



**ASIC**

Australian Securities & Investments Commission

**REPORT 90**

# **Market assessment report: Australian Pacific Exchange Limited**

February 2007



**ASIC**

Australian Securities & Investments Commission

# **Annual assessment report**

## **s794C of the Corporations Act 2001**

**Australia Pacific Exchange Limited  
ACN 080 399 220**

**February 2007**

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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 obligation to have adequate arrangements for supervising the market it operates.

This report summarises ASIC's second assessment of compliance by Australia Pacific Exchange Ltd ACN 080 399 220 (APX) with its obligations under s792A(c) of the Act.

Section 794C(1) of the Act permits ASIC to extend the scope of an assessment to review a licensee's compliance with any or all of its obligations under Ch.7 of the Act. We extended the scope of our assessment to consider APX's compliance with s792A(d) of the Act, which requires an Australian market licensee to have sufficient resources to operate its market.

Our previous report regarding APX was publicly released on 23 November 2005.

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

Generally our assessment report focuses on suggested areas of improvement in APX'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 APX's arrangements have met and continue to meet their statutory obligations.

## Compliance by APX

We conclude that APX continues to have 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 both its listing rules and business rules.

## Our approach

ASIC uses the formal assessment process to examine whether a market licensee has been and is continuing to meet its supervisory obligations. We also use the process to identify areas where improvements may be needed to enable the licensee to meet its obligations in the future.

For this assessment, we examined in detail the day-to-day supervisory functions carried out by APX. We paid particular attention to the extent to which APX has responded to issues we raised in our first assessment report.

# Section 1: Background

## 1.1 The APX group

At the time of writing this report, the substantial shareholders of APX were Austock Group Limited (Austock Group), Austock Asset Management Limited, Julius Colman and Foolscape No.2 Pty Ltd.

APX's licence permits it to operate a market in the financial products described on its licence. A copy of APX's market licence is available on ASIC's website at [www.asic.gov.au/markets](http://www.asic.gov.au/markets).

## 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 that 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 APX in our role as regulator of companies and financial markets, an on-site inspection of books and records and interviews with APX personnel, and the discussions we have with APX about the issues that have arisen from our previous assessment processes.

In conducting our assessment we have particularly considered:

- the annual regulatory report given to ASIC by APX dated 29 September 2006 as required under s792F of the Act;
- information we received from and about APX in the ordinary course of our dealings with APX as a market licensee, including APX's most recent annual report;

- information from external sources, including media commentary;
- the operation of the market throughout the period, particularly in relation to issues of disclosure and trading;
- internal APX material, including information collected by APX on a continuous basis;
- discussions with senior APX management; and
- comments made in interviews or discussions with a range of APX personnel.

We served a number of notices under the *Australian Securities and Investments Commission Act 2001* that required APX to give documents to ASIC relating to a wide range of APX activities.

On 9 and 10 August 2006 we attended APX offices in Melbourne. During this onsite phase of the assessment we reviewed APX operational records and spoke to APX management and staff.

After our onsite visit was completed we provided written findings to APX. Where appropriate, our report reflects APX's responses.

### **1.3 Focus of this assessment report**

Our assessment involved a review of various changes made by APX in response to the key recommendations and other issues made in our previous assessment report as well as issues that came to our attention during the assessment period.

We reviewed APX's conflict handling arrangements and interviewed a number of individuals to help us form a view of the adequacy of the arrangements and whether they are understood across the organisation and implemented in practice.

We also sought reassurance generally about the adequacy of APX's practices, in particular the quality and consistency of supervisory decisions, to ensure that APX is meeting its statutory obligations to supervise its market.

We also considered whether APX has sufficient resources to operate its market.

# Section 2: Observations and recommendations

## 2.1 APX is meeting its obligations

After making our assessment, ASIC concludes that APX has adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c) of the Act. We have also concluded that APX has sufficient resources to operate its market in accordance with s792A(d) of the Act.

