



ASIC

Australian Securities & Investments Commission

REPORT 61

Market assessment report: Australian Pacific Exchange Limited

November 2005



ASIC

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Annual Assessment (s794C) report

Australia Pacific Exchange Limited
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Executive Summary

Section 794C of the *Corporations Act 2001* (Act) requires the Australian Securities & Investments Commission (ASIC) to assess how well a licensed market operator is complying with its obligations as the holder of an Australian markets licence. APX was granted an Australian market licence on 11 August 2004. As a condition of receiving its licence, APX was required to provide a special report to ASIC on its compliance with its obligations as a market licensee in accordance with s794B(1) of the Act, within one month after the first six months of operation of the market. APX gave this report to ASIC on 19 August 2005.

ASIC has reviewed APX's compliance with all its general obligations as a market licensee in sections 792A(a) to (i) of the Act¹. In particular, ASIC has reviewed whether APX has:

- ensured the market is fair, orderly and transparent;
- complied with the conditions of its licence;
- adequate arrangements in place for supervising its market, including adequate conflict handling arrangements;
- sufficient resources to operate the market;
- adequate compensation arrangements in place; and
- taken all reasonable steps to ensure that no disqualified person becomes involved with the market operator.

This report is ASIC's first assessment of APX and describes our assessment, conclusion and key recommendations for improvement.

How we conducted this assessment

In conducting this assessment we reviewed the books and records of APX and interviewed APX staff, management and directors. We considered a report prepared by APX's internal auditors, Ernst & Young, to APX's Audit Committee and Market Supervision Committee dated June 2005 (EY Report) and APX's special report to ASIC dated August 2005. We also had regard to our ongoing interactions with APX and considered how well APX might comply with its obligations in the future.

Compliance by APX with statutory obligations

As at the time of our assessment and taking into account the size and operations of the APX market, in ASIC's view, APX has:

¹ The obligations contained in sections 792A(f), (g) and (h) are not applicable to APX

- ensured the market is fair, orderly and transparent;
- complied with the conditions of its licence;
- adequate arrangements in place 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 business market rules;
- sufficient resources to operate the market;
- adequate compensation arrangements in place; and
- taken all reasonable steps to ensure that no disqualified person becomes involved with the market operator.

Key observations and recommendations

Although we understand that it is APX's intention to reduce its reliance on the resources of Austock Group as the market develops, APX's current proximity to Austock Securities Limited (Austock Securities), a participant on APX's market gives rise to a source of potential conflict. APX does not yet have fully effective arrangements in place to manage the potential for conflict that arises in this instance. In particular APX needs proper written policies and procedures in place to control access to APX offices, records and information technology.

APX's chief regulatory officer is also Austock Securities' chief regulatory officer. While we saw no evidence of conflicted or inappropriate regulatory decisions, the dual roles give rise to the potential for flawed decision making by APX in relation to supervision of its participants. APX must take steps to address this issue as soon as possible.

We also have concerns about the effectiveness of APX's settlement arrangements, which are broker to broker using paper based script transfer. At least a quarter of settlements happen outside the required settlement cycle of T+5. APX is actively seeking to implement alternative arrangements with an existing licensed clearing and settlement facility. APX's trading volumes are low and we do not think this issue currently threatens the operation of the market. However, APX must take steps to rectify the problem, by putting other arrangements in place. ASIC will continue to monitor progress on this issue.

We have also made recommendations about some aspects of APX's supervisory procedures and practices, and about administrative aspects of its compensation arrangements. These recommendations are set out in Section 2 of this report.

While improvements are required in certain areas, we think, particularly given the low level of activity on APX's market, that APX is currently meeting its obligations as an Australian market license.

Section 1: Background

1.1 APX Group

The substantial holders of APX at the time of writing this report were Austock Group Limited (Austock) and Austock Asset Management Limited; and Julius Colman and Foolsap No.2 Pty Ltd.

1.2 Market summary

At 11 August 2005, APX had 1 listed entity, 1 participating broker, 2 research panellists and 3 sponsors. Research panellists are APX recognised organisations that provide written opinion (research) about a listee to the market. Sponsors are organisations who provide corporate advisory services and guide listees, pre and post listing. During the period 20 January 2005 to 11 August 2005 there were 145 trades completed on the APX market, with a total volume of securities traded of 6,617,586 and total value of \$1,503,605.

1.3 The assessment process

Section 794C(1) of the Act requires ASIC to assess whether APX complies with its obligations in section 792A(a) to (i) of the Act.

