate Governance Issues

One lesson from our experience is that it is essential to be able to respond to previously unforeseen directions in which a market operator's business might develop. There are many possible business strategies a market operator can follow, 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.

ASX's commercial initiatives, for example, illustrate the broad scope for conflict, or perception of conflict, between the role of a market operator and its role as a commercial entity able to pursue business initiatives in many directions. The ASX takeover bid for the SFE is a classic illustration of this.

As I have already mentioned, ASX announced a takeover 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 in the takeover bid for SFE ?

The legislation had not dealt with this situation – the only conflict the law dealt with related to ASX itself as a listed entity, not as a commercial rival of another listed entity. What we did in the end was to 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 decisions 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.)

The new legislative regime in the Corporations Act continues to allocate "front line" responsibility for general market oversight, disclosure by listed entities, and market participant supervision to ASX as the market operator. ASX continues to compete with financial service providers generally, and potentially with the intermediaries who trade on its markets. It has commercial interests, which may conflict with the interests of entities listed on its markets. Needless to say, there are continuing concerns about ASX's dual role as market supervisor and commercial entity. SFE's listing on ASX (proposed to take place on the 15th of this month) is certain to put the spotlight on this duality. Legislators are also showing an active interest in how conflict and other issues are being dealt with

– ASIC Commissioners and staff have, for example, appeared before a variety of Parliamentary committees interested in the question.⁴

ASX has responded to concerns about the conflicts issue by forming a special purpose subsidiary, ASX Supervisory Review Pty Ltd (ASXSR). ASXSR's role is to ensure the continued integrity, efficiency and transparency of ASX's supervision of its markets. This includes reviewing ASX's policies and procedures covering supervisory activity, providing assurance that ASX complies with its supervisory responsibilities, and overseeing the supervision of listed entities with special identified conflicts – such as commercial partners or competitors of ASX. This response is best characterised as a corporate governance solution to conflict issues. However, it is not a model that separates market and regulatory roles (such as the NASDR model). Rather, it has been presented as an additional, internal "audit" structure.

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 boards of regulated market operators to have independent, "public interest" directors, nor has ASX sought to separate its regulatory and commercial activities.

Consequently, ASIC awaits, with more than a little interest, the progress that ASXSR makes in dealing with the deep and difficult problem of ensuring that the conflict situations that may arise are dealt with appropriately and transparently, 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

⁴ Refer to the Australian Senate's Economics References Committee, *Inquiry into the Framework for the Market Supervision of Australia's Stock Exchanges*, February 2002.

that market integrity and consumer protection standards are maintained and enhanced. ASIC is also conscious that ASXSR's role and the supervisory framework as a whole will need to be kept continually under review if ASX continues to enter into cross border alliances or global linkages.

While the legislature envisages that the usual method for addressing conflicts would be through independent supervision arranged by the market operator, it was considered desirable to provide an avenue whereby ASIC could undertake this function. To achieve this, a new Corporations Regulation 7.2.16⁵ has now been made. In essence, the regulation 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. The regulation provides that a competitor may lodge with ASIC an application asking ASIC, instead of ASX, to make decisions and take action (or require ASX to take action on ASIC's behalf) in relation to the competitor's listing application, or the compliance by the competitor (if already listed) with the applicable listing rules.

Cross Border Alliances – The Australian Experience

Demutualisation has not only required us to confront issues of conflict and corporate governance. It has also required us to closely consider issues relating to cross border market regulation.

The connection between concepts of demutualisation, self-listing and cross border alliances may not be immediately obvious. It is clear in Australia's case

⁵ Inserted into the Corporations Regulations 2001 by Corporations Amendment Regulations 2002 (No.3).

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

ASX, for example, is seeking to bolster its future as an Australian capital market by ensuring it is linked effectively to, and part of, global capital markets. As well as pursuing domestic business opportunities, ASX has been actively forging cross border alliances within the global financial market. In its first year as a demutualised exchange, for example, ASX announced a strategic alliance with the American Stock Exchange (AMEX), NASDAQ and the New York Stock Exchange (NYSE). Today, it has established a cross border trading link with Singapore Exchange Limited (SGX). ASX also has Memoranda of Understanding (MOU) with the national exchanges in Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Taiwan, Thailand, Singapore and of course Japan.

I should say again that, although I have used ASX as the primary example, the path trodden by 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. For example, on 31 January 2001, it entered into a strategic initiative with the Hong Kong Exchanges and Clearing Limited (HKEx) to develop a range of new derivative trading and clearing services for the Asia Pacific exchange-traded and over-the-counter marketplaces. It also recently entered into a technological alliance with the OM market in Sweden, and proposes to become a listed ASX entity on the 15th of this month.

