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## Regulation of Demutualized Exchanges (Australia)

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### 11.1 Legislative Framework

The current legislative framework for regulation of securities and futures markets in Australia is set out in the *Corporations Act 2001 (Act)*, a Commonwealth law which commenced on 15 July 2001. The *Act* replaces and largely replicates the national scheme of *Corporations Laws* of the Australian States and Territories which has operated in Australia for the last 10 years. The national scheme has effectively been re-enacted as a Commonwealth law for Australian constitutional law reasons.

The *Financial Services Reform Act 2001 (FSR Act)* will change some aspects of the current regulatory regime in a number of important ways. The *FSR Act* will commence on 11 March 2002. Accordingly this chapter will describe the current provisions and indicate important changes that are to be made to them by the *FSR Act*.

The *Act* prohibits the conduct of an unauthorised securities or futures market in Australia. It vests in the Minister extensive regulatory functions in relation to the approval and operation of securities and futures exchanges. These include powers to approve new exchanges, and control of amendments to the business and listing rules of the exchanges by means of notification and disallowance. The Minister also has the power to remove the authorisation of an exchange.

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## 11.2 Australian Securities and Investment Commission's (ASIC) Powers

In contrast with the regulatory powers of the Minister, which focus on the adequacy of the supervisory framework and conduct of the market operator itself, ASIC's powers in relation to markets mainly focus on the conduct engaged in upon the regulated market by market intermediaries and listed entities.

ASIC can prohibit trading in certain circumstances. It also has powers to take action in relation to market misconduct including breaches of the continuous disclosure rules, insider trading, market manipulation, false and misleading trading and market rigging transactions, false and misleading statements and fraudulently inducing persons to deal in securities. ASIC regulates the conduct of licensed intermediaries in relation to their clients under the licensing provisions of the *Act*.

ASIC also receives notification of rule amendments from the exchanges and applications for authorization of new exchanges. At a practical level, ASIC reviews rule amendments and applications for new markets in detail and provides its views on them to the Minister.

## 11.3 Supervision by Market Operators

Both the current and the proposed legislation envisage that market operators play a supervisory role in relation to the markets they operate. This is an important mechanism in ensuring that the cost of the regulation to which the market is subject is borne by market participants and users.

The conduct of the market involves potentially three distinct areas of supervision:

- (i) supervision of the market itself;
- (ii) supervision of participants in the market (including their dealings with their clients); and
- (iii) supervision of entities whose securities are traded on the market.

Under the *Act*, a regulated exchange has an obligation to provide assistance to ASIC, lodge with ASIC particulars of disciplinary action and provide ASIC with details in relation to serious contraventions of the exchange rules or of the *Act*.

## 11.4 Memoranda of Understanding (MOUs)

These legislative provisions are supported at a practical level by operational arrangements between ASIC and each regulated exchange documented in Memoranda of Understanding. ASIC and Australian Stock Exchange Limited (ASX) have entered into MOU arrangements in relation to markets, membership, companies matters and transfer of information matters. There is also a MOU dealing with arrangements for ASIC's supervision of ASX as a self-listed entity.

The markets and companies MOUs deal with procedures for the referral of serious matters by ASX to ASIC for further investigation and action relating to conduct by market participants or disclosure by listed entities. The companies MOU sets out the arrangements agreed between ASX and ASIC to promote cooperation and assistance in monitoring and, where appropriate, enforcing provisions of the listing rules. It also deals with the role of ASIC in enforcing provisions of the *Act* relating to disclosure, accounting, corporate governance and related party matters.

The membership MOU sets out the arrangements agreed between ASX and ASIC to promote cooperation in monitoring, surveillance and enforcement actions in relation to ASX participating organisations.

ASIC and SFE Corporation Limited (SFE), formerly known as Sydney Futures Exchange Limited, have also entered into a MOU which covers procedures for the referral of serious matters by SFE to ASIC for further investigation and action relating to conduct by market participants.

## 11.5 Changes Due to Demutualization

In the lead up to the ASX demutualization and self-listing the self-regulatory responsibilities of regulated securities exchanges were reviewed. New provisions were enacted to:

- (i) permit a securities exchange to self-list;
- (ii) empower ASIC to supervise an exchange as a listed company on its own exchange;
- (iii) separate participants' rights of access to trading from membership of the exchange in a company law sense;
- (iv) clarify an exchange's role as a co-regulatory organization by

directly placing on it ongoing obligations to run an orderly and fair market;

- (v) require an exchange to report to the Minister annually on its compliance with its ongoing obligations;
- (vi) empower the Minister to give directions to an exchange to ensure it complies with the ongoing obligations;
- (vii) enable the Minister to require an exchange to obtain an audit report on its annual regulatory report on its compliance with its ongoing obligations;
- (viii) enable the Minister to require an exchange to prepare and give to ASIC a special report on the exchange's compliance with its ongoing obligations. The Minister may require an audit report on the special report.

This legislation also imposed a 5% shareholder limit on ASX. The statutory limitation restricts persons and their associates both Australian and foreign from owning or controlling more than 5% of the shares in ASX.

These provisions apply only to securities exchanges. This meant that when SFE demutualized, ASIC and SFE entered into a deed whereby SFE agreed to comply with contractual arrangements that are substantially the same as the ongoing obligations and reporting requirements of a securities exchange. The *FSR Act* extends these obligations and requirements to all licensed financial market operators.

Newcastle Stock Exchange (NSX) demutualized when its regulated market was revived in 2000. ASIC and NSX have entered into a comprehensive MOU covering similar matters to those dealt with in the various ASX MOU. Bendigo Stock Exchange is also a commercialised entity and ASIC is negotiating similar arrangements in relation to its market.

In demutualized exchange markets the relationship between the market operator and market participants may not be conducive to the market operator closely supervising the conduct of participants other than in their direct involvement in the market. The commercial objectives and activities of an exchange may also bring it into conflict with the listed entities that it also regulates.

The regulatory framework in which a market operates is (and will continue to be) largely determined by the approval process and the continuing scrutiny of that framework through the rule disallowance process.

## 11.6 New Legislation

The *FSR Act* 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 places a ceiling on ownership of “public interest” exchanges such as ASX and SFE of 15% (with a power to approve holdings above 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 *FSR Act* 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 license approval process. All market operators must also show that they have on an ongoing basis sufficient resources (including financial, technological and human resources) to operate their markets properly and for the statutory supervision arrangements to be provided.

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.

ASIC considers that current market supervisory arrangements in Australia are likely to continue to evolve in response to the pressures faced by markets around the world. It expects that there will be increased scrutiny of the framework of market supervision by market participants, by regulators in other countries as a pre-condition to the entering into cross border alliances and by international bodies in their reviews of how well individual countries are complying with international standards and principles.