In conducting our assessment, we took into account the matters set out in ASIC Policy Statement 172 'Australian market licences: Australian operators' (PS172). PS 172 explains how ASIC will assess how well a market licensee is complying with its obligations. Our assessment focussed on assessing APX's compliance with its statutory obligations contained in s792A of the Act, including the adequacy of its supervision generally under s792A(c)(ii) and s792A(c)(iii). To do this we looked at a number of distinct areas of supervisory activity undertaken by APX in relation to its listed entities, participants and trading on its market.

In conducting our assessment under s794C, we:

- reviewed APX's market operating rules and written procedures;
- analysed information we received from and about APX in the ordinary course of our dealings with the licensee, including APX's special report;
- reviewed information from the media, APX's website, ASIC's complaints management records and other sources;
- scrutinised trading on APX's market and reviewed media coverage of listed entities;
- interviewed a range of APX personnel;
- reviewed APX material produced under ASIC notices, including:

- files in relation to brokers, sponsors, settlement agents, research panellists and listed entities concerning their admission and ongoing compliance with the operating rules;
- board and board committee minutes, reports and charters; and
- supervisory policy and procedure documents.

Following receipt and analysis of APX's documents obtained under notice, we visited APX's offices in Melbourne from 3 to 5 August 2005 and spoke to APX directors, management and staff. We have discussed the results of our assessment with APX. This report incorporates APX's comments on our findings.

Section 2: Recommendations

2.1 Overall compliance

ASIC concludes that APX is complying with its obligations as a market licensee under s792A(c) of the Act.

This conclusion is based on the following observations drawn from information gathered during the assessment process:

1. No serious market failures or disruptions came to our attention;
2. Supervision and monitoring of participants, listed entities and trading are guided by policies and procedures consistent with statutory obligations. While the currency of certain supervisory procedures and practices requires review, generally we think that APX is performing well in this area;
3. While there is a significant issue of delayed settlement on the APX market, APX is formally seeking alternative arrangements with an existing licensed clearing and settlement facility;
4. APX has a relatively robust and transparent system of internal oversight and review in relation to its market licence obligations, although there are some weaknesses in outcomes, particularly with regard to adequate arrangements to handle conflicts; and
5. APX has sufficient resources, including financial, technological and human resources for its current operations to support its obligation to maintain a fair, orderly and transparent market. ASIC is updated quarterly on APX's financial position.

2.2 Fair, orderly and transparent market

Section 792A(a) of the Act requires APX, to the extent that it is reasonably practicable, to do all things necessary to ensure that the market is fair, orderly and transparent. ASIC's PS172 states that this obligation underlies all of the other licensee obligations, so a market licensee that is not meeting one of its other licensee obligations is also likely not to be meeting this obligation. As we have concluded that APX has met all of its other general obligations as a market licensee, we conclude that this condition has also been met.

2.3 Compliance with conditions of licence

Section 792A(b) of the Act requires APX to comply with all the conditions on its market licence. Eight of APX's market licence

conditions (condition 5 to condition 12) impose a positive obligation on APX. We have reviewed APX's compliance with these conditions.

Condition 5 – Classes of financial products

The condition restricts the type of financial products that can be dealt with on the APX market to securities and managed investment products. APX has complied with this condition.

Condition 6 – APX to operate market only in certain circumstances

The condition required APX to complete certain activities, mainly a corporate restructure before it could begin its market. APX confirmed to ASIC that it had complied with this condition on 8 December 2004. The APX market commenced on 20 January 2005.

Condition 7 – Clearing and settlement

Firstly, the condition requires APX to notify each party to a transaction the identity of the other party to the transaction. The requirement of the condition is enforced through documented procedures.

Secondly, the condition requires APX to have operating rules that provide for transactions effected through the market to be settled by the parties to the transaction. APX has such operating rules.

APX's settlement arrangements are discussed further below in section 2.4.2.

Condition 8 – Compensation arrangements

The condition requires APX to maintain a minimum cover of \$750,000 for its Division 3 arrangements and to maintain a fidelity fund as the source of fund for the arrangements. APX's compensation arrangements comply with this condition and are discussed further in section 2.6 of this report.

Condition 9 – Participants to be licensed

The condition requires APX to require each participant in the market to hold an Australian financial services licence that permits trade in the products offered on the market, unless the participant is exempt under Australian law from the requirement to hold such a licence.

The requirement of this condition is satisfied by the operating rules, which requires brokers, settlement agents and research panellists, respectively, to hold an Australian financial services licence.

