



**ASIC**

Australian Securities & Investments Commission

**REPORT 36**

# **Market assessment report: Stock Exchange of Newcastle Limited**

Month year



**ASIC**

Australian Securities & Investments Commission

# **Annual assessment (s794C) report**

**Stock Exchange of Newcastle  
Limited  
ACN 000 902 063**

**December 2004**

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# Executive summary

This report summarises ASIC's assessment of compliance by Stock Exchange of Newcastle Limited (NSX) with its obligations under s792A(c) and its financial resource obligations under s792A(d) of the *Corporations Act 2001* (the Act). This is our second assessment of NSX.

Section 794C of the amended 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.

## How we conducted the assessment

In conducting our assessment, we:

- reviewed the books and records of NSX;
- interviewed NSX staff; and
- requested written explanation and confirmation from NSX of certain matters.

We also considered NSX's Annual Regulatory Report 2002-2003, submitted to ASIC in accordance with s792F of the Act and our ongoing interactions with NSX. We also considered how well NSX might comply with its obligations in the future.

Subsequent to completing the formal part of our assessment we also made inquiries into a number of specific supervisory matters involving the monitoring of disclosure by listed companies.

## Compliance by NSX

In Section 2 of this report, we set out in greater detail our findings and corresponding recommendations. We have formed these views based on our assessment undertaken in November 2003 as well as subsequent interaction with NSX. In our view, based on NSX's operating conditions at the time we conducted our inspection of NSX's market (including trading volumes and financial products traded on its market), NSX did not have:

1. adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c); or
2. in the medium term, sufficient financial resources to continue to operate the market in accordance with its obligations under s792A.

NSX has advised ASIC that the NSX board had approved the raising of up to \$12 million in additional capital via a prospectus. Further, it intends to apply to list its securities on ASX. Should NSX be successful in raising these funds and obtaining

listing, our concerns in relation to their financial resources will be significantly reduced. Our ability to monitor NSX's financial position will also be greatly enhanced should it become subject to ASX's continuous disclosure and periodic reporting requirements.

## **Key recommendations**

In our view, at the time of our assessment NSX had not put in place adequate arrangements for the supervision of its market and handling its existing conflicts. Many issues raised by ASIC in its first assessment had not been addressed.

In ASIC's view it is vital that NSX:

- Strengthen its conflict handling arrangements in a number of respects;
- Significantly improve its supervisory arrangements for listed entities in relation to the admission of new listings to the NSX market and the monitoring of continuous and periodic disclosure by listed entities;
- Ensure that the market is supervised at all times by a person with the authority to take any action necessary to prevent uninformed or disorderly trading; and
- Provide regular information to ASIC about its financial position.

We set out the specific details of our concerns in Section 2 of this report.

We have included details of improvements NSX has agreed to make to its arrangements for the supervision of the market. There is evidence that there has been an improvement in some areas of listed company supervision since our formal assessment visit.

At the time of our formal assessment visit, ASIC was also of the view that NSX would need to continue to attract its current flow of new listings, or conclude a successful capital raising, in order to continue to have sufficient resources to operate its market in a fair, orderly and transparent manner and to provide for the appropriate level of supervision of its market. Since our inspection visit, NSX has raised further capital. There has also been a significant change in NSX's operating performance, with NSX in the quarter ended September 2004 recording a net cash flow of more than \$92,000. As discussed elsewhere in this report, NSX now plans a further capital raising and listing on ASX. As a result of these changes, our level of concern has been substantially reduced.

# Section 1: Background

## 1.1 NSX

In February 2002, NSX received formal approval from the then Minister for Financial Services and Regulation to recommence operation as a stock exchange under the former s769(2) of the Act.

NSX was granted an Australian market licence which became operative when the *Financial Services Reform Act 2001* ("FSR Act") commenced on 11 March 2002. This licence allows NSX to operate the market it was operating immediately before commencement of the FSR Act.

NSX provides a stock market for small, medium and regional enterprises whose operations are based both within and outside Newcastle and the Hunter Valley region. NSX Limited is the parent company of (and 100% owns) NSX.

At the time of our visit, NSX had 12 listed entities, 13 listed securities and 7 participant organisations. In the financial year ended 30 June 2003, the value of securities traded on the NSX market was approximately \$366,000. As at mid November 2004, NSX had 28 listings and the year-on-year value of trading for the 12 months to November had increased to \$3,850,636.

## 1.2 ASIC's assessment

Section 794C of the Act requires ASIC to conduct an annual assessment of each Australian market licensee's arrangements for the supervision of its market. ASIC may also conduct an assessment of how well a market licensee is complying with any or all of its obligations.

This is the second s794C assessment by ASIC of NSX's compliance with its statutory obligations. Our previous assessment report elaborated on NSX systems and processes. Discussion of staff roles and a detailed description of business unit processes, except where we have assessed them to be inadequate, is not repeated in this report. Our assessment is based on Policy Statement 172 *Australian market licences: Australian operators* [PS 172], which sets out what ASIC believes Australian market licensees should do to ensure compliance with their obligations.