ASIC is increasingly viewing initiatives of this kind as natural products of the demutualisation process. Demutualisation was clearly a necessary foundation for these initiatives as it also allows an entity to become more flexible, responsive and commercially focussed, capable of quickly taking up emerging commercial opportunities. Having shares tradeable on a secondary market also facilitates any capital raising associated with a cross border initiative.

Trading Links with AMEX, NASDAQ and NYSE Markets

As I have already noted, ASX has already established a trading link to the US securities market through alliances with AMEX, NASDAQ and NYSE – at this stage indirectly through an intermediary (Bloomberg). The service has been operating since March 2001 and is marketed domestically as "ASX World Link".

Under these arrangements, ASX acts as the collection point for outward-bound orders from its trading participants and their clients. Orders are routed to the US markets (currently through the Bloomberg Tradebook facility), but clients can settle their trades in Australian dollars. It is a one-way link with ASX's resources and reputation being the focus of the service.

ASX - SGX Co-trading Link

Many of you may also be familiar with an innovative cross border trading link that ASX has pursued with SGX.

After two years of planning and development, the ASX - SGX link commenced operation on 20 December 2001. A world first, I believe the ASX - SGX link is the first co-trading link of its type to be created by stock exchanges anywhere. Designed to facilitate the efficient trading, settlement and holding of SGX securities by Australian investors and that of ASX quoted securities by Singaporean investors, the linkage – known in technical terms as a "reciprocal

portal linkage" – enables ASX and SGX to carry on their markets in the usual way but, through special purpose subsidiaries. The linkage also allows ASX and SGX to act as intermediaries for transmitting orders across jurisdictions, and to participate in their own markets as executing brokers.

ASX and SGX each use a wholly owned subsidiary, referred to as a "portal dealer", to facilitate the cross border execution of orders, clearing and settlement of transactions. The ASX Portal Dealer (ASX International Services) acts as executing broker on ASX in relation to orders placed by the portal dealer subsidiary of SGX (SGXPD) on behalf of its member firms through the portal linkage service and vice versa. The relationship between ASX International Services and SGXPD for orders inbound to Australia is in essence a broker-client relationship. ASX International Services has no contractual relationship with SGX members just as SGXPD has no such relationship with ASX's Participating Organisations.

This sounds very technical – and it is – but in practical terms the result is simple. It enables investors in Australia and Singapore to:

- buy and sell selected securities in each other's market; and
- settlement takes place in the investor's home market in accordance with the rules and procedures of the securities' home exchange. This means that, in the case of Australian investors, the record of the beneficial ownership of their Singaporean securities is held by ASX on its clearing house/depository, CHESS.

Currently, 50 securities from each exchange are eligible for cross border trading through the link. The list has been limited initially to the most liquid, best-known securities on each exchange, although ASX and SGX expect to add more securities to the list as market interest develops.

The ASX - SGX link is interesting not only for its novelty. It is also an important strategic initiative. It aims to deepen the pool of investors by providing direct links for Singaporean investors into Australia and vice versa, it challenges the two exchanges to bring their technologies and practices more closely together and it responds to the demands of an increasingly sophisticated global market, especially the growing and changing demands of investors.

While ASX has successfully established a two-way trading link with SGX, it is true to say that the path to establishing exchange alliances remains difficult. There are a number of obstacles that must be overcome before successful alliances can proceed. In particular, there are regulatory and enforcement issues that need to be addressed. The ASX - SGX trading link, for example, has seen the two regulators – ASIC and MAS – closely co-operating not only to identify and solve regulatory and enforcement issues, but to enhance the mutual understanding of challenges posed by cross border linkages. Some of the issues that needed to be addressed in relation to the link included:

- the existing legislative framework, and the structuring and implementation of the co-trading link within that framework;
- how differences between the regimes could be reconciled so that overall regulatory outcomes are equivalent;
- what approach should be taken in areas where there were possibly incompatible provisions in the two jurisdictions – for example, some market offences and some disclosure provisions; and
- what information sharing and co-ordination arrangements would be needed to produce robust and effective surveillance and enforcement.

You will not be surprised to hear that, at ASIC, we have spent many hours pondering the question of what is the most effective and efficient means of regulation in these circumstances ?

A variety of regulatory mechanisms have been implemented to address some of these concerns. One of the most important is an MOU between ASX and SGX. The MOU formalises and facilitates the exchange of information and regulatory co-operation between the two exchanges. It also allows the exchange where an investor is located to take disciplinary action if an exchange's member has breached a rule in the other's market. These arrangements are additional to any powers currently held by the regulator or the exchange in the country of the affected market.

