



**ASIC**

Australian Securities & Investments Commission

**REPORT 25**

**Market assessment report:  
Australian Stock Exchange  
Limited / ASX Futures  
Exchange Limited**

June 2003



**ASIC**

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Australian Securities & Investments Commission

# **Annual assessment (s794C) report**

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

**ASX Futures Exchange Pty Limited  
ACN 006 599 364**

**June 2003**

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# Executive summary

This report summarises ASIC's assessment of compliance by Australian Stock Exchange Limited (ASX) and ASX Futures Exchange Pty Limited (ASXF) with their obligations under s792A(c) of the *Corporations Act 2001* (Act). This is the first assessment since amendments introduced by the *Financial Services Reform Act 2001* (FSR Act) came into effect on 11 March 2002.

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:

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

We also considered:

- the annual regulatory report given to ASIC by ASX on 30 September 2002 as required under s792F of the Act; and
- the annual report prepared for the ASX Board by ASX Supervisory Review Pty Limited (ASXSR), and given to ASIC on 30 September 2002.

We also considered how well ASX and ASXF might comply with their obligations in the future. For more details about the assessment process, see Section 1.

## Compliance by ASX

In ASIC's view, ASX has adequate arrangements for supervising its market, including arrangements for:

- handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner;
- monitoring the conduct of participants in the market; and
- enforcing compliance with its listing rules and business rules.

These arrangements are comprehensive, and we agree with ASXSR's conclusion in its annual report that the resources ASX expends on supervising its market are substantial.

## Compliance by ASXF

In ASIC's view, ASXF has adequate arrangements for supervising its market, including arrangements for:

- handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner;
- monitoring the conduct of participants in the market; and
- enforcing compliance with its business rules.

Our conclusions about the supervision of ASXF's market depend in part on the current low level of activity of that market. If the market grows significantly beyond its present size, we think ASXF would need to strengthen its arrangements. At the time of its application for approval ASXF provided ASIC with its plans to increase the resources applied to supervision as its market grows and it has confirmed it will do so in response to our assessment.

## Key observations and recommendations

In Section 2 of this report, we summarise observations from our assessment. We also include some recommendations for ASX and ASXF designed to facilitate future assessments by ASIC, and to support ASX's own ongoing evaluation of compliance with its obligations in the longer term.

In our view, these matters do not cast doubt on ASX's or ASXF's current compliance, or their likely ability to comply with their obligations in the next 12 months. Rather, they identify areas we will continue to discuss with ASX and expect to focus on during our assessment next year.

Our key recommendations are that ASX:

- review supervision of its warrants and futures markets to take into account specific risks arising in relation to those products, particularly where ASX is not responsible for supervising the underlying securities markets for these products;
- consider a more systematic approach in how it plans its supervision, evaluates its performance in supervising the market, and documents its regulatory activities; and
- develop more detailed procedures to ensure consistency in how it interprets and supervises its operating rules across business units and home branches.

We have discussed our recommendations with ASX and progress has already been made in a number of areas since our assessment. Where possible, this is reflected in our report.

# Section 1: Background

## 1.1 The ASX group

The ASX group holds two Australian market licences under s795B of the Act:

- one issued to ASX covers the operations of ASX’s equity, options, debt and warrants markets; and
- the other issued to ASXF covers the operations of ASX’s futures market.

An ASX wholly owned subsidiary, ASX Operations Pty Limited (ASXO), provides the infrastructure and services that support the operation of ASX and ASXF markets. ASXO provides supervisory resources for both ASX and ASXF, and supervision of both market licensees is largely conducted using common staff and infrastructure.

We therefore conducted our assessment of both ASX group market licensees at the same time, and this report covers our assessment of both licensees. Where we have specific comments about ASXF, these are noted.

