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Australian Stock Exchange—The Conversion to a Demutualized Exchange: ASX’s Experience

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12.1 Introduction

The Australian Stock Exchange (ASX) was the first stock exchange to both demutualize and be admitted to its own official list of companies. This chapter examines, with a practical emphasis, the circumstances surrounding ASX’s own demutualization and listing. General themes of interest to other exchanges in our region relative to a demutualization decision will, no doubt, emerge during later panel discussions. The discussion in this paper addresses the topic under the following headings:

- Background to ASX’s Demutualization
- Obtaining Member Approval
- Mechanism Used for Conversion
- Changes to the *Corporations Law*
- The Demutualization Process
- Memorandum of Understanding (MOU) with ASIC
- Listing and Demutualization Outcomes
- Subsequent Supervisory Development: ASX Supervisory Review
- Changes in ASX’s Focus and Activities

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12.2 Background to the Australian Stock Exchange's Demutualization

ASX was created in 1987 by the Australian Stock Exchange and National Guarantee Fund Act 1987, which deemed the Exchange to be incorporated under Australian companies law and to be a company limited by guarantee. ASX was formed by the amalgamation of six State-based exchanges located in Sydney, Melbourne, Brisbane, Perth, Adelaide and Hobart. Each of the State exchanges had a long history, being formed between 1871 and 1898.

ASX's demutualization and listing process began in 1995 when the ASX Board formed a task force, comprised of ASX Board and Management representatives, to examine options to change the Company's structure. Were the task force to consider it appropriate, then it was to formulate a proposal to change the relationship between ASX and its members and to remove the requirement that access to ASX's markets should hinge on membership of the Exchange.

At the time that the topic of demutualization was being considered by ASX, the Exchange had two classes of members: Corporate Members (Member Organizations) and Natural Person Members (members). Neither class of members was able to transfer their rights to another party directly² (i.e., that is, there were no seats). Furthermore, Corporate Members were numerically in the minority, but they dominated trading.³

By way of background, seats were abolished by the old State-based exchanges during the period 1984 to 1986, by the process of buying back by the exchanges. Thereafter access to the market was available to any applicant who met ASX's Business Rule requirements, which included the payment of a one-off fee at the time of initial application and an ongoing annual maintenance fee.

² It was possible, however, for a party to indirectly purchase the trading right of a Corporate Member through buying a controlling interest in the latter.

³ As at 30 June 1998 corporations were responsible for 99% of transactions on ASX's markets, but were in a minority of 93 compared with 522 Natural Person Members. Members in both classes each had a single vote.

12.3 Obtaining Member Approval

On 24 September 1996, ASX distributed a Notice of Special General Meeting to its members, together with an explanatory memorandum. The Notice included a recommendation by the ASX Board for a demutualization proposal.

Members of ASX were asked to vote on a proposal to mandate the ASX Board to seek from the Australian Parliament legislation that would change the nature of existing membership rights and simultaneously convert ASX from a company limited by guarantee to a company limited by shares.⁴ In essence this meant that, in return for ceding mutual ownership and any control of ASX that mutual ownership may bestow, each relevant member would be allocated shares in ASX.

The proposal was put to members on the basis that the board of ASX believed that the membership should consider whether, in order to deal with future challenges, ASX needed to change the way it was owned and governed. There was no need to raise capital; nor was there a compelling reason to find a way to distribute direct financial benefits to members. Rather, it was put to members that key determinants for their consideration included assessments whether:

- (i) competition was real and growing for ASX, and for the products and services it offered;
- (ii) a non-mutual structure would equip ASX better than a mutual structure to meet competition;
- (iii) members' interests were diverging (and were unlikely to reconverge) and the same benefits were not necessarily derived by all members from the services provided by ASX;
- (iv) members' interests would not always coincide with those of ASX itself; and
- (v) it is undesirable in the long term for control of an entity to reside with only one group of its customers.