Because a market licensee's obligations are ongoing, ASIC will consider a market licensee's likely future compliance with its obligations as well as its past and current compliance. We will not determine whether a market licensee is likely to comply in the future merely by reference to its past compliance.

In conducting our assessment we:

- analysed information we received from and about NSX in the ordinary course of our dealings with it as a market licensee, including NSX's annual regulatory report under s792F;
- monitored the operation of the market throughout the period, in particular in relation to issues of disclosure;
- interviewed a range of NSX personnel; and
- reviewed internal NSX material, including board minutes, compliance committee minutes, policies and procedures and files in relation to listed entities.

From 5 to 6 November 2003, we visited the NSX office in Newcastle and spoke to the General Manager and the Trading and Settlement Officer.

### **1.3 Review of specific supervisory matters**

Following our visit to NSX in November 2003 three supervisory matters arose which required our intervention. All three reflected poorly on the adequacy of NSX supervisory arrangements and practices. These matters are discussed in detail in section 2.2 of this report.

## Section 2 : Recommendations

### 2.1 Conflict handling arrangements

In its Annual Regulatory Report 2003, NSX states that it has the following arrangements in place for handling conflicts:

- Organisational structure;
- Audit and Compliance Committee;
- Register of interest; and
- Compliance Plan.

#### 2.1.1 Organisational structure

ASIC notes that as at the assessment date the organisational structure in NSX included the following<sup>1</sup>:

- One director held the position of CEO and Chairperson of NSX;
- Two directors were related to NSX participant organisations through their directorship and/or shareholdings in these organisations;
- Three directors were related to NSX broker or adviser organisations;
- Three directors had shares in entities listed on NSX. One director of NSX was also a director of an NSX listed company;
- Five director-related entities had obtained income or other payments from NSX; and
- Two staff members carried out day-to-day running of the NSX.

ASIC had a number of concerns about the organisational structure of NSX.

#### *CEO and Chairperson*

In its Annual Report 2001-2002, NSX acknowledged that the organisational structure of NSX plays a key role in handling conflicts of interest and to this end NSX made arrangements to separate the functions of CEO and Chairperson. ASIC is concerned that at the time that our onsite assessment visit occurred, one director was once again carrying out the functions of CEO and Chairperson.

#### **Recommendation 1**

ASIC recommends that NSX take measures to ensure that the functions of CEO and the Chairperson are not exercised by the same person.

NSX advises that since 21 November 2003 separate individuals have exercised the CEO and Chairman functions and NSX will formalise that these positions must be separated as part of its corporate governance guidelines.

<sup>1</sup> See appendix for a table of director interests as at 3 November 2003.



*Payments to director-related entities*

ASIC is concerned at the number of director-related entities that have received income or other payments from NSX. During the course of the assessment ASIC became aware of a dispute over a substantial invoice from a director-related entity for services provided to NSX.

The board resolved, after resolution of the dispute, that in future any services provided by directors personally, and director-related entities, will be on the basis of the board requisitioning such services to be provided and under a contract of service.

**Recommendation 2**

ASIC welcomes such a move by the board and recommends that NSX takes this further by developing formal protocols on the provision of services by directors and/or director-related entities.

NSX has advised ASIC that it will develop such protocols with the assistance of its compliance officer. No timing for this has been specified by NSX.

*Independence of directors*

In the 2002 Assessment Report, ASIC recommended that NSX appoint "...at least one more independent non-executive director to its board as soon as possible given its statutory obligation to have adequate arrangements for handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner..".

NSX advises that an additional independent director to NSX's board was appointed on 21 November 2003. Shortly afterwards one of the independent directors ceased to be independent through an association with a participant of the NSX. NSX advises that in March 2004 the director became independent again when the participant resigned.

However, NSX subsequently advised at the end of May 2004 that an independent director has resigned, again leaving only one independent director on the board. The continued failure to attract and retain independent directors is becoming a critical issue that must be addressed by NSX as soon as possible.

**Recommendation 3**

ASIC recommends that NSX ensures that it has at all times at least two independent directors. We consider that "independent" means a person who has no interest in the market licensee, whether as a substantial shareholder or as an associate of an entity that is a participant, nominated adviser or service provider on or to the market licensee or an employee of those entities.

### 2.1.2 Register of interests

NSX resolved in February 2003 to establish guidelines on conflicts of interest and a register of director's beneficial interests.

A "disclosure of directors' interests" document was tabled at a meeting of the Board on 17 October 2003. Despite the requirements set out in the "Procedures for maintenance of Conflicts of Interest Register" document, which states the types of interests directors must declare, the register is inaccurate and there appears to be confusion among directors as to what interests must be disclosed. For example:

1. The register does not contain an entry to the effect that a director holds a position in an NSX Listed entity, whereas ASIC located this information on the NSX website.
2. One director engaged as a consultant to NSX has disclosed this information on the register, whereas another engaged as a consultant has not made such a disclosure.

