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Demutualization of Exchanges— The Conflicts of Interest (The Australian Regulator’s Experience)

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7.1 Introduction

Today Australia has three regulated securities exchanges and two futures exchanges. They are all demutualized, for profit companies but only the Australian Stock Exchange Limited (ASX) is listed on its own exchange. Shares in SFE Corporation Limited (SFE), formally known as Sydney Futures Exchange Limited, can be traded on an exempt issues market established for this purpose. SFE has announced that it is proposing to list on ASX in the first quarter of 2002.

This chapter concentrates on ASX because so much of Australian Securities and Investment Commission’s (ASIC) learning about conflict of interest issues derives from its regulation of ASX since trading in ASX shares began on its market on 14 October 1998. This was the first time, as far as ASIC is aware, that shares in an exchange anywhere in the world traded on a market operated by the exchange.

7.2 Self-Listing

The *Corporations Act 2001* confers power on ASIC to administer ASX’s listing rules in relation to ASX as a self-listed exchange. The provisions were first enacted at the time ASX demutualized to overcome conflicts of interest, which might arise because ASX is both the securities exchange and a listed entity. They enable ASIC to require an exchange to

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enter into arrangements designed to address the potential for conflicts of interest that might arise from the quotation of its securities on its own market. The arrangements are to be entered into at the time that securities are granted quotation on the exchange.

The provisions are restricted to possible conflicts arising only from the quotation and trading of an exchange's securities on its own market. Potential conflicts of interest which may arise in an exchange's administration of the listing and business rules are not dealt with since they relate to the exchange's corporate objectives and business interests and not directly to the trading of the exchange's securities.

The limitations in the provisions have been revealed in several recent situations involving ASX as it has pursued business opportunities in many directions and concerns of possible conflicts of interest have been addressed on an interim basis.

The arrangements ASIC entered into with ASX are reflected in a Memorandum of Understanding (MOU) between ASIC, ASX and ASX Settlement and Transfer Corporation Pty Limited (ASTC), dated 23 September 1998. ASTC is a party to the memorandum because it is responsible for certain clearing and settlement functions and ASIC may have to take discretionary action in relation to ASX which it may direct ASTC to take on its behalf.

The MOU sets out the procedures that operate between ASIC, ASX and ASTC in monitoring of:

- (i) ASX's compliance with the ASX listing rules, *the SCH Business Rules* and the *Corporations Act* as a listed entity;
- (ii) ASX's enforcement of the ASX Business Rules in relation to ASX's securities; and
- (iii) ASIC's supervision of ASX as a listed entity.

ASIC makes the decisions on all listing matters affecting ASX and ASX securities and relevant staff in ASX who undertake procedural functions such as the processing of ASX company announcements act on the direction of ASIC.

As far as possible, ASIC administers the rules in relation to ASX as a listed entity in a manner consistent with the way in which ASX or ASTC applies the rules to other entities listed on ASX. ASIC charges fees for supervision of ASX as a self-listed entity calculated on the same basis that ASX charges fees to other listed entities for the same service.

To provide administrative flexibility the MOU permits administrative letters to be exchanged between the parties. These letters detail the procedures and relevant personnel within ASIC, ASX and ASTC who will be responsible for performing a relevant function or procedure which is envisaged to be performed under the MOU.

ASX has “Chinese Wall” arrangements in place whereby discussions between ASIC officers and the nominated ASX surveillance and listings staff cannot be revealed to ASX staff responsible for ensuring ASX complies with the listing rules. The ASIC officer’s contact is with the ASX staff nominated in the administrative letters. Within ASIC there is a hierarchy of responsible officers for administering the self-listing arrangements which mirrors the ASX structure of responsibilities for monitoring and enforcing compliance of the listing rules by all other listed entities.

