



ASIC

Australian Securities & Investments Commission

REPORT 46

Market assessment report: Australian Stock Exchange Limited

June 2005



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C) report

**Australian Stock Exchange Limited
ACN 008 624 691**

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Executive summary

Section 794C of the *Corporations Act 2001* (Act) requires ASIC to assess how well a licensed market operator is complying with its obligations as the holder of a markets licence. More specifically, ASIC must assess whether a market operator has adequate arrangements for supervising the market(s) it operates.

This report summarises ASIC's third assessment of compliance by Australian Stock Exchange Limited (ASX) with its obligations under s792A(c) of the Act.

The first and second reports were publicly released on 4 September 2003 and 16 September 2004 respectively.

This report describes our assessment, conclusions and key recommendations for areas of improvement

Conclusions

1. We conclude that ASX has adequate arrangements for supervising its market, including arrangements for:
 - handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner;
 - monitoring the conduct of participants in the market; and
 - enforcing compliance with its listing rules and market rules.
2. ASX has made substantial progress in responding to the recommendations in our last report that the ASX group strengthen its arrangements for supervising its markets and for monitoring and assessing its own compliance with its obligations as a market licensee. We commend ASX in particular for:
 - the establishment of arrangements so that supervisory and compliance personnel can elevate issues of concern to the Audit & Risk Committee of the ASX Board. In our view, this will assist in ensuring that decisions are made in a way that takes account of whole of organisation impacts and ASX's overriding obligations as a market operator;
 - the establishment of an internal compliance function which is close to being fully operational. We understand that ASX is adding further resources to this area and that the scope of the compliance team's role will be further defined and enhanced in the coming months; and
 - the corporate governance guidelines of the ASX Corporate Governance Council which became fully effective during 2004. In our view, ASX's initiatives in this regard, and the reporting requirements that now apply to listed entities, will have a positive impact on disclosure practices and the behaviour of market participants.

Further detail on this progress is set out at section 1.4 below

3. The scope and number of the issues for improvement raised in this report are much reduced this year, but there are still some areas where we think the pace of change needs to accelerate. We continue to have concerns about:
- supervision of the warrants market; and
 - consistency in monitoring and enforcing the disclosure provisions of the listing rules.

These issues have been raised by ASIC in previous assessments. There have been significant improvements in many areas and we have confidence in the new structures and arrangements that ASX has put in place to continue this progress. Nonetheless, in some cases these new arrangements were not always followed in practice. In our view, there is still work to be done to embed a full understanding of these changes throughout the organisation. ASX accepts our observations in this regard and has indicated its commitment to addressing these issues through a process of continuous improvement. As with any significant changes, we think the results are best measured over time.

4. At the time of writing this report, ASX has publicly stated that it is considering the appropriate structure of the group going forward. The role of Chief Integrity Officer (CIO) was introduced in early 2004, partly as a result of concerns we raised about the management of conflicts and the separation of supervisory decision making from commercial influence. The CIO left ASX on 31 December 2004. At the release of its interim financial results on 15 February 2005, ASX announced the review of a number of senior positions and titles. This included a change in the title of CIO to Group Executive Market Supervision. This position has recently been filled and reports to the CEO. In addition the Group Executive Market Supervision has access to the Audit & Risk Committee of the Board of ASX to discuss supervisory issues, particularly where there may be a potential conflict between the commercial interests and supervisory responsibilities of ASX. We understand that ASX is continuing to consider its group structure, including its arrangements for supervision. ASIC is concerned to ensure that any changes do not move away from the clearer separation between responsibility for supervision and responsibility for commercial issues created at the beginning of 2004. ASIC and ASX will discuss any proposed changes to the implementation of this separation.

Our approach

Our formal assessment of licensed market operators has two aspects.

- *The historical aspect:* we use the assessment process to examine and report on the extent to which we consider a market licensee has, since our last assessment, met and is continuing to meet its supervisory obligations;
- *The future aspect:* we also use the assessment process to identify and comment on areas of suggested improvement, that have the potential to affect the market operator's ability to meet its obligations in the future.

As with our first two assessments, in this assessment we examined in detail the day-to-day supervisory functions carried out by ASX. We paid particular attention to the extent to which ASX has responded to issues we raised in our second assessment report.

Generally our assessment reports focus on suggested areas of improvement in ASX's arrangements rather than on the more positive aspects that support our overall conclusion. It is important to make clear that none of the suggestions for improvement in this report detract from our conclusion that ASX's arrangements have met and continue to meet their statutory obligations.

The regulatory report ASX provided to ASIC and the Minister comprehensively reviews the supervisory and educational activities it undertook during the year. Those activities show the active role ASX plays as front-line supervisor of its markets and provides considerable support for our conclusion that it is complying with its supervisory obligations.

Form of this report

In previous reports, we provided a detailed account of the role of individual ASX business units, identified areas where we thought a change in supervisory practice of the business unit may be needed, and made recommendations for further action.

This report is more confined and concentrates on the main areas where we think ASX needs to make changes in the interests of continuing compliance with its supervisory obligations. Apart from those main recommendations, we comment only briefly on business units where we wish to acknowledge ASX's response to previous recommendations, or to suggest further action.