ASIC is concerned that in these instances both the Board and the General Manager of NSX were aware of the interests but the register was not updated. ASIC is concerned that there may be further instances of non-disclosure.

#### **Recommendation 4**

ASIC recommends that NSX ensures that the procedures and arrangements set out in the document "Procedures for maintenance of Conflicts of Interest Register" are strictly followed and observed in practice.

#### **Recommendation 5**

ASIC recommends that a register of interests in shares in listed companies and protocols for dealing in such shares should be developed for NSX operational staff. The development of the register and the protocols should be undertaken as a matter of priority.

NSX advised ASIC in September 2004 that NSX has in place such a register and that protocols will be improved although no time frame for this development was specified.

### 2.1.3 Compliance Plan

NSX has developed a compliance plan. The plan is a high-level document and mainly focuses on compliance with the supervisory obligations in relation to the listed entities and participants of NSX. There is no reference to any potential sources of conflicts of interest or arrangements NSX has put in place in handling conflicts. This is clearly inadequate, particularly as the circumstances of NSX are such that a high degree of related parties, shared roles and actual conflict of interest situations exist.

## Recommendation 6

In accordance with the requirements of the Act, NSX must have arrangements in place that enable staff to identify conflict situations and that mandates how those situations are to be managed in practical terms.

NSX has advised ASIC that its compliance officer has been instructed to mandate how potential conflict situations are identified and managed.

### 2.1.4 Listing Committee

In the first assessment report, we raised the issue of NSX not having a separate Listing Committee and of the General Manager reporting directly to the board on new listing applications. We noted in the report that *"..in ASIC's view, the General Manager should cease reporting to the board on his supervisory and commercial activities in relation to listing applications. Such reporting arrangements may be inadequate in the context of handling conflicts of interest. In this regard, ASIC considers that a separate Listing Committee consisting of a majority of independent members...could be established, or additional staff could be employed.."*

NSX had not, at the time of the assessment, established a separate Listing Committee. Contrary to the recommendation made in the last report, the General Manager continues to report to the board on both supervisory and commercial activities in relation to listing applications.

The General Manager has indicated that a director has been given responsibility for establishing a Listing Committee. However, the board minutes do not indicate that there was any discussion by the board of the need to establish such a committee, nor do the minutes refer to the allocation of such responsibility to a director. ASIC is concerned that there has been little or no progress on this issue.

ASIC again notes that NSX approval to recommence operation of the market was given on the basis that there would be a Listing Committee operating separately to the board. The reasons for this condition were that the shared roles of a number individuals involved in the operation of the market gave rise to an actual conflict of interest between the commercial interests of the licensee and its obligations to conduct its market in accordance with the requirements of the Act.

NSX advised ASIC in March 2004 that a Listing Committee comprising the CEO, the General Manager, the compliance officer and a panel of at least 3 independent reviewers with appropriate backgrounds was established at a board meeting of 18 March 2004. However, the scope of the Listing Committee's task is limited to recommendations about the appropriate disclosure of publicly available offer documents provided as part of the listing application. In ASIC's view the Listing Committee should have responsibility for deciding whether to admit companies to the list.

## Recommendation 7

ASIC recommends that NSX should take steps to address the structure and role of the Listing Committee as soon as possible, particularly in light of the potential for an increased number of listings in the future. We will review this matter in the next assessment.

## 2.2 Supervision of the market

The key arrangements put in place by NSX to detect potential or actual non-compliance with the Act or NSX's operating rules are as follows:

- Scrutiny of the suitability for listing of all new applications;
- Monitoring continuous and periodic disclosures made by listed entities;
- Monitoring trading activities conducted through NSX; and
- Monitoring the conduct of participants in relation to the market.

At the time of our assessment visit, the practices of NSX with regards to the supervision of disclosure on its markets fell significantly short of the standard ASIC expects of a market operator. Our concerns are detailed below.

### 2.2.1 Scrutiny of the suitability for listing of all new applications

In our first assessment report, we noted that apart from the "sign off checklist for new listing applications", there is no demonstrable analysis or substantive recommendation prepared for a new listing application and it was unclear on what basis the board approves such applications.

NSX has now developed two documents in relation to listing applications called "Listing Application Procedures" and "Listing Analysis Template", respectively.

The "Listing Application Procedures" contain the essential steps and information that a staff member of NSX should follow and look for in the application process. In particular, section 3.8 provides that an issuer is determined to have met the listing requirements once the "Listing Application Analysis template" has been successfully completed.

The "Listing Analysis Template" is in the form of a table that is to be completed to determine whether an applicant can comply with the listing requirements. Section 3.5 of the template provides that both the issuer and its business must, in the opinion of NSX, be suitable for listing.