This conclusion takes into consideration the size and nature of APX's market and is based on the following observations drawn from information gathered during the formal part of our assessment process:

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. Supervisory staff that monitor the conduct of participants and trading have adequate procedures in place to achieve this;
4. Our review of operational records on supervisory decisions showed that:
  - decision-making on supervisory matters is based on sound principles;
  - APX conducts ongoing supervision of its participants and listed entities;
5. APX has contracts in place to ensure access to good market infrastructure (including technology) and appropriate funding arrangements to support its obligations to maintain a fair, orderly and transparent market; and
6. There was one particular instance where there was a significant delay in the identification of a potential conflict of interest. Otherwise, we consider that APX has adequate conflict handling arrangements.

## 2.2 Other observations and recommendations for future action

### 2.2.1 CONFLICT MANAGEMENT

Section 792A(c)(i) of the Act requires that APX must "have adequate arrangements for handling conflicts of interest between its commercial interests... and the need to ensure that the market operates in a fair, orderly and transparent way".

APX has adopted a Conflict Management Plan and a Compliance Plan. The Conflict Management Plan sets out APX's specific conflict handling arrangements. It acknowledges that the APX board is not independent, and as such, requires delegation of its supervisory decisions to independent committees to ensure that the potential for

conflict at board level does not impact APX's supervision of its market. These committees include:

- a Markets Supervision Committee that meets every two months to review APX's compliance with the Conflict Management Plan, Compliance Policy and its written policies and procedures;
- a Quotation Committee to make decisions regarding waivers and the admission of entities; and
- an Adjudicatory Tribunal to make decisions regarding the business rules, such as the admission of participants.

In our previous assessment report, we recommended that APX's Market Supervision Committee perform an audit of potential conflicts present in APX's operation and assess whether APX has adequate conflict handling arrangements for each potential conflict. In particular, we recommended that the arrangements should address the conflict arising from APX's General Manager Compliance and Supervision's concurrent senior roles with APX and Austock Securities Limited ("Austock Securities").

#### *General Manager Compliance and Supervision*

To address this issue, APX appointed a new General Manager Compliance and Supervision on 1 June 2006. The new General Manager is employed on a part time basis however arrangements are in place to ensure he is available during market hours. The General Manager has other employment outside of APX.

In a report to APX's independent directors dated 31 October 2006, APX's Market Supervision Committee identified issues in relation to a conflict of interest between the General Manager's role at APX and his other employment outside of APX, in particular, as legal adviser to Austock Group and its subsidiaries. We discussed this with the APX board, who agree there is a potential conflict. APX has since sought a written undertaking from the General Manager precluding him, while he remains in his current position at APX, from acting as legal adviser to Austock Group or its subsidiaries. The General Manager has provided this written undertaking.

APX's arrangements to handle conflicts of interest did not identify this issue when the new General Manager was appointed. We understand this occurred because of a particular interpretation of the conflict handling arrangements taken at the time by the new General Manager. APX's board did not appear to be aware of the issue prior to the Market Supervision Committee report in October 2006. The initial failure to identify the potential conflict of interest is of some concern given that we raised a similar issue in our last assessment report about the duality of the roles of the previous General Manager, as noted above.

However, we acknowledge that the matter was subsequently identified by the Market Supervision Committee. The board of APX has advised us that it is satisfied with the arrangements now in place to handle the conflict. ASIC will continue to closely monitor APX's arrangements in this regard to ensure that potential conflicts can be identified and are properly dealt with.

*Access to APX facilities*

In our previous assessment report, we noted that APX relies on information technology supplied and controlled by Austock Group. We recommended that access arrangements to APX's office, records and information technology be reviewed to ensure there are proper written policies and procedures in place to control access. In response, APX, with the assistance of Ernst & Young, has drafted an Information Security Policy Document covering these issues.

*Conflict Management Plan*

Clause 11.3 of APX's Conflict Management Plan requires each supervisory unit, amongst other things, to have criteria for making supervisory decisions. APX's Market Supervision Committee has recommended that more specific criteria be developed at department level, in an attempt to clarify aspects of the rules that require discretion, such as a decision to admit an entity to official list or a decision to recognise a person as an affiliate, or what constitutes sufficient working capital. We agree that this would be a useful initiative. APX have advised that they will consider the Market Supervision Committee's recommendation.