Section 1: Background

1.1 The ASX group

During the period of the assessment, ASX held an Australian market licence that permits it to operate a market in the financial products described on its licence. A copy of ASX's market licence is available on ASIC's website at www.asic.gov.au. Two ASX group entities, Australian Clearing House Pty Limited and ASX Settlement and Transfer Corporation Pty Limited, hold licences to operate clearing & settlement facilities. ASIC's assessment of these licensees is set out in a separate report.

1.2 The assessment process

ASIC's role

Section 794C of the Act requires ASIC to assess at least once a year how well a market licensee is complying with certain of its obligations as a market licensee. The assessment must consider whether the licensee has adequate arrangements for supervising the market, including arrangements for handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market it operates is a fair, orderly and transparent market.

A market licensee's obligations are ongoing, and whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance. We therefore use the assessment process to:

- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market in accordance with its obligations under the Act at the time of the assessment; and
- identify issues which in our view need, or may need, to be addressed to ensure ongoing compliance.

Assessment process

ASIC's assessment and the views expressed in this report are a combination of processes - the ongoing interaction we have with ASX in our role as regulator of companies and financial markets, an on-site inspection of books and records and interviews with ASX personnel, and the discussions we have with ASX about the issues that have arisen from the first and second processes.

In conducting our assessment we have particularly considered:

- the annual regulatory report given to ASIC by ASX on 30 September 2004 as required under s792F of the Act;
- the annual report prepared for the ASX Board by ASX Supervisory Review Pty Limited (ASXSR), and given to ASIC on 30 September 2004;
- information we received from and about ASX in the ordinary course of our dealings with ASX as a market licensee, including:
 - information received as part of the rule amendment process;

- interaction with ASX on a range of operational issues;
- referrals of serious contraventions;
- the register of listing rule waivers; and
- ASX's most recent annual report;
- information from external sources, including media commentary and reports published by ASX;
- the operation of the market throughout the period, in particular in relation to issues of disclosure and trading;
- internal ASX material, including disciplinary and investigation files, internal reports and information collected by ASX on a continuous basis;
- comments made in interviews or discussions with a range of ASX personnel; and
- discussions with senior ASX management, including members of the board.

In conducting our on-site visit, we:

- interviewed ASX group personnel;
- reviewed policies and procedures for the conduct of ASX markets in general and their supervisory responsibilities in particular; and
- reviewed extensive material provided by ASX under the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

In our assessment this year we reviewed the operations of 16 business units and conducted 22 interviews.

We served a number of notices that required ASX to give ASIC documents relating to a wide range of ASX activities. From 1 November 2004 to 24 November 2004 we attended ASX offices in Sydney, Melbourne, and Perth. During this on-site phase of the assessment we reviewed ASX operational records and spoke to a wide range of personnel across all levels of ASX management.

After our visit, we corresponded and had discussions with ASX about our findings and their proposed responses to a number of issues we raised. Where appropriate, our report reflects ASX's responses.

1.3 Focus of this assessment report

In our assessment report dated September 2004 we made a number of recommendations. The key recommendations arising from that assessment were that ASX should:

- accelerate steps to restructure its supervisory areas, to ensure a more coordinated approach to supervision and to provide clearer lines of accountability for its supervisory obligations;
- review its arrangements for managing conflicts between its commercial interests and its requirement to supervise its markets; and
- improve the consistency with which it monitors and enforces its listing rules.

Much of this assessment has involved a review of various changes made by ASX in response to the issues that we had previously raised. Accordingly the themes of this assessment have been similar to those on which we reported in our previous assessment report dated September 2004.

In brief these themes can be described as the adequacy of the practices of those business units that have a direct supervisory role, or in our view affect the ASX supervisory effort. For those core supervisory units such as Market Surveillance, Compliance Services, Companies, Risk Management and Investigation and Enforcement we looked in particular at the quality and consistency of their outcomes.

More broadly we also considered the structure and organisation of the group, the oversight practices of senior management and the board, and the overall approach of ASX to risk management and group compliance.

We continued to focus on the quality of the arrangements for managing conflict. We reviewed the procedures, practices and relevant events but we also interviewed a number of individuals to help us form a view as to how well the conflict handling arrangements are understood across the organisation and implemented in practice.

1.4 ASX responses and changes since our second assessment

In our previous report we made a series of observations and recommendations about the way ASX approached supervision, conflict management, compliance, enforcing the listing rules and other operational matters. Some of these comments were relevant to the group as a whole while others were more specific to particular operational business units. Overall we said that ASX placed too much reliance on informal reporting and planning arrangements and on individuals to ensure that the group complied with the Act.

Since our previous assessment ASX has undertaken a significant amount of work to improve its arrangements. This process is ongoing and is having a positive impact on the effectiveness of its supervision and its conflict handling arrangements. There are now much clearer lines of accountability for supervision at the most senior levels of ASX, as well as a higher degree of formality in the way that processes and decisions are documented.