Condition 10 – Disclosure to clients

The condition requires APX to require each participant to give to a client a written statement that describes the market and the risks of trading on the market before accepting the first order from the client.

The requirement of condition 10 is covered by APX BR 8.34 that requires each APX broker or affiliate to give to clients risk disclosure statement. However, we noted that the requirement of the BR is only effective for one year from the date of commencement of trading of APX. APX advised that they would amend BR 8.34 accordingly.

Condition 11 – Reporting

This condition requires APX, within 14 days after the end of each quarter occurring during the first 2 years of operation of the market, to give ASIC a report concerning participation, cash flows and financial position in addition to the following:

- (a) the opinion of the directors of APX, as at the end of the quarter, as to whether APX will be able to pay its debts when they become due and payable; and
- (b) the opinion of the directors of APX, as at the end of the quarter, as to whether APX has sufficient resources to meet, in the next 6 months, its obligations under Chapter 7 of the Act as a market licensee.

These reports have been received. We noted that the quarterly cash flow report did not separately itemise cash available to APX to operate its market and the cash that is part of APX's fidelity fund (which is not available to APX for operation of its market). APX has agreed to amend the quarterly cash flow report in the future to separately disclose these items.

Condition 12 – Suspension of market

The condition requires APX to notify ASIC in writing as soon as possible if APX suspends the operation of the market. APX has not suspended the market during the assessment period.

2.4 Supervision of the market

Under s792A(c) of the Act, APX is required to have adequate arrangements in place for supervising its market, including arrangements for handling conflicts of interest, monitoring the conduct of participants on or in relation to the market and enforcing compliance with its operating rules.

2.4.1 Conflict handling arrangements

Under section 792A(c)(i) of the Act, APX is required to have adequate arrangements in place 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 operates in a fair, orderly and transparent way.

At the time APX's market licence was granted there were several features of the proposed market that gave rise to some risk of actual or perceived

conflicts of interest between the commercial interests of APX and its obligations to ensure the market operates in a fair, orderly and transparent way. At start up a significant proportion of APX's equity was controlled by persons who planned to become listees and who had a common industry background as direct property syndicators. This was likely to create the potential for serious conflicts of interest, or perceptions of conflicts of interest, to arise in relation to APX's obligation to supervise its market under section 792A(c). To manage this APX adopted various conflict handling arrangements including the following measures.

APX shareholders are prohibited from individually exercising more than 15% of the eligible vote at a meeting of members by way of a provision in APX's constitution. APX adopted a Compliance Policy and Conflict Management Plan. The Conflict Management Plan sets out specific conflict handling arrangements. The Conflict Management Plan also sets out a decision-making framework to ensure decision makers are free from conflicts of interest and decision making is transparent. The Conflict Management Plan also recognises that the board is not an independent body and is required under the Conflict Management Plan to delegate all of its powers to make supervisory decisions to independent committees.

APX has set up a number of committees. The Market Supervision Committee is established pursuant to a terms of reference document and is composed of independent persons. It meets monthly to review APX's compliance with the Conflict Management Plan, Compliance Policy, APX's written policies and procedures and to generally oversee APX's compliance with its supervisory obligations. APX has also established a Quotation Committee to make decisions pursuant to the listing rules such as the admission of entities and an Adjudicatory Tribunal to make decisions pursuant to the business rules such as the admission of participants.

The purpose of this structure was to remove the board from day to day involvement in supervisory decisions and to establish appropriate reporting and review mechanisms to ensure that the potential for conflict at the board level does not affect the quality of APX's supervision of the market. We reviewed APX conflict handling arrangements including the underlying documents referred to above and the workings of the various committees referred to above. We spoke in detail with the Market Supervision Committee during our visit. While in general we think that APX's system of independent oversight committees is relatively robust, we think that the potential conflict that arises from APX's relationship with Austock is not being adequately addressed. This potential conflict has become more apparent since APX commenced operations. Interests

associated with Austock own 36.45% of APX. It is collocated with Austock and shares the services of key personnel. APX uses information technology supplied and controlled by Austock.

The conflict created by this relationship arises from the fact that an Austock subsidiary, Austock Securities, is a participant of the APX market in the capacity of a broker, a sponsor and a research panellist. Accordingly APX has an obligation to supervise Austock Securities' compliance with APX's operating rules, it's AFSL conditions and Chapter 7 of the Act.

APX moved into office space separate from the other activities of Austock in early June 2005, but continues to rely on Austock's IT infrastructure and staff.

