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## **Demutualization of Exchanges— The Conflicts of Interest (An Australian Perspective)**

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### **6.1 Introduction**

Demutualization and listing of an exchange places a spotlight on management of potential conflicts of interest. This chapter briefly outlines the nature of these conflicts, and the means of addressing them, under the following headings:

- Background to Conflicts
- An Exchange's Listing
- Regulation of Other Listings
- Supervision of Intermediaries
- Profit Motive versus Supervisory Function
- Public Interest versus the Exchange's Commercial Interest
- New Business Lines

Where appropriate reference is made to the Australian Stock Exchange's (ASX) experience.

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## 6.2 Background to Conflicts

The incidence of conflict or potential for conflict is not unique to a demutualized exchange. However, a key consideration in preparing for a demutualized environment is the need to demonstrate that effective mechanisms exist to address potential conflicts of interest arising from an exchange's profit motive and the supervisory function that it performs.

Four main types of conflict present themselves:

- *The resources conflict.* Will a for profit organization devote sufficient resources to regulatory activities?
- *Executive time conflict.* Will senior executives of an exchange devote sufficient of their "high-powered" time to regulation compared with profit making?
- *Listings supervisory conflict.* Will the Listings Division ease up on scrutiny of new listings, grant listing rule waivers more readily and subject existing listed companies to less intense scrutiny? In addition, will the Listings Division be too tough in applying listing rules to listed competitors, or conversely, give favoured treatment to any listed companies with which the exchange conducts business?
- *Broker supervisory conflict.* Will the Compliance Division ease up on its scrutiny of brokers because they are now viewed as paying customers?

There are a number of ways of dealing with these conflicts:

- *Removal of activity option.* Remove the activity from the relevant division of the exchange.
- *Separation option.* Separate the business activities of the exchange from the regulatory activities of the exchange.
- *External oversight option.* Subject the regulatory activities of the exchange to external oversight.
- *Disclosure option.* Disclose how an exchange has dealt with regulatory issues, for example in an annual report.
- *Restricting ownership or involvement option.* Limit those who can control or influence exchange activities.

These options are not always mutually exclusive for a given activity. Moreover, it is possible to adopt different options for different types of activities; indeed ASX has adopted elements of each option across its business. Examples include:

- The removal of activity option has been adopted in relation to the oversight of ASX's own listing, see below.
- ASX has created a separate Investigations and Enforcement Unit. Prior to demutualization that role was blended with "membership" administration.
- The law was amended to clarify the continuing obligations of ASX and to ensure accountability to the government regulator and the government in carrying out these responsibilities. Reporting requirements and audit and direction powers concerning compliance with these ongoing requirements were introduced.<sup>2</sup>
- ASX has taken initiatives to enhance transparency of its supervisory policies and procedures. This has included public consultation for rule development proposals, publication of waiver and disciplinary determinations, issue of Guidance Notes about our procedures and compliance expectations and improved mechanisms for public access to supervisory outcomes. More recently ASX announced the formation of ASX Supervisory Review Pty Limited (discussed below) which, among other things, reviews and separately reports on ASX's supervisory activities.
- An ownership limitation was imposed on ASX. This limited persons and their associates to having voting power in ASX not exceeding 5%.<sup>3</sup>

Whichever model is chosen, it is important regularly to review existing arrangements to help ensure that an exchange builds for itself a reputation for integrity, efficiency and transparency. In view of the increasing globalization of markets, there is also a need to monitor

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<sup>2</sup> The external oversight mechanisms in the law will be further enhanced under the *Financial Services Reform* legislation by conferral upon Australian Securities and Investment Commission (ASIC) of direct audit powers.

<sup>3</sup> The *Financial Services Reform Bill* proposes to increase the limit to 15% with the capacity to acquire more than 15% provided the Government considers the proposed acquisition is in the national interest and agrees to vary the limit. This amendment will be accompanied by the introduction of a fit and proper person requirement in relation to those involved in ASX.

international developments in governance of supervisory activities and to assess whether the model chosen will best equip an exchange to embrace international alliances.