Significant examples of changes since our last assessment are:

- the creation of an independent group compliance function that reports to both the CEO and the Audit and Risk Committee;
- an expansion in the risk management and internal audit functions and the role of the Audit and Risk Committee;
- the creation of new supervisory structures and reporting protocols, specifically the creation of the Integrity Division (now known as Supervision, but throughout this report we refer to it as the Integrity Division);
- the creation of the Chief Integrity Officer position (now to be known as Group Executive Market Supervision), which assumed overall operational

responsibility for all supervisory operations and outcomes across the ASX group;

- improvements in the procedures and practices for monitoring and recording supervisory functions;
- the expansion in resources applied to coordinating supervisory operations;
- a more systematic approach to supervisory policy formation; and
- since July 2004, significant improvements in the arrangements for managing conflict.

Significant changes have also been made to improve conflict-handling arrangements. These include a revision of the relevant procedures and an expansion in the detail contained in the procedures documentation. The procedures in place at the time of our assessment appear to be adequate.

The ASX has also revised the Key Result Areas (KRAs) that are applied to its supervisory personnel. The current KRAs are clear in the predominance given to supervision over commercial or other considerations. They appear detailed and thorough in their scope.

A number of operating rule amendments were made since our last assessment. These appear to have reduced the numbers of waivers being granted over time.

In its supervisory areas ASX has improved its record keeping practices, which has resulted in improved transparency in many of its activities.

Significant progress has also been made in establishing a functional centralised complaints handling system.

Section 2: Conclusions and recommendations

2.1 Overall compliance

After making our assessment, ASIC concludes that ASX has adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c) of the Act.

This conclusion is based on the following observations drawn from information gathered during the formal part of our assessment process, our observations on the basis of our regular contact with ASX and the present operating conditions (including trading volumes and financial products traded on each market):

- 1 No serious market failures or disruptions came to our attention during the course of our assessment.
- 2 The operating rules and guidance notes provide an adequate framework for a fair, orderly and transparent market.
- 3 Key supervisory areas that monitor the conduct of participants and trading have adequate procedures in place.
- 4 During the course of our interviews, key management and staff responsible for supervision demonstrated a strong commitment to their supervisory role and a high level of expertise in the operations of the market.
- 5 Our review of operational records on supervisory decisions showed that:
 - decision-making on supervisory matters is generally sound;
 - ASX conducts ongoing supervision of its participants and listed entities.
- 6 ASX has good market infrastructure (including technology) to support its obligations to maintain a fair, orderly and transparent market.
- 7 ASX demonstrated a strong commitment to educating participants and listed entities in their obligations under the market rules and listing rules.
- 8 ASX actively shares information on supervisory matters with ASIC.

2.2 Observations and recommendations for future action

Notwithstanding our conclusion on overall compliance, ASIC believes ASX should make improvements to, or review, a number of specific arrangements for supervision to ensure continued compliance with its obligations under the Act.

The key recommendations of this assessment are that ASX:

- substantially improve the arrangements for the supervision of the warrants market;

- address continued inconsistencies in the monitoring and enforcement of the disclosure provisions of the listing rules;
- continue with its efforts to ensure that management of conflicts of interest work effectively in practice; and
- improve its monitoring practices in relation to derivatives, specifically where those derivatives relate to underlying assets that are not listed on an ASX market.

All of these matters have been raised to varying degrees in our previous assessments. Accordingly, we indicated to ASX the need to give a higher priority to these improvements. In response to these findings on these matters ASX has indicated its agreement with our analysis and conclusions. It has taken or is proposing to take steps to address our concerns. We will continue to work with ASX in the implementation of our recommendations.

Warrants market supervision

In our view the arrangements for supervision of the warrants market require substantial improvement. We have expressed similar concerns about supervision in this area in our two previous assessment reports. It is therefore disappointing that little substantive progress appears to have been made to address our concerns.

Our concerns in relation to the warrants market are summarised as follows:

- The present rule framework does not fully reflect the way ASX describes the market as operating or the obligations ASX says it imposes on warrant issuers. Market users are asked substantially to rely on agreements with warrant issuers to support an orderly market, but these agreements are not embedded in the market operating rules and ASX therefore arguably has limited capacity to enforce them. We have raised this issue in both of our previous assessments and only limited progress has been made to address this concern.
- ASX does not appear in practice to actively supervise the conduct of warrant issuers or their adherence to agreements given, particularly in relation to market making activity. This has resulted in some instances of disorderly trading and in at least one instance, the need to cancel a number of trades after the event. ASX supervisory staff appear to have identified this issue, as well as the limitations on ASX's ability to enforce these agreements, but no corrective action has been taken.
- Only minimal consideration appears to have been given to a number of complaints received in relation to the market.
- During the course of the year, the primary responsibility for supervision of the warrants market remained with the Structured Products Unit (SPU). In addition to supervisory responsibilities, this unit clearly has a significant commercial focus. The supervisory functions of SPU appear to have been unique in not being brought within the scope of the Integrity

Division. In our view there remains a high risk of actual or perceived conflicts of interest in relation to this area of the market.