At the time of ASIC's visit there were no written policies or procedures covering the authorising of physical access to APX's office space and its information technology systems. Although ASIC understands that APX does have arrangements in this regard, these should be documented. APX have advised that its policies and procedures in this regard while not fully documented have been subject to independent oversight and that APX is in the process of documenting them.

We also understand that it is APX's intention to reduce its reliance on the resources of Austock Group as the market develops.

Recommendation 1

We recommend that access arrangements to APX's office, records and information technology be reviewed to ensure that there are proper written policies and procedures in place to control access. The arrangements need to recognise APX's supervisory role over Austock Securities.

The General Manager Compliance and Supervision at APX (the General Manager) is also concurrently the Compliance Manager and in-house counsel for Austock Securities. There is clear potential conflict in the duality of the General Manager's role as he is effectively the senior compliance executive for both the market supervisor and one of its few regulated entities. We are advised that the General Manager absents himself from certain decisions when necessary. For example, the General Manager does not attend meetings concerning Austock Securities' clients who are listed on APX. We are also advised that other staff at Austock Securities monitor its compliance with APX requirements and Chinese walls within Austock Securities separate the General Manager from APX-related activity. Having said this, APX has no arrangements in place itself to deal with this potential source of conflict. For example under the Conflict Management Plan the name of each decision maker, the decisions they make and any material interest they may have are

recorded in the 'Decision Making Register', which is kept by APX's Compliance division. A copy of the register produced to ASIC did not record the General Manager's professional involvement with Austock Securities as a material interest effecting the decisions he is responsible for making. We made the Market Supervision Committee aware of this issue and they said they would consider this matter further.

Furthermore and in practice it would seem that the conflict arising from the General Manager's dual functions are impossible to practically manage. In the General Manager's view the issue is a result of APX's failure to meet its listing targets and obtain the necessary scale to demand his full time attention. This is an obvious difficulty, and one that has been faced by other start-up market operators. APX have advised that it's board has agreed that the General Manager should step down from his positions at APX and will put in place alternative arrangements which it will discuss with ASIC.

Recommendation 2

We recommend that the Market Supervision Committee perform an audit of potential conflicts present in APX's operation and assess whether APX has adequate conflict arrangements in regard to each of these. In particular the arrangements will need to address the conflict arising from the General Manager's concurrent senior roles with APX and Austock Securities.

2.4.2 APX supervision of market and participants

Under s792A(c)(ii) and (iii) of the Act, APX must have adequate supervisory arrangements for monitoring the conduct of participants on or in relation to the market and for enforcing compliance with the market's operating rules respectively.

APX has set up various divisions and committees to ensure adequate supervision of its market. In particular, APX has set up three key operational areas being the Compliance Division, the Listing Division and the Market Administration and Supervision Division. Each of these divisions comprises several departments dealing with separate areas of market supervision.

In order to make an assessment of APX's compliance with its supervisory obligations, we selected specific areas of supervisory activity undertaken by APX in relation to compliance by listees, sponsors, research panellists and brokers with APX's operating rules, as well as APX's supervision of trading activity.

We identified the relevant obligations in APX's rules and the applicable supervisory procedures APX has in place for monitoring these so we could test their effectiveness.

COMPLIANCE DIVISION

APX's Compliance Division is responsible for monitoring compliance by other APX business units with their respective obligations, handling complaints about APX and its market, investigating breaches of the operating rules and taking appropriate enforcement action. Overall, and apart from some exceptions related to the initial operation of a new market, no significant issues were found.

According to its procedures, a compliance officer reviews internal departments to confirm compliance with APX's rules and procedures and completes a quarterly compliance checklist. Where suspected breaches are identified, a breach report is prepared and an entry made in the breach register. The General Manager Compliance and Supervision reviews these documents and recommends appropriate action be taken, where appropriate.

We reviewed the quarterly compliance checklists for the March and June 2005 quarters and noted that the report for the March quarter was completed by the General Manager Compliance and Supervision without review and was completed late in contravention of APX procedures. The June quarter report was duly completed in accordance with procedures. The General Manager Compliance and Supervision advised that the March quarter report was late because of implementation problems and was completed by him as APX had not appointed a compliance officer at that time. A part time compliance officer was appointed by APX in early June 2005.

We reviewed APX's breach register and associated breach reports. We observed that there were no breach reports for each of the entries in the registry and understand this was due to implementation issues.