The ASX Board and Management considered that each of these factors brought into question the suitability of the mutual form of

⁴ Under ASX's constitution for the resolution to be passed there needed to be a 75% majority of votes cast at the members' meeting in favor of the resolution.

ownership for ASX, and that collectively they represented a strong case for demutualization. Nevertheless, great care was taken to include objective analysis of both sides of the argument—for and against—in the materials provided to members.

On 18 October 1996 the members voted overwhelmingly to endorse⁵ alterations to the constitution of ASX, requiring the Board to seek the enactment of Australian Commonwealth legislation that would allow demutualization.

12.4 Mechanism Used for Conversion

The main resolution approved by ASX members was that a new article should be inserted into ASX's Articles of Association which would mandate the board to approach government for legislation to convert ASX to a company limited by shares. The Article set out the components of the legislation that would be sought by ASX. The chief components were:

- (i) conversion of the corporate status of ASX to a company limited by shares. At the time that the members' resolution was passed, there were no legal means by which a company limited by guarantee could convert to a company limited by shares;
- (ii) vesting of the shares in ASX, in its members; and
- (iii) breaking the nexus in the *Corporations Law* between membership of ASX (as a corporation) and access to its trading facilities by, and regulation of, market participants.⁶

Ancillary elements of the legislation to be sought were:

- (i) recognition of a new Memorandum and *Articles of Association* to be prepared by ASX in accordance with the guidelines and principles set out in the foregoing new *Article*. The guidelines and principles were essentially those appropriate for a listed public company;

⁵ Over 96% of members supported the recommendation. Members were entitled to one vote each.

⁶ The *Corporations Law* reflected a general assumption that membership of an exchange is limited to brokers or those with access to the securities-related services provided by the exchange.

- (ii) recognition of amended ASX Business Rules to be prepared by ASX in accordance with the guidelines and principles set out in the new *Article*. These guidelines and principles were intended, to the extent appropriate, to replicate the existing systems and disciplinary principles and procedures of members and Member Organisations reflected in the Articles of Association and Business Rules of ASX prior to conversion;
- (iii) recognition of every organisation which was a Member Organisation at the time the legislation took effect, as a trading Participating Organisation for the purposes of the new Memorandum, Articles and Business Rules;
- (iv) recognition of every Natural Person Member at the time the legislation took effect, as an Affiliate for the purposes of the new Memorandum, Articles and Business Rules; and
- (v) a statutory statement that the ASX Business Rules had a legally binding effect as between admitted trading participating organizations, affiliates and ASX itself.

12.5 Changes to the Corporations Law

Following the overwhelmingly positive vote by ASX members, management of ASX worked closely with the Australian Government to develop the legislation necessary to achieve the change in structure. This legislation was released in Bill form for public comment on 6 August 1997⁷ and it came into effect on 16 December 1997.

New provisions were inserted in the *Corporations Law*, which clarified ASX's responsibilities as a self-regulatory organization and ensured appropriate accountability to the Australian Securities and Investments Commission (ASIC) and to the government in carrying out those responsibilities. Obligations were imposed on ASX (and on securities exchanges generally) as follows:

- (i) to the extent reasonably practicable, to do everything necessary to ensure that the market ASX conducts is an orderly and fair market;

⁷ *Corporations Law Amendment (ASX) Bill 1997*.

- (ii) to have adequate arrangements for monitoring and enforcing compliance with ASX's rules;
- (iii) to have adequate arrangements for the expulsion, suspension or disciplining of market participants for inappropriate conduct;
- (iv) to have adequate arrangements for the settlement of transactions that result from trading in securities on a stock market ASX conducts; and
- (v) to have adequate arrangements for investigating complaints by investors.⁸

The Australian Commonwealth Government Minister responsible for financial regulation in Australia (hereafter the Minister) was empowered to direct an exchange to do specified things that the Minister believed would promote compliance with these requirements.

An obligation was also introduced for annual reports to be provided by Securities Exchanges about compliance with these requirements. These reports must be prepared within three months after the end of each financial year and be provided to ASIC. The Minister may request that the reports be audited. Furthermore, at any time, the Minister may request a special report about compliance with ongoing requirements by an exchange, and may also require that the special report be audited.