### 6.3 An Exchange's Listing

If an exchange is to remain credible in its oversight of public companies, it must ensure that, in relation to its own listing, it adheres strictly to the highest standards set for other companies.

In Australia the *Corporations Law* has been amended to provide that a securities exchange such as ASX may be included in its own official list and its securities granted quotation, if the securities exchange has entered into such arrangements as the Australian securities regulator, the Australian Securities and Investments Commission (ASIC), requires for:

- (i) dealing with possible conflicts of interest that might arise from the securities exchange quoting its own securities on itself; and
- (ii) the purpose of ensuring the integrity of trading in securities of the securities exchange.

To complement this change in the law, ASX and ASIC entered into a Memorandum of Understanding (MOU) setting out the way that ASX and ASIC would relate to each other in the monitoring of ASX's compliance as a listed entity with the listing rules, the settlement rules and the *Corporations Law*, and of ASIC's supervision of ASX as a listed entity. A key objective of ASX and ASIC in negotiating the MOU was to ensure consistency of outcomes and timing between ASX in the administration of the listing rules for other entities, and ASIC in its administration of the listing rules for ASX.<sup>4</sup>

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<sup>4</sup> Under the MOU, ASIC is responsible for supervising ASX's compliance with the listing rules. It received ASX's application for admission to the official list. In relation to the continuing regulation of ASX as a listed entity, ASIC is responsible for exercising the powers and functions that ASX has as a securities exchange in relation to other listed entities. ASX is not bound to monitor or enforce the listing rules in relation to itself. If ASX wishes to apply for an exemption or declaration in relation to a modifiable provision of the *Corporations Law*, or a waiver of the Listing Rules it may apply to ASIC. ASX pays fees required by the listing rules to ASIC. Under the MOU, ASIC is responsible for supervision of ASX's compliance with the *SCH Business Rules* and its application for admission to CHES, as it is for other listed entities. However, ASIC may direct ASIC to exercise certain powers and functions.

Under the terms of the MOU, ASX makes its own announcements to ASIC in the same way that other entities make their announcements to ASX. Once cleared by ASIC, ASX's announcements are released to the market through ASX's own company announcements platform. Furthermore, ASX sets appropriate parameters for generating surveillance alerts relating to dealings in its own securities. If required by ASIC, ASX must provide assistance and allow ASIC access to ASX's surveillance department in order to analyze trading in ASX's securities.

This structure is designed to allow independent supervision of ASX's compliance with its listing rules, while at the same time utilizing the same platforms and mechanisms that ASX has established practically to accommodate supervisory activities. ASX is confident that this structure operates effectively and efficiently.

## **6.4 Regulation of Other Listings**

As noted above, an issue arises as to whether a for profit exchange will ease up on its supervision of listed companies. It is argued here that there are strong commercial reasons for exchanges to maintain a high level of supervision: if they do not, a fall in investor confidence is likely. Where there is a loss of confidence, investors will almost certainly withdraw from the exchange's market and go elsewhere to make their investments. The consequentially reduced market activity will have a direct negative impact on an exchange's profits.

In addition to this commercial discipline, there are usually significant regulatory controls on exchanges that collectively serve as a strong deterrent to inappropriate supervisory decisions. These are outlined below in part 6.6.

## **6.5 Supervision of Intermediaries**

Similar issues to those outlined in the preceding section arise in relation to the supervision of intermediaries.

When it was a mutual, ASX had a membership department that was responsible for monitoring and enforcing compliance with ASX's business rules, as well as acting as the central point of contact for members regarding exchange enquiries. When it demutualized, ASX separated its supervisory functions associated with brokers from its customer relations

functions. The situation now is that, within its Market Services Division (replacing the old Membership Division), ASX has separated the client relations and compliance units, and investigations and enforcement matters are handled by a department, which has a separate reporting line through to the Office of General Counsel of ASX.

## 6.6 Profit Motive versus Supervisory Function

### 6.6.1 Market and Regulatory Controls

In Australia, the regulatory framework governing supervision of exchanges and prohibiting anti-competitive behaviour provide powerful incentives to an exchange and its board of directors and senior management to behave ethically and responsibly. So do the commercial interests of an exchange in promoting public confidence in, and therefore custom to, its markets.