We have reviewed all the listing applications lodged with NSX since our last assessment. In general, we note that NSX staff have followed the procedures as stated in the "Listing Application Procedures", including the completion of the checklist and the "Listing Analysis Template".

However, even though the Listing Analysis Template requires information as to whether an issuer and its business are suitable for listing on NSX, only very superficial information has been recorded in the template. Documents reviewed do not demonstrate that NSX conducts a comprehensive analysis of whether an issuer and its business are in fact suitable for listing on NSX.

Between October 2002 and October 2003 ASIC applied stop orders on two occasions to the disclosure documents of entities that were seeking to list on NSX.

As a prospectus is usually the most comprehensive source of information regarding a new applicant at the time of the listing application, we would expect NSX to review this document and assess whether the proposed disclosure by the applicant was adequate for listing purposes. However, NSX did not identify any disclosure issues in either case. If NSX staff had thoroughly reviewed the prospectuses, NSX may have been in a position to identify the matters of concern. These instances reinforce ASIC's concerns about the degree of rigour NSX brings to its assessment of new listing applicants.

It appears that NSX has assumed (subject to adequate completion of the Listings Analysis Template) that a listing is suitable. NSX has indicated that it is willing to improve this process and has established a Listing Committee to review disclosure issues. The NSX Board at its meeting of 18 March 2004 created a Listings Committee made up of three NSX executive officers and "at least three independent reviewers." The Committee's scope is described as being limited to "[recommending] ..appropriate disclosure of publicly available offer documents provided as part of the listing application."

## **Recommendation 8**

We recommend that NSX develops a more substantive and analytical assessment process with regards to new listing applicants. While its current "checklist approach" to listing applications is acceptable as a control mechanism, it is not in itself a substitute for substantive analysis of the applicant, or its proposed disclosure document. To this end, NSX must develop more detailed guidance on the analysis of listing applications that is to be undertaken by NSX personnel.

### **2.2.2 Monitoring continuous and periodic disclosures made by listed entities**

#### *Continuous disclosure*

In our first assessment report, we commented that although NSX had a procedures manual relating to processing of incoming announcements, it did not contain procedures for identifying and dealing with price-sensitive information.

We note that NSX has issued a 'Practice Note on Continuous Disclosure' and a 'Company Announcements' booklet since our last assessment.

The 'Company Announcements' booklet contains a list of the types of information that should be disclosed to the market. However the list may be construed as being exhaustive, whereas there are other items omitted from the list which could be considered as price sensitive - for example, a change in the entity's financial forecast or expectation; the appointment of a receiver, manager, liquidator or administrator; or a proposal to change the entity's auditor. In response to concerns of this nature expressed by ASIC, NSX has advised that the 'Company Announcements' booklet will be revised.

Both the General Manager and the Trading & Settlement Officer confirmed that most company announcements are directly uploaded by a listed entity onto NSX's company announcements platform. After an announcement has been received by NSX, the General Manager and the Trading & Settlement Officer will be notified of the announcement via a system-generated email.

The General Manager confirmed that he is the person primarily responsible for scrutinizing the content of announcements. He vets a majority of the announcements lodged with NSX before they are released to the market.

The General Manager said that when he is not in the office, the Trading & Settlement Officer has the authority to release announcements to the market, but that the General Manager can be contacted if there is any doubt regarding an announcement. He also indicated that he and the Trading & Settlement Officer do not consult directors of NSX regarding the content of announcements because this will delay the release of information to the market.

On the other hand, the Trading & Settlement Officer informed us that when the General Manager is not available, she will seek approval from an NSX director before releasing an announcement to the market.

In view of the inconsistency of approach and understanding of the process for release of announcements, we have concerns about NSX's arrangements for handling company announcements lodged with it, as:

- (a) despite there being only two operational staff at NSX, it appears that there is some confusion as to who is authorised to review and release announcements, both in principle and in practice;
- (b) there is potential for delay if the General Manager is absent from the office. The Trading & Settlement Officer said she would seek approval from a director before releasing an announcement to the market. This arrangement may cause considerable delay in the release of announcements, as directors of NSX are generally not working out of the NSX premises and it may take time to contact a director; and

- (c) similarly, the General Manager had said that he could be contacted by the Trading & Settlement Officer when he was away from his office and that it is not difficult for him to get access to a computer to log into the NSX website to understand the nature of the announcements. However it is very likely that considerable time could be spent in establishing contact with the General Manager and for him to understand the issues. As a result, the release of the announcement may be delayed considerably. In addition, the General Manager agrees that he can be out of reach and/or does not have access to a computer on some occasions - for example, when he is on a plane or in a meeting.

NSX advised ASIC in March 2004 that the Trading and Settlement Officer may release price sensitive announcements if neither the General Manager nor the CEO can be contacted. ASIC expects that all relevant staff of NSX must be made aware of who has authority to release announcements and must receive appropriate training..