Since June 2005, all breaches have contained a corresponding breach report. A review of the nature of the breaches indicates that the majority were administrative and procedural and not considered serious and were appropriately dealt with. Initially, APX had one breach register covering all breaches. In an attempt to improve transparency, in June 2005, breaches were classified according to whether they were market or participant breaches and separate registers were set up for each participant.

LISTING DIVISION

APX's Listing Division is responsible for assessing applications by organisations to become listees, brokers, sponsors or research panellists and to supervise and monitor their ongoing compliance with the

operating rules. The division comprises four departments being the Listee Regulation Department, the Broker Regulation Department, the Sponsor Regulation Department and the Research Panellist Regulation Department.

Listing regulation department

We reviewed APX's process for considering applications by entities to be listed on its market and its monitoring of their compliance with continuous and periodic disclosure requirements.

Processing of applications for admission to APX's market

Chapter 4 of APX's listing rules sets out the requirements that must be satisfied before an entity can be listed on APX. According to its procedures, in processing listing applications the Listee regulation department action officer will receive applications and complete the Listing application checklist and Listing recommendation for the listee and forward the application, recommendation, and checklist to the department manager, who will review the decision and forward the recommendation along with the checklist to the Quotation Committee for a decision. As part of the review of the application, the department action officer will ensure that it includes a declaration lodged by the applicant's sponsor, attesting that the applicant has met all of APX's listing requirements, and be satisfied that the sponsor has discharged its obligations and test the applicant's compliance with the APX listing standards on a 'spot check' basis. To finalise the application, the department action officer has to complete an official list admission form and forward this to the department manager for review and approval.

We reviewed the process followed by APX for the three applications received during the assessment period for listing on its market. In particular we reviewed the listing files to ensure the following had been provided and satisfied the relevant listing rules:

- at least three years worth of annual accounts or if 3 years worth of accounts were not provided, APX was satisfied that investors had the necessary information available to arrive at an informed judgement concerning the applicant and its securities;
- shareholder spread information; and
- applicable financial parameters at the time of admission.

Following a review of the relevant documents and discussions with APX staff, we concluded that APX had adhered to its written procedures regarding the handling of applications and had applied its admission criteria appropriately.

Ongoing compliance with APX listing rules – continuous disclosure

Under APX LR 8.1.1, if an entity becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, it must immediately provide this information to APX.

According to its procedures, APX monitors compliance by listed entities with this obligation through completion of a listee daily compliance checklist. This involves a review of major newspapers and other information such as listee websites for articles about listed entities. These are examined for information that suggests a listed entity should have disclosed information to APX and a comparison is made with the latest announcements. If, after assessing these, it appears information should be disclosed to APX, a query is made to the entity.

We conducted a search of national newspapers over the assessment period on all listed entities as at 5 July 2005. The purpose of the search was to identify whether newsworthy items relating to a particular entity were noted in the media without corresponding disclosure to APX. We matched media coverage to listed entity announcements or were satisfied that the media articles would not give rise to disclosure obligations under the rules.

We reviewed a sample of daily compliance checklists for listed entities to ensure they had been duly completed. Our review noted one instance when APX queried a listee about its continuous disclosure obligations. They received a satisfactory explanation from the listee.

Our review concluded that APX had followed its written procedures and practices in monitoring continuous disclosure by listees.

Ongoing compliance with APX listing rules – periodic disclosure

At the time of this assessment, only half year financial information had been lodged by listees with APX, so we focussed on these. Pursuant to LR 9.16.1 a listee is required to prepare a half yearly financial report and under BR 9.17.1 it must also complete Appendix 9-2 and give it to APX within 75 days.

According to its procedures, in monitoring periodic compliance, the department action officer will review listee compliance with the Listee Half Yearly/Yearly compliance checklist. We reviewed the completed yearly checklist for the two listees for June 2005. Some of the various checks done appear to lack currency. For example:

- The yearly checklist lagged the obligations they were checking against. For example, the checklist requires APX to assess, on a yearly basis, if the listee is complying with its continuous disclosure obligations by ensuring that any documents were received prior to any release to the market. APX is also required to perform this function on a daily basis. Checking compliance with this at the full year appears unnecessary and untimely.
- The yearly checklist requires confirmation that the listee has lodged the required half yearly financial report with all required disclosures. As the half yearly financial report is lodged in March

2005 and the yearly checklist is completed in July 2005, APX is reviewing the half yearly report well after lodgement.

- The yearly checklist also requires confirmation that the annual accounts were lodged and includes all the relevant disclosures required by the rules. The review however was performed on the 30 June 2004 accounts. At the time the June 2005 yearly checklist was completed, listees 30 June 2005 annual accounts had not been lodged with APX.