The ASX - SGX link relies on market integrity measures in the home exchange to provide the primary level of protection to investors. The underlying principle is that the home exchange is best able to regulate its own members and to prosecute breaches of its rules. Accordingly, ASX and SGX have each amended their business rules to include Core Trading Rules (or principles), which apply to participants who deal through the link into the other's market. These rules reflect the important principles underlying the trading conduct rules in the other's market, and are designed to protect the integrity of the other's market by imposing standards of conduct on brokers submitting orders over the link – for example, it is a disciplinary offence for an SGX broker using the link to engage in conduct that would adversely affect the ASX market and vice versa. The Core Trading Rules also provide that each exchange is to supervise participants in its market that trade through the link in the other's market by monitoring compliance with the rules of the other's market and disciplining them for any breach.

Each exchange is therefore able to rely on co-operative arrangements in relation to information sharing, and the co-ordination of supervision and enforcement. This enables them to seek assistance from, or request the home exchange to commence enforcement action where there is a breach, or suspected breach, of their rules.

ASIC and MAS are in the process of reviewing their MOU arrangements with a view to enhancing and strengthening information sharing and investigatory assistance arrangements in light of the increased cross border trading that is expected to result from the link.

The Australian Senate's Economics References Committee noted in its recent report on the framework for the market supervision of Australia's stock exchanges that there are some significant regulatory differences between Singapore and Australia, and that investors need to be aware that regulatory differences do exist and that ASIC cannot impose the standards embodied in the Australian legislative framework in other countries.⁶ The Committee suggested that ASX introduce a "health warning" for potential investors, reminding them of these differences. On a different point, the Committee noted that ASX, in consultation with ASIC, is developing formal measures to ensure that the supervision and administration of its business rules in relation to ASX International Services is consistent with the administration of the rules for all other Participating Organisations, and that conflict, or the perception of conflict, is addressed given that ASX International Services is a subsidiary of ASX.⁷

⁶ Refer to paragraph 5.50 of the Australian Senate's Economics References Committee Report in footnote 4.

⁷ Refer to paragraph 5.51 of the Australian Senate's Economics References Committee Report in footnote 4.

Apart from being an important strategic link, the ASX - SGX link has truly paved the way in terms of cross border trading. The link raises some difficult regulatory and enforcement issues. However, ASIC believes that the measures we have developed with both exchanges and with MAS – that are now in place – deal effectively with the more complex and challenging regulatory issues.

Cross Border Recognition Principles

As I have mentioned earlier, demutualisation is an important gateway opening up domestic markets to the world. ASIC is conscious of the fact that new entrants will want to enter the Australian market place as a result of globalisation and technological change.

The development – post demutualisation – of cross border trading linkages highlights the need for regulators to respond to cross border activities in a strategic and thoughtful manner. In order to protect consumers and ensure market integrity in all affected jurisdictions, there is clearly an increasing need for regulatory regimes to operate effectively – at both the legislative and administrative levels – across national boundaries. ASIC is tackling the need for a regulatory regime that works in a cross border environment by developing a set of "principles" for the consistent regulation of cross border activity. In our view, this is a necessary first step in articulating, more fully, the approach we will take in dealing with proposals involving offshore financial products and services being made available in Australia.

ASIC's overriding objective in developing these principles, and in regulating cross border activity, is to protect and promote the interests of Australian investors, to protect the integrity of Australian markets, and to reduce systemic risk. ASIC also aims to facilitate the availability and provision of foreign financial facilities, services and products in Australia in order to enhance

competition and innovation in the financial services industry, and increase Australian investors' access to investment opportunities. 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 currently dealing with.

The framework we envisage deals with all aspects of cross border 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, and how Australian investors can protect their rights and obtain redress. 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.

It will not surprise you to learn that the *Objectives and Principles of Securities Regulation*, adopted by the International Organisation of Securities Commissions (IOSCO) in 1998, and re-issued in February this year, are a major point of reference for developing these high-level principles. There are clearly difficult questions to resolve at a practical level – especially how to ensure there are effective enforcement arrangements, and that consumers in one jurisdiction have effective access to remedies when things go wrong in another.

Before we finalise the principles and make them publicly available, we will be inviting key Australian stakeholders to discuss the principles at a regulatory roundtable to be held next month. We will also be seeking comments from a number of foreign regulatory authorities.

You will note that I have not discussed the issue of mergers of exchanges today. We briefly had exposure to the issues a merger might raise during a

period when ASX and the New Zealand Stock Exchange were discussing a possible merger of the two markets, either under a common holding company or as a single cross-jurisdictional market. This proposal did not come to fruition. However, the regulatory implications associated with mergers can be very complex – indeed, more so than those associated with alliances and co-trading linkages. In evidence put to the Australian Senate's Economics References Committee, ASX confirmed that mergers face obstacles that it regards as insurmountable at the present time.⁸

Conclusion

ASIC's 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, such as the issues 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.

⁸

Refer to paragraph 5.19 of Senate Economics References Committee Report in footnote 4.