## 1.2 Section 794C

The FSR Act, which came into effect on 11 March 2002, requires ASIC to conduct an annual assessment of each Australian market licensee. Section 794C of the Act says:

- “(1) ASIC may do an assessment of how well a market licensee is complying with any or all of its obligations as a market licensee under this Chapter. In doing the assessment, ASIC may take account of any information and reports that it thinks appropriate including information and reports from an overseas regulatory authority.*
- (2) In respect of the obligation in paragraph 792A(c), ASIC must do such an assessment at least once a year for each market licensee.*
- (3) As soon as practicable after doing an assessment under this section, ASIC must give a written report on the assessment to the licensee and to the Minister.”*

Paragraph 792A(c) states that a market licensee must:

- “... have adequate arrangements (whether they involve a self-regulatory structure or the appointment of an independent person or related entity) for supervising the market, including arrangements for:*
- (i) handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market operates in the way mentioned in paragraph (a); and*
- (ii) monitoring the conduct of participants on or in relation to the market; and*
- (iii) enforcing compliance with the market’s operating rules;”*

### 1.3 Policy Statement 172

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. We issued [PS 172] on 6 March 2002 after extensive consultation with existing market operators.

It is important to note that:

- this is the first assessment of ASX and ASXF as Australian market licensees;
- [PS 172] was only issued in March 2002; and
- s792A did not come into effect until 11 March 2002.

While market licensees may be moving towards practices that more closely meet the guidelines in [PS 172], we accept that it will take some time. We therefore applied the guidelines flexibly to take into account both the new obligations and in particular, the long-standing practices of established licensees.

[PS 172.71] states that:

*“Generally, a market licensee will best be able to ensure continuous compliance—and report on the extent of its past compliance for the annual report (see reg 7.2.06(c))—if it actively plans:*

- (a) what it will do to ensure compliance; and*
- (b) how it will monitor and assess its compliance.*

*We think that such planning is especially important to ensure compliance with the supervisory obligation.”*

[PS 172.86] addresses how ASIC will assess Australian market licensees’ compliance with their supervisory obligations:

*“In assessing how well a market licensee is complying with its obligation in s792A(c) to have adequate arrangements for supervising the market, ASIC will consider how the market licensee:*

- (a) handles conflicts of interest;*
- (b) monitors the conduct of participants;*
- (c) monitors trading and other market activity and (if relevant) disclosure by listed entities, to detect potential or actual non-compliance with the law or the market’s operating rules;*
- (d) deals with actual or suspected breaches of the law or the market’s operating rules, including remedial, disciplinary and other deterrent measures;*
- (e) deals with complaints about the market or participants;*
- (f) shares supervisory responsibilities and information with:*
  - (i) us; and*

- (ii) *operators of other markets and clearing and settlement facilities that have the same participants as the market licensee; and*
- (g) *makes available and uses resources for conducting supervisory activities.*

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.

## **1.4 The assessment process**

In conducting our first assessment under s794C, we:

- analysed information we received from and about ASX and ASXF in the ordinary course of our dealings with each of them as a market licensee, including:
  - information received as part of the rule amendment process;
  - referrals of serious contraventions;
  - the register of listing rule waivers;
  - ASX's most recent annual report; and
  - ASX's annual regulatory report under s792F;
- analysed information from external sources, including media commentary, reports published by ASX and relevant academic research reports;
- interviewed key ASX staff with supervisory responsibilities;
- reviewed internal ASX and ASXF material, including disciplinary and investigation files, internal reports and information collected by ASX on a continuous basis; and
- reviewed ASXSR's annual report and various documents underlying that report.

From 11 November 2002 to 29 November 2002, we spent some time at ASX offices in Sydney, Melbourne and Perth and spoke to a number of business units (see the Appendix.) On 19 December 2002, we held an "exit" interview with ASX to discuss our preliminary findings. We also discussed the final results of our assessment with ASX, seeking their comments on both the factual matters set out in this report and our conclusions.



# Section 2: Observations and recommendations

## 2.1 Overall compliance

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

This conclusion is based on the following observations drawn from information gathered during the assessment process, and the present operating conditions (including trading volumes and financial products traded on each market):

- 1 ASIC is satisfied that arrangements for handling conflicts of interest are robust due to the combined effect of:
  - the ASX group's internal structure, which delivers to key management considerable decision-making autonomy on supervisory matters;
  - the absence of demonstrable examples of commercial influence on supervisory decisions; and
  - the hands-on role played by ASXSR in overseeing decision-making of Review Group Entities.