Broker regulation department

We reviewed APX's broker admission procedures to monitor brokers' compliance with their ongoing obligations, including their capital adequacy.

The daily operation of the department is carried out by the department action officer with the department manager performing the review function.

Admission procedures

APX BR 2.12.1 specifies the criteria for admission as an APX broker. According to procedures, upon receipt of an application, the department action officer checks it against the admission criteria using the Affiliate/Broker Application Checklist. After completing the checklist, the department action officer makes a recommendation, reviewed by the department manager, which is then submitted to the Adjudicatory Tribunal. The Adjudicatory Tribunal makes a decision on the application. We reviewed the checklist against the admission criteria, the applications and the minutes of the Adjudicatory Tribunal.

APX had received two applications, both from Austock Securities (i.e. application for admission as broker (fixed interest) and application for admission as broker (property & equity)). We examined the two applications and the documents attached. We noted that both applications were processed in accordance with the prescribed procedures and all the required documentations were received and attached to the files.

Our review noted one minor issue. We noted that the checklist does not cover the requirement of BR 2.12.4 (applicant must be incorporated in Australia).

Recommendation 3

APX should review its procedures and in particular the content and timeliness of its various checklists to ensure that they are an effective compliance tool.

Brokers ongoing obligations

Chapter 3 of APX business rules sets out various requirements in relation to brokers' ongoing obligations, including insurance and capital adequacy requirements.

The department action officer monitors brokers complying with their ongoing obligations by filling out checklists for both daily compliance (Affiliate/Broker daily compliance checklist) and periodic compliance (Broker Monthly/Yearly Compliance Checklist).

We examined the monthly compliance checklists for the period January to June 2005. We observed that Austock Securities had complied with the obligations referred to in the checklist, including the obligation to maintain professional indemnity insurance under BR 3.7.1.

APX monitors brokers' capital liquidity by requiring them to lodge monthly returns showing surplus liquid funds calculated according to a formula prescribed under BR 3.2.3. Brokers are required to lodge a monthly return within five business days after the last day of each month.

We examined the returns lodged by Austock Securities for the period between January 2005 to May 2005 and noted that Austock Securities maintained the required level of capital liquidity during the period. However, all the returns we examined were lodged after the due date. The General Manager Compliance and Supervision said that APX is aware of this problem and is constantly reminding Austock Securities to lodge its returns on time. According to APX, the problem with late lodgement lies partly with Austock Securities problem obtaining signatures from two directors on time to have the return lodged within five business days. APX has proposed to amend the relevant business rule to either extend the five day limit or allow returns to be lodged with signature of one director only.

Recommendation 4

APX should ensure that brokers lodge monthly capital returns in accordance with its requirements. Rather than tolerate ad hoc compliance, APX should either extract compliance from Austock Securities or amend its rules in a way that is appropriate from its regulatory perspective.

Sponsor and research panellist regulation department

As part of our assessment we looked at the requirements for sponsors and research panellists. Potential sponsors and research panellists must apply for admission to APX and observe certain requirements in relation to their independence. We looked at the application processes followed and whether the appropriate documents concerning independence had been filed. No issues were identified.

MARKET ADMINISTRATION AND SUPERVISION DIVISION

The role of the Market Administration and Supervision Division (MASD) is to operate APX's trading system, receipt and release listee market disclosures, supervise APX's clearing and settlement

arrangements and carry out market surveillance. It comprises four departments - the trading system department, the announcements office, the settlement department and the market surveillance department.

Announcements office

APX's announcements office is responsible for receiving, assessing and announcing disclosure information from listees to the market. It must also report suspected breaches of the rules to the compliance division. We reviewed the way APX processes and monitors announcements.

The announcement procedures require that APX send a confirmation receipt to the listee confirming when an announcement is received. Our review indicated that APX was not complying with this procedure although we were advised that it has rectified this.

Most announcements are placed onto APX's announcements platform and website within a few minutes of receipt, depending on whether it is received in hard or soft copy. In all other regards, APX appears to be following its procedures in the area.

APX advised that an assumption is made that all announcements received whilst the market is open (10am to 4pm) are considered 'price sensitive' and an entity's securities are put into a trading halt for 10 minutes after the announcement is made. ASIC disagrees with this approach. Clearly not all announcements are price sensitive, such as announcements of a change in registered office. A uniform halt of 10 minutes will also not always be sufficient time for the market to digest more involved issues.