In addition to clarifying the responsibilities of ASX as a self-regulatory organisation and ensuring appropriate accountability for the proper conduct of them, an ownership limitation was imposed on ASX. This limited persons and their associates (Australian and foreign) to having voting power in ASX not exceeding 5%.

The Law was also amended to allow ASIC to supervise ASX's compliance with its listing rules in respect of ASX's own listing.

12.6 The Demutualization Process

ASX undertook the following actions in the lead-up to demutualization and listing:

- It amended its listing rules on 1 July 1998 to introduce a special chapter dealing with its listing.

⁸ *Corporations Law*, section 769A.

- It rewrote its Memorandum and Articles of Association and its Business Rules. The amendments included a mechanism for downsizing the Board and changing the Board's broker-dominated composition.
- It conducted roadshows and consulted extensively with its Members concerning these amendments and the issues pertinent to demutualization.
- It separated Board and management functions by reviewing the role of committees.
- It implemented a due diligence program for the conversion and listing of ASX including detailed briefings to Board and senior management and the establishment of data management processes for the due diligence process.
- It created employee share plans to incentivise and retain staff and developed rules concerning dealing in the securities of ASX by directors and staff.
- It introduced obligations on directors and staff designed to promote compliance with the continuous disclosure requirements of the listing rules.
- It developed a dividend policy and a policy on the use of cash balances.
- It issued a detailed Information Memorandum dated 28 August 1998 to support its listing.
- It made application to ASIC on 31 August 1998 for ASX to be demutualized.

It entered into an MOU with ASIC on 23 September 1998 under which ASIC was to administer ASX's listing and the quotation of its securities in order to avoid the conflict of interest that may have arisen had ASX administered its own listing and quotation. The MOU is discussed further below.

ASX also made changes to its business structures to prepare for the transition to a for-profit company. In particular, ASX undertook a comprehensive review of its operating and management structure in preparation for listing. As a result, a new structure was adopted in May

1998, better to reflect the importance of customer service, quality and efficiency. Key changes included the creation of a separate Investigations and Enforcement Unit and the establishment of a Corporate Relations Division for liaison with analysts and investors.

Fortunately for ASX, the exchange already had in place many of the corporate governance mechanisms and annual reporting practices suitable for a large public listed company.

12.7 Memorandum of Understanding (MOU) with ASIC

As noted above, ASX and ASIC entered into an MOU in relation to ASX's self-listing. This MOU set out the way that ASX, the Australian Settlement and Transfer Corporation Pty Ltd (ASTC)⁹ and ASIC relate to each other in monitoring ASX's compliance as a listed entity with the Listing rules, the *SCH Business Rules* (ASX's settlement rules) and the *Corporations Law*. The MOU also addressed ASIC's supervision of ASX as a listed entity.

An important objective in negotiating the MOU was the desire to ensure consistency of outcomes and timing between ASX in its administration of the listing rules for other listed entities, and ASIC in its administration of the listing rules for ASX.

Some key aspects of the MOU include:

- ASIC is responsible for supervising ASX's compliance with the listing rules. In relation to the continuing supervision of ASX as a listed entity, ASIC is responsible for exercising 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.
- ASTC is responsible for supervision of ASX's compliance with the *SCH Business Rules* and its application for admission to CHESS, as it is for other listed entities, and ASIC may direct ASTC to exercise certain powers and functions in relation to ASX.

⁹ ASTC is a wholly owned subsidiary of ASX and is responsible for the development and operation of ASX settlement system, CHESS.

- ASX makes its announcements to ASIC in the same way that other entities make their announcements to ASX. Once cleared by ASIC, ASX's announcements are to be released to the market through ASX's own company announcement platform.
- ASX will set appropriate parameters for generating surveillance alerts relating to dealings in its own securities. If required by ASIC, ASX will provide assistance and allow ASIC to analyse trading in ASX's securities.