We also note that NSX currently allows one of its listed entities to embargo its announcements (that is, the entity may upload an announcement but ask NSX not to release it until a pre-arranged time). The General Manager advised that the entity is listed on ASX, New Zealand Stock Exchange, and NSX and that it is a small company. Consequently, it is difficult for the entity to release announcements to the three markets at the same time. NSX has indicated it is willing to take steps to try to deal with this issue via contact with the company and arrangements with other market operators, but it appears that the embargo arrangement will remain in place for the time being.

### **Recommendation 9**

NSX must revise its 'Company Announcements' booklet to avoid any possible misinterpretation that the types of price sensitive information referred to in the booklet are exhaustive.

### **Recommendation 10**

NSX must reassess whether its arrangements in relation to company announcements are adequate.

### **Recommendation 11**

NSX must not allow any listed entity to embargo its announcements. This type of arrangement will hinder the timely flow of information to investors in the NSX market. The practice of embargoing company announcements should cease.

### *Periodic disclosure*

NSX requires its listed entities to comply with a number of periodic disclosure obligations. NSX listing rule 6.24 requires the entity to provide an annual report to its shareholders within 3 months of the end of its financial year. NSX listing rule 6.8 stipulates that a listed entity must provide four copies of its annual accounts to NSX

for dissemination to the market as soon as the accounts are available. Accordingly, an entity must give NSX a copy of the annual report containing the annual accounts within 3 months of the end of the financial year.

Additionally, listing rule 6.10 requires a listed entity to send four copies of half-yearly and preliminary full year financial statement to NSX for dissemination no later than 75 days after the end of the relevant accounting period.

ASIC received information in relation the non-lodgement of annual and half-year accounts by an entity listed on NSX.

Our inquiries established that the listed entity had failed to provide NSX with its half-year report for the periods ended 31 December 2000, 2001 and 2002 and its annual reports for the years ended 30 June 2001 and 2002. These reports were eventually submitted by the listed entity to NSX in early December 2003.

Notwithstanding the specific requirements under the operating rules and the prolonged period involved, NSX was either not aware of the non-compliance by the listed entity until we raised the matters with them in early November 2003, or alternatively, was aware and failed to enforce compliance with its operating rules. No satisfactory explanation for this lapse in supervision has been provided.

We further note that another NSX listed entity was late in lodging its audited annual report and convening its annual general meeting. In late November 2003, the listed entity announced that it was unable to publish its annual report or set a date for the 2003 annual general meeting on the grounds that ASIC had not approved the resignation of the incumbent auditor of one of its subsidiaries.

We do not accept the representations made by the relevant entity as this process of resignation of an auditor has no bearing on an entity's periodic disclosure obligations, nor on the requirement that NSX ensures that the markets are at all times fully informed.

In this case, either NSX was not aware that the entity had failed to lodge its year-end financial statements as required, or had simply failed to take any action against the listed entity until ASIC raised the matter with NSX in late January 2004.

At that time we requested NSX to suspend trading in the securities of the entity. NSX made an announcement that trading in these securities had been halted but nonetheless, trading in the securities occurred the next day. When queried about this, NSX said that it followed its procedures in this instance but that its procedures for putting in place a trading halt had failed to achieve their stated purpose.

On 5 February 2004 ASIC informed NSX that the annual accounts of a third entity had not been lodged as required by NSX listing rule 6.24 and 6.8. At the time ASIC raised the issue with NSX it was not apparent that NSX was aware that the entity had failed to comply with its disclosure obligations.



We regard the above series of matters as serious failures on NSX's part to adequately monitor and enforce compliance with its listing rules. These events confirm the views we formed during our visit to NSX in November 2003, that NSX's present arrangements for supervision of its market are not adequate. In March 2004, NSX advised ASIC that it will send out reminder notices about due dates for periodic disclosure and has sent out a general notice to listed entities and their nominated advisers concerning timely disclosures. While this is a positive step to satisfy its obligations as a market operator under s792A, NSX must itself actively monitor whether listed entities are complying with their periodic and continuous disclosure obligations of listed entities rather than simply relying on listed entities to comply.

### **Recommendation 12**

NSX must immediately put in place arrangements to ensure that its listed entities are in compliance with the periodic and continuous disclosure requirements as stipulated under the Act and NSX operating rules.

We note that subsequent to our inspection visit NSX issued reminder notices to listed entities about due dates for upcoming disclosures. NSX has advised that it will continue to do this on a regular basis. NSX advises it has also sent a general notice to listed entities and their nominated advisers concerning timely disclosures.

On 1 October 2004 NSX forced four listed entities into trading halts due to non-lodgement of financial statements, suggesting that NSX's procedures for identifying non-compliance with its listing rules have now improved.