Recommendation 5

We recommend that APX review announcements individually as required to determine their price sensitivity or otherwise call a trading halt which is appropriate in the circumstances of the information contained in the announcement.

Settlements department

APX has a broker to broker, paper based settlement system. The rules require settlement to occur at T+5.

Settlement agent

BR 6.27.1 allows APX to appoint settlement agents to provide clearing and settlement services to the market. In its licence application, APX indicated that it would likely appoint ACS Management Services Pty Limited as its settlement agent. However, this did not occur and currently Austock Securities is the only settlement agent. APX believes Austock has sufficient capacity to settle transactions in light of the current level of trading.

T+5 settlement requirement

APX settlement procedures state that APX sends information about executed trades to brokers who will then notify the clients of the same upon receipt of the information. The selling client is required to send a completed transfer form and share certificates to the broker and the purchasing client is required to send payment for the shares (and brokerage) and complete the transfer form. The broker of the purchaser has the responsibility to lodge the document with the company's registry for registration.

We examined the settlement reports for the period 20 January to 30 June 2005 and noted a considerable number of transactions did not settle within T+5 as required by the business rules. APX is aware of this issue, which it attributes to its manual paper based system and the physical transfer of documents. APX has advised that around 26% of transactions did not settle within T+5.

APX's settlement system and its associated problems would not be sustainable in a more active market, as buyers may not have title at T+5. There is a risk that if APX becomes more active, a disorderly market could emerge, particularly in periods of high turnover or volatile market conditions.

APX agrees that the problem with its settlement arrangements is serious and must be addressed. APX is actively seeking alternative arrangements with an existing licensed clearing and settlement facility. APX's trading volumes are low and we do not think this issue currently threatens the operation of the market. However, APX must take steps to rectify the problem, by putting other arrangements in place.

Market surveillance department

APX's market surveillance department conducts market surveillance and refers suspected breaches to its Compliance division. In monitoring the market, APX reviews daily trading data and market announcements, investigates irregular or suspicious trading activity and investigates referrals from other departments.

According to its procedures, in monitoring daily compliance, the department action officer receives the daily reports from the trading department and prepares a market surveillance daily report that checks for insider trading and market manipulation.

We reviewed a sample of these daily reports and concluded that APX's market surveillance procedures were followed during the assessment period.

ASIC independently reviewed trading in both listed entities on APX as at July 2005, to identify any unusual trading patterns such as extraordinary price or volume movements where there was no underlying market

announcement. Our review did not find any transactions requiring further investigation.

Further, APX reports on the surveillance of the market on a monthly basis. The department action officer prepares a monthly surveillance report, which is reviewed by the department manager. This report reviews and notes any significant announcements, suspensions, transactions, and includes an analytical review of trading in the relevant month and is sent to the Market Supervision Committee.

Our review found that these monthly reports had not been sent to the Market Supervision Committee as required. This was attributed to implementation problems that have now been rectified.

2.5 Resources to operate the market

Pursuant to s792A(d) of the Act, APX must have sufficient resources, including sufficient financial, technological and human resources for the operation and supervision of its market.

Financial resources

We reviewed whether APX has sufficient financial resources to operate its market properly and to provide the required supervisory arrangements. We considered APX's current financial position, which is important given the low number of listings and trading turnover to date.

We reviewed APX's quarterly cash flow reports to ASIC for the March and June 2005 quarters and held discussions with senior members of APX management and an APX director. We also reviewed APX's draft budgets for 2006.

Our review noted that APX's expected number of listings had been revised down substantially from that originally envisaged when APX's market began, which has affected its expected operating result.

Our review concluded that based on APX's current cash reserves and burn rate, it has sufficient funds to operate its market. Our discussions with APX management suggested that APX shareholders may need to provide additional funds during 2006. We understand that shareholders have indicated a willingness to support APX. ASIC is updated quarterly on APX's financial position. ASIC will continue to closely monitor APX's financial position to ensure it is able to comply with this obligation.

Technological resources

Our review focussed on whether APX has sufficient technological resources to keep operating its market. During our on-site visit we spoke to APX's Information Technology (IT) Manager and inspected their IT

facilities. APX uses the IT infrastructure of Austock Securities subject to a service level agreement.

Ernst & Young identified a number of issues relating to APX's IT systems and security to which APX has agreed a process to implement these improvements by the end of December 2005. These issues relate to APX's IT infrastructure and policies and procedures, and in particular its policies and procedures concerning security and password controls.