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

12.8 Demutualization and Listing Outcomes

Demutualization of ASX occurred on 13 October 1998 and as part of the demutualization process former eligible members were issued shares in ASX. The issue of shares occurred on the following basis:

- Each of the 606 eligible former Corporate and Natural Person Members received 166,000 shares resulting in a total issued capital of 100,596,000 shares.¹⁰
- There was no "cash out" offer for members, and there were no additional shares offered or funds raised by ASX.
- There were no special restrictions placed on members concerning the sale of ASX shares.¹¹
- There were no minimum shareholding requirements placed on members.

Following demutualization, ASX made an application to ASIC for admission to ASX's own official list and for quotation of its shares. Listing of ASX and quotation of its shares occurred on 14 October 1998.

¹⁰ While ASX had both corporate and natural person members, all members were treated equally for share distribution purposes.

¹¹ There was however a 5% individual ownership cap imposed by the Government and contained in the *Corporations Law*. This is in the process of being lifted to 15%.

12.9 Subsequent Supervisory Development: ASX Supervisory Review Pty Limited

A demutualized exchange needs to be constantly looking at ways of innovating, and of enhancing its reputation for integrity. In this context, earlier this year, ASX established an entity with a charter which, among other things, empowered it to review ASX's supervisory activities. The new entity, ASX Supervisory Review Pty Limited:

- (i) reviews the policies and procedures of the units in the ASX Group which have supervisory functions. This includes a review of the level of funding and resources provided by ASX for its supervisory functions;
- (ii) provides reports and expresses opinions to the ASX Board on whether appropriate standards are being met and whether the level of funding and resources for supervisory activities are adequate;
- (iii) as a result of these activities, provides assurance that the ASX Group adequately complies with its ongoing responsibilities as a market and clearing house operator, is conducting its supervisory activities ethically and responsibly, and is maintaining appropriate controls against employee conflict of interest; and
- (iv) oversees supervision of those of ASX's listed entities which have special identified conflicts and which select this option (the Review Group).¹² The oversight function encompasses consultation on each supervisory decision which involves the exercise of discretion.

In addition to reporting to the ASX Board, ASX Supervisory Review's reports are used to assist in the preparation of ASX's annual regulatory report to the Minister and are made available to ASIC.

¹² The "Review Group" will comprise entities which satisfy one of the following criteria: (a) their business is in direct competition with ASX's business in a material way for ASX; (b) they hold a substantial shareholding interest in ASX; (c) ASX holds a substantial shareholding interest in them; (d) the entity "controls" an entity falling with paragraphs (a), (b) or (c). For this purpose "control" means the direct or indirect capacity to dominate decision making in accordance with AASB 1017: Related Party Disclosure; or (e) it is otherwise desirable for the entity to fall within the Group because of the potential for significant conflict of interest.

The Board of ASX Supervisory Review Pty Limited is comprised of a majority of nonexecutive, independent¹³ persons with complementary skills. Individual appointees are chosen from a panel nominated by ASX. ASIC has the power to veto any particular panelist. Proposed appointees are notified to the Minister prior to their appointment. Appointments are for a term of three years. Existing directors may be reappointed.

ASX considers this structure best promotes consistency of outcomes and timing while affording an extra dimension of transparency and accountability.

12.10 Changes in ASX's Focus and Activities

Since demutualization ASX has experienced a number of significant changes in its focus and activities. These include:

- (i) increased flexibility in decision-making;
- (ii) increased customer focus; and
- (iii) expansion of activities.

12.10.1 Increased Flexibility in Decision-Making

One of the most important changes that has accompanied demutualization is that ASX now has much greater flexibility in its decision-making. The Exchange is therefore better equipped to make timely decisions for market users, and to respond to changing circumstances.