There are numerous checks and balances to ensure an appropriate level of accountability by ASX in respect of its market supervision obligations. These include:

- (i) clear and continuing obligations imposed on ASX as a market operator under the *Corporations Law*;
- (ii) transparency of processes, by their embodiment in rules which are available for public scrutiny and comment; these rules are subject to informal ASIC approval processes and ministerial disallowance procedures;
- (iii) structural arrangements which enable the quarantining of supervisory decision-making;
- (iv) hearing and appeal rights afforded to customers;
- (v) public registers of listing rule waiver decisions and of business rule disciplinary determinations;
- (vi) the publication of the bases upon which the exchange exercises discretion under, or grants relief from, business rules;
- (vii) a requirement to lodge a compliance report annually with ASIC and the relevant Australian Government Minister; and the Minister's power to direct that this report be audited;

- (viii) a ministerial power to direct ASX to do specified things in order to promote compliance with its ongoing obligations under the *Corporations Law*,<sup>5</sup>
- (ix) the Minister's ability to request a special report from ASX on the extent to which ASX is complying with its ongoing obligations under the *Corporations Law*, and the minister's power to direct that this report be audited;
- (x) ASIC's power to prohibit trading in the securities of any listed company;
- (xi) the power of ASIC or of an aggrieved person to apply for a court order for ASX to enforce its rules;
- (xii) the requirement to lodge particulars of disciplinary action and serious contraventions of the law/rules with ASIC;
- (xiii) the obligations imposed by ASX's MOUs with ASIC,<sup>6</sup>
- (xiv) the committees and tribunals which assist ASX in the performance of its supervisory responsibilities; these committees and tribunals include people external to ASX; and
- (xv) prohibitions on anti-competitive behavior or misuse of market position contained in trade practices law.

### 6.6.2 Supervisory Activities

Where there is discontent with a supervisory outcome, commentators may try to attribute this to an exchange's for-profit status. ASX has accordingly been very careful to ensure that its internal structure best complements the legislative framework designed to ensure the fair and efficient conduct of the market. ASX commits significant financial, human and technological resources to ensure the highest standards of integrity. ASX also works closely with the market regulator, ASIC, in the implementation of its supervisory responsibilities. Table 6.1 summarises below some of the key market integrity activities undertaken by ASX.

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<sup>5</sup> Refer to *Corporations Law*, section 769A for these on-going requirements.

<sup>6</sup> ASX has entered into a number of MOUs with ASIC to further refine, and ensure that, ASX properly implements and carries out its supervisory responsibilities. These MOUs, dealing with markets, membership matters, companies matters and transfer of information, place responsibilities on ASX which expand on and complement its supervisory responsibilities under the *Corporations Law*. A description of these MOUs is contained in *Part II: Demutualization Cases Studies*, Chapter 12, section 12.7.

**Table 6.1. Supervision**

AREA OF SUPERVISION	MARKET INTEGRITY ACTIVITIES
<b>Systems</b>	<ul style="list-style-type: none"> <li>• Establishing standards for the testing and authorization of designated trading representatives.</li> <li>• Maintaining trading parameter settings and access passwords.</li> <li>• Gauging compliance with trading rules and procedures.</li> <li>• Reporting incidents to relevant ASX departments.</li> <li>• Provision of fair, orderly and transparent systems for trading, settlement, clearing and dissemination of company information.</li> <li>• Guarantees of trade completion.</li> <li>• Risk management.</li> </ul>
<b>Markets</b>	<ul style="list-style-type: none"> <li>• Surveillance of market activity.</li> <li>• Identifying unusual trading.</li> <li>• Preliminary investigation of unusual trading and where necessary, referral to ASIC or relevant ASX departments</li> </ul>
<b>Listed Entities</b>	<ul style="list-style-type: none"> <li>• Setting standards for listed entities through the ASX listing rules.</li> <li>• Supervising and encouraging compliance with the listing rules.</li> <li>• Implementation of trading halts, suspensions and removals.</li> <li>• Where necessary referral to ASIC.</li> </ul>
<b>Market Participants</b>	<ul style="list-style-type: none"> <li>• Setting standards for participants, including prudential and systemic risk management through business rules.</li> <li>• Supervising and encouraging compliance with business rules and relevant provisions of the <i>Corporations Law</i>, including education, administration of self assessment procedures, inspections, as well as formal investigations.</li> <li>• Investigating breaches and presenting appropriate cases for disciplinary action.</li> <li>• Adjudication and appeal of disciplinary matters.</li> <li>• Powers to restrict or suspend access.</li> <li>• Referral or notification to ASIC, as required.</li> </ul>