- At the time of our assessment, ASX's website gave prominence to describing the market making "obligation" that exists for warrant issuers. For the reasons outlined above, this obligation may not be enforceable at law and is clearly not enforced in practice. In these circumstances, we were concerned that investors may have been misled by ASX's website statement that, "This means that apart from limited circumstances outlined later, there will always be a price quoted on SEATS at which you as a warrant holder will be able to sell at during normal trading hours".¹ We identified a number of circumstances, outside those covered by the "limited circumstances" referred to by ASX, where no prices were provided.

The warrants market remains a significant source of activity. Accordingly, in our view it is critical that supervision be effective. The basis for our observations is set out below.

Rule framework

Judging by the material on its website, ASX considers that the obligation in relation to market making is an important element in user confidence in this market. Information on the website highlights the role played by the requirement that warrant issuers provide an undertaking to maintain a bid on a continuous basis during the life of a warrant and states that as a result of the market making "obligation" there generally should be a price quoted at which a warrant holder will be able to sell at during normal trading hours. In ASIC's view, where ASX imposes obligations on warrant issuers to ensure a fair, orderly and transparent market, those obligations should, as far as practical, be embedded in the market rules.

While the warrant rules have admission criteria for issuers, these are largely related to the issuers' financial position only. There are no rules concerning the suitability of issuers' broader resources and capacity to administer and monitor the various features of the warrant products that they issue. This appears to be a critical issue, given ASX's present reliance on the conduct of issuers in ensuring a fair, orderly and transparent market.

We recommend that ASX conduct a full audit of the warrants market and the warrant rules to determine what obligations issuers must perform, and whether ASX can adequately enforce the performance of those obligations without commensurate rule amendments.

ASX has now appointed an external expert to conduct an audit of the warrant market and its rules, and advised that the review process is well underway. We understand that the terms of reference of the review include:

1. The ASX website has been changed since our assessment and now reads: "...there generally should be a price quoted at which you as a warrant holder will be able to sell at during normal trading hours".

- issuer obligations in the warrants market;
- any gaps in the rule framework in respect of these obligations, including in respect of admission criteria for issuers;
- approach to monitoring of compliance with these obligations – this will include monitoring of an issuer’s capacity and resources to ensure compliance;
- approach to monitoring of market activity, including market making; and
- approach to assessing effectiveness of market making generally.

ASX have told ASIC that it will ensure that the expert, in conducting the review, seeks specific input from ASIC and participants. ASX said that it would prioritise the review of warrants rules in relation to market making obligations and issuer capacity and resources.

ASX exposed relevant rule amendments to the market for comment at the end of May 2005 and has stated that the balance of the review will be complete by July 2005.

Monitoring warrant issuer obligations

ASIC is concerned that, in a number of instances, ASX does not and in some cases cannot, monitor warrant issuers' compliance with all their obligations, particularly those obligations the subject of undertakings to ASX.

Until 1 December 2004 monitoring of market making was undertaken by SPU staff undertaking a weekly inspection of an IRESS watchlist screen. We were advised that incidences where there was no bid displayed for a warrant series would then be investigated. If the absence of a market maker bid was not explainable by reference to an exception of a type that was identified in ASX's guidance note to market makers, the market maker was to be contacted by SPU and the results of the inquiry recorded in an exceptions log. In ASIC's view monitoring in this way is unlikely to identify with any accuracy the extent of compliance with market making obligations.

Our concerns may be illustrated by reference to an incident that occurred since our last assessment. We discussed in some detail a case in which trading in a warrant occurred in breach of certain conditions for trading of the product for over 4 days. During this period a significant number of trades were executed that subsequently needed to be cancelled.

Trading in this instance occurred because the relevant issuer did not meet its obligations to advise ASX of certain events. In this instance, the problem was compounded by the fact that ASX did not have in place a reliable mechanism to monitor the relevant conditions of the warrant and so did not itself identify the issue. In effect, SPU accepted a supervisory arrangement that was entirely dependent on the compliance systems of the broker to the warrant issuer. No operating rules imposed a direct obligation on the issuer or broker. That arrangement failed and in the absence of an adequate supervisory practice at ASX, a disorderly market developed.

A memo in relation to the incident from the then head of the ASX Market Surveillance business unit states that the "failure to notify ASX arguably resulted in a disorderly market, but that ASX had no clear regulatory powers available to it...while warrant issuers might agree or undertake to do certain things, such as make markets and give notifications to ASX, consideration should be given to whether such requirements should be contained within a business rule."

ASX took some disciplinary action by way of a management letter to the warrant issuer and its broker. However ASX did not review its own arrangements or put in place mechanisms to minimise the risk that similar events could occur again.

ASX have said in response that it accepts that the weekly monitoring arrangement was inadequate for detecting the absence of market making activity in the above case and perhaps more broadly, as indicated by certain of the complaints received.

ASX has taken and is proposing to take further steps to improve its arrangements for monitoring warrants market making activity.