## **2.2.3 Monitoring trading activities conducted through NSX**

### *Market surveillance*

At the time of our formal visit NSX continued to have a very low level of trading activity and the General Manager was said to review every trade executed on NSX each day.

However, we are concerned that the General Manager is at times away on business during the trading hours and does not have access to the NSX trading platform, even though he has access to some information through the NSX website.

As the General Manager is the only person authorised to conduct market surveillance, this may compromise NSX's ability to take appropriate actions in response to potential market misconduct.

Having regard to the nature of the market, its participants and the participant conduct being monitored, we consider that the existing arrangements adopted by NSX in monitoring trading activities conducted through NSX are inadequate, as the key person risk is significant. NSX has appointed two additional part time staff and indicated that as part of ongoing training, these staff will be trained in market surveillance and monitoring activities.

### **Recommendation 13**

At least one additional staff member or other officer of NSX should be fully trained to perform market surveillance and monitoring activities.

#### *SEAT market control*

The Trading and Settlement Officer advised us that whenever a company makes an announcement, she is required to input a code into the NSX trading system. The appearance of the code notifies NSX participants and investors that the company has issued an announcement and the nature of the announcement. Currently, there are approximately twenty codes.

However, the Trading and Settlement Officer indicated that she does not fully understand the meaning and usage of these codes. She further said that on one occasion she was advised by a staff member of an NSX participant to input a specific announcement code into the trading system.

In late January 2004 ASIC requested that trading be suspended in one of the NSX markets until such time as the relevant listed entity had lodged its audited financial statements. NSX made an announcement that said "...NSX had imposed a trading halt..." on the trading of one of the relevant securities and that the trading halt would continue until the entity had released its 2003 annual report to shareholders and NSX.

However, the procedures followed by NSX failed to prevent a participant undertaking an on-market trade of 18,000 shares in the listed entity. NSX procedures had in fact failed to give effect to the trading halt that it had announced.

When queried by ASIC, NSX stated that the relevant procedures document, the 'Market Control Procedures Manual', did not describe the correct procedure for implementing a halt in trading in the securities. After ASIC communicated its concern to NSX that the procedures were inadequate, NSX advised ASIC in March 2004 that it had reviewed and updated the 'Market Control Procedures Manual' to reflect the correct process for implementing trading halts.

### **Recommendation 14**

It is essential that the appropriate code is assigned to each announcement, so that market participants and investors are able to get timely and accurate access to market announcements. NSX must ensure that its staff are provided with sufficient training to carry out their supervisory functions in a reliable and timely manner.

### **Recommendation 15**

NSX must ensure that all procedures contained in the 'Market Control Procedures Manual' are correct and adequate for their stated purpose.

## 2.2.4 NSX participating organisations

### *Monitoring the conduct of participants in relation to the market*

Under s792A(c)(ii) of the Act, NSX must have adequate arrangements for monitoring the conduct of participants on or in relation to the market.

In ASIC Policy Statement 172 *Australian market licences: Australian operators*, at PS172.92 – 172.101, we say that adequate arrangements will include things such as continuous electronic monitoring and/or physical inspections of participants' offices to ensure compliance with the business rules, including rules relating to capital liquidity and trust accounts.

At the time of our assessment in November 2003, NSX had seven participating organisations admitted to its market, of which five were also participants of ASX. An eighth participant was terminated on 21 March 2003 in accordance with NSX business rules.

To assess whether NSX has adequate measures to monitor the conduct of participants, ASIC reviewed:

- NSX assessment program;
- the minutes of the Compliance Committee meetings; and
- NSX policy in relation to participating organisations.

### *Self-assessments*

A key arrangement adopted by NSX in monitoring the conduct of its participating organisations is to require lodgement of participant self-assessments as part of the NSX assessment program. The purpose of the assessment program is to understand the type of business operated by the participating organisation, the products and services the participating organisation provides or is proposing to provide, and what policies and procedures the participant has in place to ensure compliance with financial services licensee requirements under the Act. Another purpose of the assessment program is to highlight areas that require further review.

At the time of our visit, only three participant organisations had lodged their self-assessments. The remainder were expected to lodge by February 2004. As at the date of this report, we cannot form a firm view on their compliance, nor can we form a view about whether NSX has taken appropriate action in response to any issue in the self-assessments. We will examine this issue in our next assessment.

We examined policy documents in relation to participating organisations. NSX stated that it is developing a compliance program and extensive investigation and enforcement procedures, and that in areas of high risk to investors, ongoing site visits will be carried out on a regular basis. However, it appears that it will be some time before this program is implemented. ASIC is of the view that policy development in

this area is in its infancy, and in its current form, reflects what ought to be done rather than what is actually done.