## 6.7 Public Interest versus the Exchange's Commercial Interest

There is a high level of public interest surrounding the affairs of an exchange. Given that exchanges have commercial objectives, the issue arises whether an exchange might put its commercial interests ahead of public interests. The potential conflicts are generally regarded as greater where exchanges are structured as for-profit bodies.

There is a very high correlation between what is in the public interest and what is in an exchange's interests. For example, it is a commercial imperative for any stock exchange to engender confidence among investors in the operation of the exchange's market(s). This is achieved by providing a fair and efficient marketplace in which investors may buy or sell their securities.

Another commercial imperative for exchanges is to operate a listings business and to encourage listings by providing an environment where companies are able to lower their costs of raising capital.

In addition to the alignment of such interests as noted above, there are also a variety of controls on exchanges that help to reduce the possibility that they will act in a manner contrary to the public interest. First and foremost, exchanges are typically subject to some form of regulatory approval process that includes an assessment of whether an exchange has paid due regard in its rules to the interests of the public. Other controls include:

- (i) anti-trust legislation which prohibits anti-competitive behaviour or misuse of market position; and
- (ii) a requirement that there be transparency in processes. This may encompass, for example, the embodiment of processes in rules, rule changes being made available for public scrutiny and comment, and government oversight of rule changes.<sup>7</sup>

## 6.8 New Business Lines

If an exchange expands its business lines, it may find itself in collaboration or competition with entities that it supervises. Such a relationship might develop, for example, because an exchange decides that there are strong commercial imperatives for it to enter into a joint venture with another listed company. In the absence of special arrangements, this may place the exchange in a position where it could, potentially, favor that company.

Conflict may also arise when the exchange is in competition with another listed company. The exchange could, conceivably, in the

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<sup>7</sup> In Australia, rule changes are subject to informal ASIC approval processes and ministerial disallowance procedures.

performance of its supervisory functions, discriminate against the other listed company.

One way of addressing this potential for conflict is by ensuring the transparency and accountability of the supervisory decision-making process. A mechanism for this is the introduction of an oversight role in relation to supervisory decision making concerning entities with whom there is potential for conflict of interest. This is the model adopted by ASX. Under the ASX model, there is both:

- (i) general oversight of the supervisory activities of ASX; and
- (ii) specific oversight of ASX's supervision of those of its listed entities who have special identified conflicts. The latter oversight function encompasses consultation on each supervisory decision involving the exercise of a discretion.

ASX considers this model to be preferable to the removal of supervision responsibility for such parties to another entity. In considering what are appropriate arrangements to handle conflicts, it is important to remember why markets around the world have tended to favour a co-regulatory model in the first place. Co-regulation is designed to achieve a productive collaboration between the government regulator and the self-regulatory organization with its special expertise and close proximity to the market. The proximity of the market operator to the market and its participants allows it to respond quickly and effectively to supervisory issues. If the market operator outsources part of that function for particular entities with whom there may be potential for conflict, there is a risk that the distance and isolation of the alternate supervisor will produce less effective supervisory responses or result in a disparity of outcomes and timing of supervisory responses.

## 6.9 Conclusion

This chapter has sought to comment briefly on the main types of conflict that can arise for demutualized exchanges. Many of these conflicts also arise in the case of mutual exchanges, but they are brought into sharper focus when an exchange demutualizes. There are a variety of ways of addressing these areas of potential conflict and the chapter identifies some of them.

The fundamental truth is that it is in the commercial interests of each exchange to ensure that there are appropriate controls in place for comprehensively addressing these areas of potential conflict in order to retain public confidence in the integrity and efficiency of the markets operated by the exchange.