Prior to demutualization, access to ASX's market facilities was largely controlled by its existing market customers. Key criteria for admission to market participation comprised "membership" criteria and was set out

¹³ An independent director for this purpose is a person who: (1) is not and has not been in the previous two years an affiliate of ASX; (2) is not and has not been in the previous two years a partner, director, officer or employee of a Participating Organization of ASX or a related body corporate; (3) is not and has not been in the previous two years a director, officer or employee of ASX or a related body corporate; (4) does not have a material interest in ASX or a related body corporate; (5) is not a spouse, de facto spouse, parent or child of a person in any of the previous categories; and (6) is not and has not been in the previous two years a professional adviser to ASX or a related body corporate.

in the Articles of Association. A special resolution of the membership was required to broaden access to the ASX market. Much of ASX's decision-making prior to demutualization was by brokers on committees. Following demutualization most of the decision-making responsibility was transferred to ASX management. Committees continue to exist, but their composition reflects competencies and experience required for the particular function and they are typically used for consultation and/or appeals from management decisions.¹⁴

12.10.2 Increased Customer Focus

Another important change that has occurred is an increased customer focus. Prior to demutualization, as brokers were the owners of ASX, a disproportionate amount of time was spent serving their needs. Since demutualization, while brokers remain an important and valued customer, ASX has spent a great deal of time focusing on the needs of other customer groups such as listed companies and investors. This has resulted in changes in organizational lines to provide a better fit with customer groups, the appointment of various account managers for key customers, and more attention being devoted to marketing, education and information dissemination.

12.10.3 Expansion of Activities

Since demutualization ASX has examined ways of enhancing profitability, diversifying its revenue base and providing value-adding services to customers. This has resulted in ASX expanding into new but related businesses, including:

- (i) a joint venture arrangement involving a share registry business;¹⁵
- (ii) the acquisition of a 15% stake in a company that provides trading

¹⁴ As an example, decisions made in relation to admissions to ASX's official list of companies used to be made by a Listing Committee comprised of some eight members, the majority of whom were brokers. As part of the demutualization process, decision-making authority was transferred to ASX Management. Management now has decision-making authority to admit new companies to the official list, whereas there is a Listing Appeals Committee to hear appeals on Listing Rule decisions.

¹⁵ On 20 March 2000 ASX and Perpetual Trustees Australia Limited (Perpetual) announced that they had formed a joint venture, incorporating the operations of Perpetual's share registry division, Perpetual Registrars Perpetual is listed on ASX.

and order management services to professional financial market participants;¹⁶ and

- (iii) the acquisition of a 50% stake in a company that provides an investor consultancy service.¹⁷

ASX has also announced a number of initiatives aimed at facilitating cross-border trading by investors. These have included:

- (i) a two-way trading link with Singapore Exchange Limited, which is expected to be operational later this year; and
- (ii) a one-way trading link into the United States market, utilizing Bloomberg's TradeBook system.

12.11 Conclusion

This chapter has discussed the main steps that ASX took to achieve its demutualization and self-listing, which was a world first. The process was a complex one, taking more than three years from the time that the ASX Board first established a working group to consider ownership options. The process could not have been achieved without the strong commitment of the Board and of ASX Management. The outcome has been extremely beneficial for both ASX and the markets that it operates, and it places ASX in a strong position to respond to changes in its business environment.

The environment faced by exchanges that are in the process of demutualization can be markedly different. Nevertheless it is worthwhile noting that ASX's demutualization and listing had the following features:

- (i) demutualization was at the initiative of the Exchange—it was not mandated by government;
- (ii) while ASX had both Corporate and Natural Person Members, circumstances were such that they could be effectively treated on the same basis for share distribution purposes;

¹⁶ On 19 September 2000 ASX announced that it had agreed to take a 15% stake in Bridge DFS Ltd. Bridge DFS subsequently listed on ASX.

¹⁷ ASX announced on 5 February 2001 that it had acquired a 50% stake in Orient Capital Pty Ltd, an unlisted company.

- (iii) ASX did not have any “seats” on issue (i.e., brokers’ trading rights were not directly transferable);
- (iv) demutualization did not involve the merging of separate entities;
- (v) ASX had a Board and a Management team committed to demutualization; and
- (vi) ASX already had in place many of the corporate governance mechanisms and annual reporting practices found in its large listed companies.

Demutualization and self-listing has been a good experience for ASX and its stakeholders; it continues to serve the Australian investment community well.