The types of matters dealt with at the operational level include monitoring compliance by ASX with continuous disclosure and other obligations in the listing rules, referring any share trading anomalies, approving for release market announcements, assessing waiver applications and reviewing notices of meetings. Matters such as significant waivers from the listing rules are elevated to more senior staff within ASIC based on their regulatory significance. The arrangements are working well under the MOU.

ASX introduced a specific chapter (Chapter 20) in its listing rules that apply solely to it as a listed entity. The effect of the rules is to provide a substitute for the ordinary listing arrangements reflected in the listing rules for all other listed companies. In short, ASX makes all the undertakings that any listed entity makes normally to ASX, but these undertakings are made to ASIC and not ASX.

ASIC is empowered by the *Corporations Act* to exempt ASX and ASTC from compliance with the Act where it considers it is necessary to provide for appropriate operation of the statutory provision. This power was included to remove the need for extensive law reform to accommodate the “one-off” circumstance of ASX as a self-listed entity and co-regulatory organization and to provide some flexibility in case a section of the Act was subsequently identified which needed modification or for which an exemption was required. Declarations making technical modifications and exemptions of the legislation as it applies to ASX and ASTC were made by ASIC pursuant to this power immediately before ASX listed on its exchange.

7.3 Other Conflicts

ASX's retention of the listings function on demutualization and self-listing gave rise to the potential for a conflict of interest that was not covered by these comprehensive arrangements within months of their being entered into. As outlined earlier in this chapter the only conflict the law dealt with was about ASX itself as a listed entity, not as a commercial rival of another listed entity. This regulatory gap is to be filled under the Financial Services Reform Act 2001.

7.3.1 Bid for the Sydney Futures Exchange (SFE)

ASX had announced a bid for the SFE in December 1998. In May 1999, Computershare Limited, a public company listed on ASX, announced a rival bid for SFE. Computershare has a major business in supplying market technologies and a substantial part of the share registry services business in Australia and elsewhere. The question confronting ASIC was what arrangements should be put in place to ensure that the supervision of Computershare as a listed company was not seen as tainted by the obvious conflict between ASX's role as a market supervisor and its interests as a competing bidder for SFE.

What ASIC did was to enter into an agreement with ASX and Computershare, which provided that until the issue of the rival bids was resolved, ASX as market operator would not make any substantive decision about Computershare without first consulting with ASIC and acting in accordance with advice provided by ASIC. The agreement was made public and details released to the market. As it turned out neither bid succeeded and SFE proceeded with its demutualization independently.

This experience taught ASIC that conflicts can arise very quickly without any prior warning, that they need to be dealt with immediately when they arise and must be dealt with as close to instantly as ASIC as a regulator can manage. In this 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.

7.3.2 Other Commercial Conflicts

ASX has pursued a number of other business opportunities in the three years since demutualization. They illustrate the broad scope for possible conflicts between an exchange's role as a market regulator and

its role as a commercialized entity able to undertake a variety of business initiatives. 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 conflicts with entities listed on its exchange and it no longer has the close ties of ownership and membership with those who trade directly on its markets.

ASX has responded to concerns about the conflicts issues by forming a special purpose subsidiary, ASX Supervisory Review Pty Limited. 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 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.

7.3.3 Financial Services Reform Act 2001

The *Financial Services Reform Act 2001* directly addresses the wider conflicts issue. It permits regulations identifying conflicts and potential conflicts between the commercial interests of a licensed market operator and its statutory obligations to run an orderly, fair and transparent market and empowers ASIC to act in place of the licensee or to require the licensee to take action under its rules in relation to a conflict or potential conflict. The *Act* also places an obligation on ASIC to audit annually the adequacy of supervision arrangements of all licensed market operators, including arrangements for dealing with conflicts of interest. The *Act* is to commence on 11 March 2002.

Under these new arrangements, ASIC will be working to ensure that the conflict situations, which are likely to arise, are appropriately dealt with, that the costs of market supervision continue to be borne by those who use the market rather than the public purse, and that market integrity and consumer protection standards are maintained and enhanced.