Most significantly, we understand that since mid December 2004, the Market Surveillance unit has assumed responsibility for monitoring market making in the warrants market. The new arrangements involve the ASX automated market surveillance system, SMARTS, generating a series of alerts that may indicate non-compliance with an issuer's market making obligations. In particular, where there is no bid in place for a warrant series for a specific period of time an alert is generated. We understand that the system has been enhanced to provide automatic notifications to market makers and follow up alerts to ASX in the event of a bid not being re-entered.

ASX has informed ASIC that procedures are being developed for dealing with apparent breaches of market making obligations. All apparent breaches are to be actioned by Surveillance particularly where this requires reinstatement of a bid. The procedures are to be refined once rules in relation to market making are introduced.

These initiatives appear likely to address a number of ASIC's concerns and are welcomed.

During our assessment we were advised that SMARTS will not have the capacity to generate alerts with respect to market making, barrier levels, delta price (for instalment and trading warrants) and market manipulation where the underlying is not an ASX listed product. This was the case in relation to 37 warrant series on issue at the time of our assessment. In these circumstances, we think it is important that ASX develop alternative procedures to ensure an adequate level of supervision of these obligations where reliance cannot be placed on SMARTS.

In February 2005, we understand that Surveillance established a manual process to monitor activity in warrants where the underlying is not an ASX listed product. Additionally, ASX have advised that informational links to enable SMARTS to generate the types of alerts referred to above is due to be implemented during June 2005.

SPU investigations of complaints

We reviewed the complaints SPU received from warrant market users during the period July 2003 to November 2004 and in particular the complaints made about market making. During this period, 43 complaints were received, including 16 specifically about market making. In our view a number of the complaints were not adequately investigated by SPU.

Given that ASX appears to largely rely on undertakings to ensure market making occurs on a fair and reasonable basis, we think it is of particular concern that there are examples of inadequately investigated complaints.

In their response to ASIC, ASX stated that they agree that a relatively small number of complaints could have been handled better. ASX also advised that responsibility for complaints handling in relation to warrant matters, including market making, will be transferred to the Integrity Division as part of an overall separation of supervisory and operational functions of the Structured Products Unit.

We understand that Complaints about warrants are now handled by Surveillance (trading and market making issues) or Companies Departments (Issuer obligations issues) and are recorded centrally.

Supervisory operations and conflict management

ASX decided at the time that it was restructuring its supervisory obligations on 1 January 2004 that it would not move the supervisory functions of SPU under the Integrity Division.

We examined correspondence to ASX Supervisory Review Pty Ltd (ASXSR) on this matter in which ASX stated that SPU had not been moved into Integrity because of the "very limited market integrity functions" that SPU "now performs and also because of the need for its highly specialised team to remain together in an environment where they can easily share their knowledge and effectively coordinate the administration of the warrants market." ASX also said that SPU cannot be compared with "Issuers Integrity, because of the highly professional nature of the warrants market...warrant issuers and their executives are all market professionals whose business depends on there being efficient and fair warrants markets."

We were concerned that ASX's response to ASXSR might imply ASX need not be as vigilant in the supervision of warrant issuers as compared to listed entities because of the professionalism of issuers and their interest in maintaining efficient and fair warrants markets. In our view this statement does not give proper weight to the significance of the supervisory functions performed by SPU or of the scope of conflicts of interest that may arise.

In response ASX took steps to improve arrangements for handling the potential for conflicts. Initially this involved the adoption of a reporting protocol between SPU and the Integrity Division. Under this reporting protocol some matters were reported periodically after the event while others required Integrity Division involvement at the time that the matter was "live".

We noted that the protocol allowed for SPU to make decisions in relation to admission of a new warrant series to trading status without the involvement of the Integrity Division. In our view there is a potential for significant supervisory content in a decision to admit a new warrant series and grant any associated waivers. While most decisions about admissions may be routine, we see this process as the entry point of new warrant types. In our view the decision to "admit" is not just an operational matter. We believe that the decision must be considered from a market supervisory as well as commercial point of view.

We are advised that as at 31 May 2005 ASX had transferred all supervisory decision making in relation to admissions, waivers and review of periodic reports from SPU to the Integrity Division.

Following completion of the warrants market review in July 2005 and of the review of Supervision being undertaken as part of the broader organisational review, ASX has indicated that it may transfer further decision making and/or functions to the Integrity Division.

ASX have also undertaken a revision of the content of their website and the ASX Warrants booklet and other educational material.

ASIC welcomes these measures. In our view they are likely to address the concerns that ASIC has identified in this report.

Consistency in monitoring disclosure

There is no doubt that there is now a greater focus by ASX on consistency in the administration of its listing rules than in prior assessments. Structural initiatives since our last assessment and our interviews with Companies Department managers make us confident that considerable progress has been made in this area. However we think that further work is required to ensure the supervisory functions performed by this unit are as consistent as we think is necessary.

Our interview with Companies managers showed that there was an increased recognition of the need to be transparent in their actions and that considerable attention is being given to recording their actions. Managers also indicated that they had adopted a more systematic approach to reviewing the work of their staff. All of these developments are positive.

Notwithstanding these changes, there still appear to be significant unexplained variances between the activity levels of State offices and the outcomes resulting from those activities. Our observation is that the State offices continue to operate differently and that their outcomes are sometimes different.