Clause 8.2 of the Conflict Management Plan states all supervisory decisions identified must be entered in a register and the register must identify which decisions are "time critical". We noted that the "Register of Supervisory Decisions Made" did not contain such an indicator, however this has subsequently been addressed.

*New managing director of APX*

APX has recently appointed the former managing director of Austock Group to the vacant position of managing director of APX. However, the appointee remains on the board of Austock Group and on various Austock Group investment committees. This gives rise to a potential conflict of interest as Austock Group controls APX's only participant, Austock Securities. APX advise that the new managing director will have no day-to-day role with Austock Securities or be involved in supervisory decisions, but rather, will concentrate on marketing activities for APX. We are satisfied that APX's conflict handling arrangements adequately deal with any potential conflict that may arise.

*APX's risk management policy*

APX's risk management policy provides guidance on the management of APX's business risks and obligations with respect to operating a financial market in Australia. We noted that ownership of all of the risk categories included on APX's risk register reside with APX's General Manager Compliance and Supervision. We do not think it is appropriate for APX's General Manager of Compliance and Supervision to have ownership of business development, client retention and profitability related risks, given the potential conflict of interest inherent in these responsibilities with his obligation to oversee APX's supervisory activity.

**Recommendation 1**

We recommend that APX review its risk management policy to more appropriately allocate risk ownership.

## 2.2.2 SUPERVISION

Section 792A(c)(ii) and (iii) of the Act requires APX to have adequate supervisory arrangements in order to monitor participant conduct on or in relation to its market and for enforcing compliance with its operating rules.

In order to meet these obligations, APX has set up a number of divisions and committees, with its key operational areas comprising a Compliance Division, a Listing Division and a Market Administration and Supervision Division.

To assess APX's compliance with its statutory obligations, we selected specific supervisory activities undertaken by various departments within these divisions, to ensure APX was adhering to its stated procedures in these areas.

### *Monitoring periodic disclosure by listees*

According to its procedures, in monitoring periodic disclosure APX will review listee compliance with a listee half-yearly/yearly compliance checklist.

In our previous assessment report, we noted that some of the items in these checklists appeared to lack accuracy. For instance, we noted that half-year financial report disclosures were being checked well after lodgement. We recommended that APX review its procedures, and in particular, the content and timeliness of various checklists to ensure their effectiveness as a compliance tool. In response, APX amended their announcement checklist form so that the relevant disclosures are checked when the relevant periodic announcement is received. Furthermore, APX changed the dates that their half-year and annual reviews are performed to ensure they correspond with the release of financial information.

### *Monitoring ongoing obligations of brokers*

APX procedures require the completion of a daily affiliate/broker compliance checklist and a broker monthly/yearly compliance checklist. These checklists review compliance with various periodic requirements such as brokers' capital liquidity. APX monitors capital liquidity by requiring brokers to lodge monthly returns showing surplus liquid funds according to a prescribed formula. Brokers are required to lodge this within five business days of the end of the month.

In our previous assessment report, we noted that Austock Securities' capital liquidity returns were frequently lodged after the due date. We recommended that rather than tolerate regularly late compliance, APX should extract compliance or amend their operating rules. During our current assessment we found that Austock Securities' compliance with these rules had not materially improved. APX has subsequently informally lodged rule changes with ASIC to address the reasons attributed for late lodgement.

### *Price sensitivity of announcements*

In our previous assessment report, we noted that APX assumed that all announcements received whilst the market is open (10am to 4pm) are considered price sensitive with an entity's securities put into a trading halt for 10 minutes following an announcement. We thought that this was an inferior approach because of the potential for the market to be confused by non price sensitive information being treated as price sensitive and recommended that APX review announcements

individually to determine their price sensitivity. APX has continued with this policy although our preference remains for each announcement to be individually scrutinised. APX has advised that it will revisit this issue.

#### *Settlement arrangements*

APX's market operates a broker-to-broker paper based settlement system with settlement meant to occur at T+5. In our previous assessment report, we noted that approximately 26% of transactions did not settle within T+5. APX was aware of the issue, which it attributed to its manual paper based system and the logistics of moving settlement documents using the postal system.