### *Exchange examining accountant*

NSX continues to outsource monitoring of participants' surplus liquid funds to an exchange examining accountant (EEA). The current EEA is a chartered accounting firm. NSX requires participating organisations to lodge their surplus liquid funds returns with the EEA within twelve business days of the end of each month. The EEA is responsible for reviewing the returns to ensure that each participating organisation is meeting its ongoing capital requirements as set by NSX. This has mainly been in the form of exception reporting.

NSX has made some attempts to address the concerns raised in our first assessment report in relation to this outsourcing arrangement, mainly by requiring the EEA to provide monthly reports, irrespective of exceptions. However the lodgement of some returns continues to be irregular. There does not appear to be any prompt action taken by the EEA in following up late returns. In our view, NSX still does not have any systematic processes in place to monitor and assess the performance of the EEA. We consider that NSX should develop adequate processes for monitoring and assessing the performance of this outsourced obligation as soon as possible. NSX advised ASIC in March 2004 that procedures for monitoring the EEA have been written and agreed with the EEA. In its September 2004 regulatory report NSX noted that site visits to participants were in the process of being scheduled by the NSX Compliance Officer.

### **Recommendation 16**

Continuing from the recommendation made in the first assessment report, NSX should put in place adequate processes for monitoring and assessing the performance of the EEA in relation to surplus liquid funds returns by participating organisations.

## **2.3 Financial resources**

Under s792A(d) of the Act, NSX must have sufficient resources to operate the market properly and to provide the required supervisory arrangements. This year, in view of NSX's financial position during our previous assessment, we again decided to assess NSX's compliance with this statutory obligation.

The audited financial accounts of NSX as at 30 June 2003 showed that NSX incurred a loss of \$543,237 during the financial year (as compared to a loss of \$667,698 in 2002). The operating loss consumed a substantial amount of the cash resources of NSX. As at 30 June 2003, NSX had \$387,701 cash at hand, while the amount of cash available to NSX as at 30 June 2002 was \$941,023.

A loan of \$2,308,285, which NSX received from its parent company in 2002, was converted into equity on 16 May 2003. Despite the conversion, the accumulated

losses incurred by NSX in recent years have eroded NSX's shareholders' equity. As a result, NSX had shareholders' equity of \$353,445 as at 30 June 2003.

Besides the audited financial statements, various documents produced by NSX showed that its financial resources were very constrained. In particular, we note that:

- (a) the cash balance in one bank account (all income and expense items for NSX go through this account) was as low as \$2,263 as at 30 June 2003;
- (b) at the NSX's board meeting on 20 June 2003, the General Manager emphasised to the board the precarious financial position of the entity and commented that if a cash injection was not forthcoming, at the current rate of cash burn, NSX's funds would run out by the end of the calendar year; and
- (c) the board of NSX discussed on several occasions that the only apparent alternative to any contemplated fundraising was to place the company in administration.

In August 2003, NSX Limited (the parent company of NSX) successfully issued 2 million shares at \$0.35 each to two investors raising \$700,000.

NSX also prepared a financial forecast for the next two years (i.e. 2003/04 & 2004/05). On the basis of the forecast, NSX projected that its cash balance (taking into account the recent fundraising) as at 30 June 2004 and 2005 would be \$603,090 and \$436,370 respectively. The forecast had been prepared on assumptions including:

- (a) that the number listed entities will increase from 11 as at 30 June 2003 to 21 by the end of 2004 and then increase to 41 by the end of 2005; and
- (b) that the number of trades will increase from 68 in last financial year to 4,800 and 15,500 trades in 2004 and 2005 respectively.

The forecast for the year ending 2004 has more than been achieved, with NSX now having 29 listings and a cash balance of more than \$1 million. To a certain extent, our concerns at the time of our inspection visit were based on NSX's forecast which contains the following statement:

*"In terms of the cash flow position of the Exchange, on the basis of the [above] projections the working capital would be exhausted by the end of the 2004/2005 Financial Year if any of the underlying assumptions are proven to be optimistic. As a consequence it will be necessary to consider a capital injection during 2004/2005 Financial Year."*

NSX Limited conducted fundraisings in both 2001 and 2003. NSX Limited raised a total of \$2.4 million (before expenses) by issuing 2.4 million shares at \$1 per share in 2001, but raised a much lesser total of \$0.7 million by issuing 2 million shares at \$0.35 per share in 2003. This suggests that in order to attract new investors, NSX Limited had to lower the issue price of its shares substantially in the second fundraising. If NSX were to lose listings or not attract further new listings it would

continue to incur operating losses. Its ability to continue to attract new capital will be critical.

We note at the time this report was finalised NSX is in the process of raising further funds through a fully underwritten issue under a prospectus.

### **Recommendation 17**

We recommend that NSX give a report to ASIC within one month after the end of the March, June, September and December quarters, setting out:

- a statement of cash flows;
- a statement of financial position;
- a declaration by the directors of NSX as to whether in their opinion NSX will be able to pay its debts as and when they become due and payable; and
- a declaration by the directors of NSX as to whether they believe NSX has sufficient resources to meet and continue to meet its obligations as a market licensee in the next six months.