Some offices continue to generate significantly less queries and obtain significantly less announcements in response to queries than other offices. We accept that variations should be expected as a consequence of the differences in the type and size of companies resident in the different States. However the size and persistence of the statistical variance we observed leads us to the conclusion that the offices are not operating on a comparable basis. We have also provided some specific examples to

ASX of matters where we were concerned that ASX's Guidance Note appeared to suggest that there should have been a different disclosure result.

We note that the ASX figures for the three months ending 30 September 2004 indicate some change to the statistical pattern referred to above. However at this time it is not possible for us to conclude that this change signifies the beginning of a longer-term trend.

In response to our initial discussions with ASX on this issue following our visit, ASX have provided significant detailed analysis which goes some way to explaining these variances. They have also provided detailed explanations in relation to the specific examples we have raised. ASX have told us that they do not believe any of these issues suggest that their arrangements for monitoring continuous disclosure are not adequate. We agree with that.

We acknowledge that ASX has put in place procedures intended to address the concerns that we have raised in this and our previous assessment report. We also acknowledge that the better record keeping practices and increased attention being given to issues of policy and consistency should over time have an effect. We nonetheless remain of the view that achieving a higher degree of consistency remains important in the interests of market certainty. We recommend that ASX continues to improve its monitoring and analysis of these issues.

Record keeping

Overall, our review indicates that record keeping practices in the unit have improved and are generally at an acceptable standard. However record keeping practices remain inconsistent. While it will not necessarily follow that different record-keeping standards will equate to different practices more generally, there is some evidence that this is the case. It is difficult to be conclusive about a correlation between how an office operates and records its activities, and differences in query numbers and further disclosure obtained. We observe that the offices that retain more material about their monitoring activities are also those offices that are raising more queries and obtaining further disclosure.

It is important that both ASX itself and ASIC have sufficient records to enable a systematic review of the quality and timeliness of supervisory decisions taken. Accurate and contemporaneous records are in many cases vital to enable enforcement action on breaches of the rules and the Act, including ASIC enforcement action.

A national log has been established to document continuous disclosure issues and a compliance log in each office supplements this. Our observation is that the new initiatives have improved the standard of reporting. However, there are still some significant differences in the quantity of material that is being kept in each office and the practices relating to the compilation of these records across the unit.

A mandatory procedure for recording supervisory activities now sets out the minimum records that are to be maintained and this is a positive step. However it still leaves considerable discretion to each office to work out the form and content of

records kept and accordingly is less likely to promote consistency than a more prescriptive approach.

One area of particular concern is the fact that the new protocol did not require the contemporaneous recording of real-time activities in every case. To be fully effective, the real-time monitoring of continuous disclosure must in our view be matched by the real-time recording of events. In our view the Compliance logs, as a minimum, should record the times at which events such as telephone discussions, lodgements, trading halts etc occur. We also believe that the file notes required in relation to continuous disclosure issues must be recorded at the time that these events arise. ASIC regards this practice as having a direct bearing on its ability to enforce compliance with the ASX listing rules and the Act.

ASX advised that it had adopted a system for the contemporaneous recording of all supervisory activity in March 2005. We welcome that initiative. It is important that ASX continue its work to improve the consistency and completeness of its record-keeping in this key supervisory area.

Conflicts management

In view of our recommendations in our last assessment report that ASX review its arrangements for managing conflicts between its commercial interests and its requirement to supervise its markets, we have undertaken a comprehensive review of the changes put in place over the past year. Our conclusion is that the current arrangements that ASX has in place for managing conflicts of interest appear to be adequate. Nonetheless, there remain some areas where we think ASX could still improve its arrangements, particularly in their practical application throughout the organisation. There have been further changes proposed for conflict handling arrangements since our visit and these are discussed below.

The changes implemented by ASX in the past year have been substantial and reflect a considerable cultural shift. We believe that ASX needs to continue its efforts, particularly to ensure that the procedural changes are complemented by a commitment, at all levels of ASX, to identifying and appropriately managing its conflicts.

ASXSR is one of the mechanisms ASX uses to manage the potential for conflicts of interest between ASX's supervisory and commercial functions. As part of its mandate ASXSR prepares a written annual report to the ASX Board, and most recently provided this report in September 2004. While in previous years ASXSR's report has been made public, ASX decided not to publish this most recent report. ASIC was, however, provided with a copy. We note that its analysis and conclusions largely support our own conclusion on the overall adequacy of the policies and procedures for conflict management that were developed by ASX and put in place in July 2004. As ASXSR notes, these policies and procedures, if effectively implemented and continuously complied with, should overcome some of the shortcomings of the previous arrangements.

We remain appreciative of the role played by ASXSR, which has demonstrated a commitment to acting independently and a willingness to vigorously pursue issues.