Since our last assessment, in order to reduce the level of late settlements, APX decided to impose fail fees on brokers, for trades settling after T+8. This initiative appears to have assisted, with data produced by APX showing a reduction in the rate of transactions not settling within T+5 to 15%.

While this improvement is pleasing, as noted in our previous assessment report, APX's settlement system and level of late settlements would not be sustainable in a more active market. There is a risk that if APX becomes more active, a disorderly market could emerge, particularly in periods of high turnover as buyers may not have title at T+5.

APX has been seeking alternative settlement arrangements with an existing licensed clearing and settlement facility, but no arrangements have been finalised as yet. However provided APX continues to closely monitor compliance with its existing settlement arrangements, we are not minded, given the current level of activity in the market, to recommend further action at this stage.

#### *Compliance Division Procedures and Practice*

APX's Compliance Division is responsible for monitoring compliance by all the other business units of APX with their respective obligations and handling complaints about APX, the market and participants. It also investigates breaches of operating rules and takes appropriate enforcement action when necessary.

APX's compliance procedures include, as appendices, a monthly and annual compliance checklist. However our review noted that the procedures manual did not provide any instructions or guidelines on how to complete these checklists. We observed that APX was preparing monthly compliance checklists, but not annual checklists.

APX's breach register and reports noted that quarterly breach summary reports were not prepared and tabled at APX's Audit and Compliance Committee and Market Supervision Committee as required by its procedures.

#### **Recommendation 2**

We recommend that the Compliance Division update its procedures to deal with the completion of monthly and annual compliance checklists and also to ensure that actual reports are prepared as required by procedures.

### **2.2.3 RESOURCES**

Under s792A(d) of the Act, APX is required to ensure that it has sufficient financial, technological and human resources for the operation and supervision of its market.

#### *Financial resources*

We reviewed whether APX has sufficient financial resources for operation of its market. We considered APX's financial position, given the low level of listings and trading, by reviewing its quarterly cash flow reports to ASIC for the September 2005, December 2005, March 2006 and June 2006 quarters and held discussions with senior members of APX management and an APX director.

Our review noted that at 30 June 2006, APX had \$162,651 in cash. APX has access to a loan facility up to a maximum of \$1.25 million until 31 October 2007 and has also commenced a fundraising from existing shareholders, which seeks to raise \$1.5 million.

Given these developments, we are satisfied that APX has sufficient financial resources to operate its market. ASIC will continue to monitor developments in APX's financial position to ensure its ongoing ability to comply with this obligation.

#### *Technological resources*

During our onsite visit, we spoke to APX's Chief Information Officer (CIO) about aspects of APX's technological infrastructure. During our assessment, we became aware that APX's trading system experienced a minor malfunction affecting the processing of orders, which occurred intermittently over a period of months. We were advised that this issue created an inconvenience for APX's terminal operator, who had to revert to manual processes but it did not seriously affect the operation of the market. We were told that this problem had since been addressed.

### **2.2.4 COMPENSATION ARRANGEMENTS**

APX's approved compensation arrangements are currently comprised of a fidelity fund with a minimum balance of \$750,000.

In our previous assessment report, we observed a series of minor and administrative inconsistencies and instances of non-compliance with APX's compensation arrangements that required attention and recommended that APX should address these, which APX has done.

Following a review of bank statements during our current assessment, we identified that APX had withdrawn excess money from its fidelity fund on three separate occasions and transferred the funds to a separate APX bank account. The excess money in the fidelity fund comprised interest earned and the withdrawals totalled \$52,936.38.

We indicated to APX that the withdrawal of these excess funds appeared to be a breach of the Act, Corporations Regulations and APX's own compensation arrangements, contained in Appendix 8-2 of its business rules.

APX advised that the funds were withdrawn because it formed the view that the fidelity fund was not a fidelity fund under the Act and that as the fidelity fund was an asset of APX, the interest earned on the money could be treated consistently with that view. Following discussions with ASIC, APX subsequently re-instated the withdrawn money back to the fidelity fund, and ASIC does not intend to take any further action on the matter.

APX has proposed changing its compensation arrangements from a cash deposit to a bank guarantee. This will require a variation to APX's market licence under s796A(2)(b) of the Act and a change to its compensation rules under s884A and s884B of the Act.