We are satisfied that APX has sufficient technological resources but needs to implement the Ernst & Young recommendations as indicated.

Human resources

We reviewed whether APX has sufficient human resources to operate its market and whether key staff involved in the operation and supervision of the market are appropriately qualified. We reviewed APX's organisational chart and held discussions with APX's management and staff.

Our review noted that APX has a few key personnel fulfilling numerous roles. This is to be expected given APX is a start up market with one listing and low turnover. We also noted the recommendations made in the Ernst & Young report relating to APX's lack of a training policy. APX has agreed to create an appropriate training policy.

At this time, we are satisfied that APX has sufficient and appropriate human resources to operate its market, but would need to revisit the issue should growth in the business dictate the need for additional staff.

2.6 Compensation arrangements

APX must maintain compensation arrangements consistent with the requirements of Division 3 of Part 7.5 of the Act. Condition 8 of APX's market licence also requires APX to maintain a fidelity fund as the source of funds and a minimum cover of \$750,000.

APX's compensation arrangements are established by APX BR 8.33.1 which requires APX to maintain a fund, known as the 'APX Compensation Fund', and hold it on trust in accordance with the terms and conditions set out in APX's Compensation Rules (appendix 8-2 to APX's business rules).

Generally speaking, APX has complied with its obligations in relation to compensation arrangements. The Compensation Rules have adequately dealt with the statutory requirements and APX has maintained a fidelity fund with a balance of \$750,000 or above during the period between 14 December 2004 and 30 June 2005. There are however some inconsistencies in its arrangements and their implementation that need attention.

Name of fidelity fund

APX's Compensation Rule 10 requires a fidelity fund to be set up as source of fund for the compensation arrangements. The fidelity fund was set up on 14 December 2004 with an initial deposit of \$750,000, which APX advises came from shareholders funds.

The fidelity fund is kept in a separate bank account with the National Australia Bank Limited. We examined the bank statements for the account between 14 December 2004 and 30 June 2005. The bank statements show that the account is called "Australia Pacific Exchange Limited Professional Funds", however BR 8.33.1 requires the fund to be known as the "APX Compensation Fund".

The supervising committee

The Market Supervision Committee is responsible for monitoring the fidelity fund. In particular, it is meant to monitor the extent to which APX has complied with the compensation rules and the adequacy of the compensation arrangements including the size of the fund. APX BR 19.4 requires the Market Supervision Committee to be constituted by at least 3 members with at least one of them also a member of the Board.

This is inconsistent with the terms of reference of the Market Supervision Committee, which prohibit a member of the Board from becoming a member of the Committee. No Market Supervision Committee members are members of the board.

Contribution to the fidelity fund

Compensation rule 4.1 prohibits participation in the APX market unless a participant pays an initial contribution of \$500 to the compensation arrangements. The rule also requires a participant to pay an annual contribution on or before 31 March each year. The bank statements we examined show no record of any such contribution. However a contribution was received in July 2005. APX has agreed to review its supervision in this area.

Reporting arrangements

Under section 4 of APX's Compliance Policy, a number of internal reports must be produced on a certain timeframe including a quarterly report from the General Manager Compliance and Supervision to the Board and the Market Supervision Committee on compliance with the compensation rules or statutory obligations; a quarterly report from the fund administrator to the Market Supervision Committee estimating the likely claims in the next quarter and how they can be met; and an annual report from the Market Supervision Committee to the Board on whether it believes any of the compensation arrangements should be changed. We found respectively that the first General Manager Compliance and Supervision quarterly report was produced 2 months late, the quarterly report from the fund administrator was not produced at all and the first

annual report from the Market Supervision Committee was not produced at all. Following ASIC's assessment visit the Market Supervision Committee of APX prepared a report to the APX board dealing with the issues raised above and we understand that the board will address the recommendations in due course.

Recommendation 6

APX should address the above issues of non-compliance or inconsistencies in requirements, by amending either its procedures, the compensation arrangements or other APX requirements as necessary in order to resolve these issues.

2.7 Disqualified individuals

Under s792A(i) of the Act, APX must take all reasonable steps to ensure that no disqualified individual becomes, or remains, involved in it. In order to comply with this obligation, APX must not allow a disqualified individual to be a director, secretary or a senior manager of the company. As at 22 August 2005, none of the individuals concerned was a disqualified person. APX also must not allow a disqualified person to have more than 15% of the total voting power in APX. Similarly none of the shareholders with more than 15% of the voting power was a disqualified individual.