The test ASIC seeks to apply to the adequacy of arrangements for managing conflicts of interest is that they are adequately identified, that there are clear procedures for managing and in some cases, avoiding those conflicts and that the arrangements are subject to continued monitoring. While ASX accepts this characterisation, it is not clear that ASX has all of these elements in place in every case. In particular, there still seem to be some instances of clear conflict that ASX has not appropriately recognised. For example, a number of the comments we have made in relation to the supervision of the warrants market by the Structured Products Unit suggest that there is not a clear delineation between commercial and supervisory objectives. In that particular case, there is evidence that the close commercial relationship with warrant issuers is leading to less stringent supervisory practices than those applied in areas where a clearer distinction has been made.

Other examples came to our attention during the year that suggested that ASX has still not fully realised the scope of its potential conflicts, or that it necessarily gives the appropriate weight to supervisory issues, alongside commercial ones. The significant amendments proposed to the ASX Listing Rules in relation to share placements was one example where, despite requests from ASIC to address possible shareholder impact, as well as the interests of listed companies, particularly small listed companies, ASX's submissions continued to focus primarily on the benefits to the listed company sector.

ASX cited its protocol for managing conflict that was approved by the ASX board in July 2004 as embodying the approach it takes to conflict handling arrangements. ASX note that its former managing director presented this protocol to key staff at ASX following its introduction, which we think sends an important message in setting the tone at the top.

ASX recognise that at times during the reporting year, in a minority of cases, their arrangements may not have been sufficiently robust and may have needed improvement. They said that when this was identified the improvements were promptly made. Specifically, ASX accept that the examples cited by ASIC in respect of Structured Products and the proposed amendments to the Listing Rules in respect of share placements highlight areas where, in terms of ASX's conflict handling policy, the arrangements could have been better.

ASX has now advised that it has separated the commercial and supervisory functions of SPU as they relate to admissions, waivers, review of periodic reports and monitoring of issuers market making obligations. ASX is also considering structural improvements aimed specifically at its policy formulation process. These initiatives are welcome.

Derivatives market surveillance

Monitoring derivatives

In our 2002 assessment, we concluded that the supervision of warrants and futures should take into account the specific risks arising in relation to those products, particularly where the underlying asset is not supervised by ASX. In our assessment last year, we observed that Market Surveillance had developed written procedures in relation to the monitoring of derivatives.

We have expressed concerns above in relation to monitoring of warrants where the underlying asset is not an ASX listed product. We have the same concern in relation to any derivative where ASX does not quote the underlying asset. As with the warrants market, ASX's automated monitoring system SMARTS does not generally provide sufficient support for monitoring derivatives where ASX does not list the underlying product, often because the necessary data feeds from other underlying markets are not acquired, or are not available.

We accept that automated alert systems are not the only method of monitoring a market. We do believe however that where automated monitoring is not possible, that alternative methods and procedures should be put in place to ensure an equivalent standard of supervision is achieved. Accordingly we recommend that ASX continue to review its procedures for monitoring trading in derivatives where it does not list the underlying product.

After our assessment, ASX undertook an evaluation of where it may be possible and useful to incorporate automated data feeds from other markets into its monitoring systems. ASX have advised that as a result of that review, live feeds of relevant market data will be implemented by end June 2005. At the same time ASX will be introducing enhancements to the SMARTS alerts for derivatives. ASIC welcomes these developments.

Other issues

ASX International Services

ASX International Services Pty Limited ("AIS") is a participant in ASX's market. It acts as the broker for the Worldlink service. AIS is subject to the ASX market rules but section 27 of those rules provides that a number of the rules do not apply to AIS. This is because of the limited nature of AIS's participation in the market.

There is a conflict of interest in ASX supervising compliance with and enforcing rules in relation to AIS, as AIS is wholly owned by ASX. At the time that AIS became a participant in ASX's market, ASX and ASIC agreed that ASIC should be involved in conflict handling arrangements for AIS. Trial arrangements involving ASX and ASIC were put in place at the time AIS became subject to the market rules.

While there was a delay in establishing formal conflict handling arrangements, in April 2005 formal procedures (approved by ASIC) were finalised that established interim ASXSR oversight of three ASX subsidiaries including AIS.

Note: ASX has recently announced that, for commercial reasons, it is scaling back the Worldlink service.

The rule amendment process

ASIC regards the ability of ASX to make rules in a timely and effective way as critical in fulfilling its obligations to maintain a fair, orderly and transparent market. In previous assessments, we have raised ongoing concern with the heavy reliance on rule waivers for the introduction of new products, and more generally as a way of meeting commercial demands for changes in the marketplace. As we have stated in those reports, we believe that the reliance on waivers both reduced transparency in the operation of the market and risked circumventing the Ministerial disallowance process that accompanies changes to the operating rules. It is evident that there has been some progress in addressing these concerns, particularly by implementing rule amendments to replace long-standing routine waivers.

Notwithstanding these changes, the number of rule waivers in the past year remained high. According to the ASX Annual Regulatory Report for the year to 30 June 2004, there were 947 waivers of listing rules granted. This compares with the year to 30 June 2003 in which there were 901 waivers granted and the year to 30 June 2002, in which there were 1066 waivers of the listing rules granted.