NSX has voluntarily commenced providing reports on its financial position to ASIC. We will review the need for these reports in the event that NSX raises further funds and becomes listed on ASX.

## **2.4 Other matters**

### **2.4.1 Policies and procedures**

During the assessment visit ASIC reviewed copies of NSX policy and procedure documents. ASIC notes that notwithstanding all documents being requested under notice, certain documents were not provided to us until January 2004.

Of the documents we reviewed, eight documents contain either:

- NSX views on what the NSX policy ought to be on certain issues such as, the "Policy on participant financial difficulty" which does not refer to any procedures that NSX staff ought to follow to monitor, detect or supervise participants financial viability; or
- statements to the effect that NSX is developing the relevant policy.

The Act requires NSX to have in place adequate arrangements for supervising the market, including arrangements for handling conflicts, monitoring the conduct of participants on or in relation to the market and enforcing compliance with the market's operating rules.

ASIC expects these arrangements to be in writing and in a form that gives operational staff detailed and practical guidance on how these arrangements are to be put into practice. In ASIC's view, NSX's policy and procedure documentation does not

achieve this objective. Accordingly we do not find NSX's arrangements to be adequate for the purposes of the Act.

### **Recommendation 18**

We recommend that NSX take steps to ensure that it has in place all arrangements, in the form of approved policy and procedure documentation, to ensure that NSX is at all times in compliance with its statutory obligations under the Act.

#### **2.4.2 Listing fee rebate scheme**

NSX offered a rebate scheme to attract new sponsoring brokers to its market. Under the scheme, NSX agreed to rebate 75% of the listing fee paid by an entity to the participant that brings the listing to NSX. NSX confirmed that the rebate scheme had failed to attract any new participants and that it had never been taken up.

NSX did not publicise the existence and operation of the rebate scheme. Moreover, it did not have any written policies and procedures in relation to the operation of the rebate scheme. We have concerns about the way the rebate scheme operated (or was proposed to operate) and in particular that there may have been a failure on the part of NSX to do all things necessary to ensure that its market operated in a transparent manner. NSX abolished the scheme on 5 January 2004.

#### **2.4.3 MoU with ASX and BSX**

As five out of the seven NSX participant organisations are also members of ASX, NSX is expected to have an appropriate supervision and information sharing arrangement with ASX. We understand that NSX, ASX and Bendigo Stock Exchange Limited (BSX) signed a Memorandum of Understanding (MOU) in May 2004 in relation to information sharing. We will review these arrangements during our next assessment.

# Appendix 1

**Table of director interests  
as at 3 November 2003.**

<b>Current directors</b>	<b>Position(s) with NSX</b>	<b>Related PO(s)</b>	<b>Related broker/ adviser</b>	<b>Director related entities which received income or other payments from NSX</b>	<b>Shares in companies listed on NSX</b>
Mr Warwick Evans	Chief Executive Officer Chairman			WWE Investments for business development advice provided to NSX in 2001/2002 financial year  IXION Pty Ltd for consulting work during the 2001/2002 and 2002/2003 financial years.	Pegmont Mines  Winpar Holdings  Various wine securities (AWX)
Mr Francis Markham Menzies	Director Company Secretary	Tonkin Scorer Menzies	Tonkin Scorer Menzies	A.H. Hough Pty Limited payment for a loan guarantee during the 2002/2002 financial year	
Mr John O'Connor	Director			Forsythes Accountants for compliance committee services during the 2002/2003 financial year	
Mr Paul Seymour	Director			Newcastle Capital Markets Pty Ltd for share registry services during the 2001/2002 and 2002/2003 financial years	Pegmont Mines NL  Winpar Holdings Limited



<p>Mr Steven Pritchard</p>	<p>Director</p>	<p>Pritchard &amp; Partners Pty Ltd  Cameron Stockbroking</p>	<p>Pritchard &amp; Partners Pty Ltd  Cameron Stockbroking</p>	<p>Newcastle Capital Markets Pty Limited for share registry services during the 2001/2002 and 2002/2003 financial years  Rees Pritchard Pty Limited for accountancy services during the 2001/2002 and 2002/2003 financial years  Pritchard &amp; Partners Pty Ltd conference income during the 2001/2002 financial year  Loan repayment by NSX to Lateral Pacific Properties during the 2001/2002 financial year  Rees Pritchard Pty Limited for compliance committee services during the 2002/2003 financial year</p>	<p>SwepDri Limited  Winpar Holding Limited*  Australian Property Systems Ltd  Heritage Gold NZ Ltd  Pegmont Mines NL  *Director of Winpar Holding Limited</p>
<p>Mr Michael Cox</p>	<p>Non-executive director</p>				
<p>Mr Ray Whitten</p>	<p>Non-executive director</p>		<p>Whitten Lawyers and Consultants</p>		