While the annual figures do not yet reflect a change in emphasis to the adoption of appropriate rule changes in place of the repeated use of waivers, the batch of rule amendments that came into effect on 31 March 2004 have significantly reduced the number of listing rule waivers granted in the quarter ending 30 June 2004. The warrant rule amendments in the 3rd quarter of the year ending 30 June 2004 have also resulted in a significant reduction in the standard relevant rule waivers.

Whilst this is a promising trend, we do consider that the extent of the shift towards adopting appropriate rule changes, rather than the routine use of rule waivers, is a shift that is best measured over time.

In relation to our concern about the speed at which changes are implemented, ASX have responded that while they do not think this is an area of significant concern, the high levels of market activity and new listings that prevailed over the past 12 to 18 months had stretched the legal and other resources involved in developing and implementing listing rule changes in particular. ASX said that it would review and more closely monitor the resources needed.

ASIC sees the ASX operating rules as fundamentally a part of its regulatory structure. Accordingly, while the impetus for rule amendments will often be commercial demands of issuers or brokers for the introduction of new products or changes in the way the market operates, the involvement of supervisory areas in the rule amendment process is very important. That involvement is necessary, both to ensure that the rules

provide appropriate integrity standards, and to ensure that supervisory arrangements can be modified as necessary to take into account rule changes.

During last year's assessment we noted the development of more detailed procedures for both operating rule amendments and for the Legal Business Unit's interaction with other business units during that process. We noted at the time that this appeared to address our previous concerns regarding the lack of documented procedures relating to the rule amendments process, particularly in relation to the involvement of supervisory areas. Having said this, because of the recent introduction of these processes, we were unable to verify their value or the extent to which they had been adopted in practice.

Our understanding is that following the supervisory restructure on 1 January 2004 those procedures were reviewed and replaced by new procedures. We understand that at the time of this year's assessment, these new procedures had been in effect for approximately 4 months.

We reviewed a sample of files relating to listing, market, clearing and settlement rule changes to determine the extent to which these new prescribed procedures were in fact being followed. The extent to which this appeared to be the case varied markedly between files, although adherence to the rule change process did appear more evident in the more recent files. We propose to revisit this issue next year to confirm that the trend towards appropriate engagement with supervisory areas in the rule amendment process has continued.

Interest Rate Market

In ASIC's view, ASX responds differently to non-compliance with its rules by entities admitted as debt listings when compared with ASX equity listings. While we accept that the debt market is considerably smaller and less actively traded and that a number of debt issuers have not, in fact, listed products since their admission, we think it is important in principle that supervisory standards are equivalent. We have expressed reservations about the supervisory arrangements for debt issuers in previous assessment reports. While significant changes have been made to those arrangements in the past year, this remains an area where we think considerable improvement is required.

ASIC's primary concern about supervision in relation to debt issuers is that ASX appears to have categorised those entities that have not sought to quote their securities as not being required to lodge annual returns, or comply with any other ongoing requirements in the rules, and accordingly has not been reviewing these entities as part of its ongoing supervision of the debt market. We raised this issue in our previous assessment. In response, supervision of debt issuers was moved from the primarily commercially focused Interest Rate Market business unit (IRM) to Companies.

Since taking over the supervisory role from IRM during the past year, Companies have written to most entities (other than those that have never issued any securities) and advised them of their periodic disclosure obligations and various other, ongoing

requirements. At the time of our assessment not all entities had responded to ASX. Of those that had not responded, there is no record to indicate that ASX has taken, or intends to take, any further action.

We appreciate that Companies have only recently assumed supervision of the interest rate market, but we are concerned to see ASX approach listing rule enforcement with a closer degree of consistency, regardless of the type of listing or product involved.

In response to our concern that ASX has not sought to follow up breaches of ongoing requirements by those issuers yet to issue securities, ASX have said that in following up on those issuers that appeared to be in default, Companies prioritised its task by reference to those issuers that had issued securities. ASX say that it is certainly their intention to follow up the others in due course and it believes that this type of prioritisation is quite appropriate in managing their supervisory obligations. They said that they expect the process to be completed by end June 2005.

In ASIC's view, once an issuer is admitted to ASX, we think it is crucial for the reputation of ASX's market that their compliance with all of their obligations as a listed entity be monitored and where necessary, enforced.

ASX noted our comments that across products and markets ASX appeared to approach enforcement of the listing rules in an inconsistent manner. ASX agreed with the general principle that monitoring and enforcement should be consistent.

ASX have said that Companies will review the way in which continuous disclosure operates in the debt market to ensure adequate disclosure of material information. ASX said that it expects to have a protocol in place by June 2005.

Customer Service

Since our last assessment, ASX has worked to implement a process for the centralisation of complaints management. We support the move to a single system for complaints management and understand that this work will be complete by June 2005. We propose to follow-up on this project's progress in our next assessment.

Group Compliance

We are much encouraged by the establishment of a group compliance function that reports directly to the Managing Director and the Audit and Risk Committee.

We note comments made during the assessment that it is the intention of ASX to increase the resources within the Group Compliance unit. In our view this unit is playing a critical role at this point and we encourage this initiative. In particular, we think further resources would enable an enhanced level of monitoring of activities by Group Compliance.