(In addition, ASIC undertakes direct supervision of ASX as a listed entity on its own market.)

- 2 There were no serious market failures or disruptions from 1 July 2001 to 30 June 2002.
- 3 In most instances, the business rules, listing rules and guidance notes provide a good framework for a fair, orderly and transparent market.
- 4 Key supervisory areas that monitor the conduct of participants, trading, and disclosure by listed entities have satisfactory procedures in place, and follow them.
- 5 During the course of our interviews, key management and staff responsible for supervision demonstrated a strong commitment to their supervisory role and a high level of expertise in the operations of the market.
- 6 Our review of operational files on supervisory decisions showed that:
  - decision-making on supervisory matters is generally sound;
  - ASX actively pursues breaches of its operating rules; and
  - ASX conducts ongoing supervision of its participants and listed entities.
- 7 ASX has good market infrastructure (including technology) to support its obligation to maintain a fair, orderly and transparent market.

- 8 ASX demonstrated a strong commitment to educating participants and listed entities in their obligations under the business rules and listing rules.
- 9 ASX actively shares information on supervisory matters with ASIC and with other market operators.
- 10 ASX devotes substantial staffing and technological resources to supervising its market.

## **2.2 Ongoing work**

Notwithstanding our conclusion on overall compliance, ASIC believes that, in the following areas, ASX should undertake further assessment of its own compliance and support ongoing development of its procedures, to ensure continued compliance with its obligations:

- supervision of warrants and futures markets;
- complaints handling;
- decision-making;
- approach to compliance;
- documentation of supervisory procedures and decisions;
- rule changes, use of rule waivers and new products; and
- ASX annual regulatory report.

It should be stressed that, in ASIC's view, these matters have not as yet manifested themselves in any way to threaten the objectives of a fair, orderly and transparent market. They are based on the material available to ASIC at the time of our assessment.

### **Supervision of warrants and futures markets**

ASX has considerable expertise and a strong track record in operating and supervising its options market, supported by sophisticated operating and monitoring systems.

In ASIC's view, ASX's and ASXF's approach to supervising its warrants and futures markets appears to be heavily influenced by its experience in supervising options trading. In the case of options, ASX generally also directly supervises the market in the underlying securities. ASX's markets have grown in complexity, and a number of products are now traded (particularly on its futures market and to some extent its warrant products) where ASX does not supervise the underlying securities markets. Examples include warrants traded over foreign indices and commodity-based futures contracts.

In our assessment, ASX and particularly ASXF did not demonstrate that they have comprehensively reviewed their approach to supervision in light of the different nature and characteristics of these products, or that they have considered and addressed the specific risks of those markets. ASX has advised us that they have

carefully considered these factors and that they will make available that analysis for our further review. We believe however that this analysis is not yet reflected in ASX's policies and procedures for supervision of those products.

In most business units, policies and procedures do not specifically refer to supervision of warrants and futures trading, nor to ASXF participants. We recommend that ASX and ASXF review in detail their Market Surveillance policies and procedures for supervising warrants and futures markets to ensure that they adequately deal with the specific characteristics of these products. This will be particularly important for its futures market as it grows.

We also recommend that ASX's Structured Products business unit develop more detailed and specific procedures for its supervision, including supervision of issuers, in the warrants market. ASX have indicated that Structured Products will prepare further procedural documents to guide supervisory activity. They expect that these will be in place by the end of September 2003.

On ASXF, trading volumes remain relatively low. During the assessment period, ASIC received no referrals about trading or participants on ASXF, and no disciplinary matters arose. While trading in ASXF is subject to scrutiny, the detailed system parameters developed for supervision of trading in ASX's other markets have not yet been developed for ASXF. These should also be subject to review as trading volumes increase. ASXF have accepted the need to do this.

In the warrants market, the business rules as they stand do not sufficiently reflect the current operating environment. Many waivers are routinely given, some rules are not enforced, and other requirements are imposed by undertakings rather than rules. At the time of our assessment it was ASIC's view that the business rules that apply to warrants needed to be reviewed and re-written as matter of priority. ASX has now undertaken a comprehensive review of its rules for structured products and relevant rule amendments have been informally lodged with ASIC.

### **Complaints handling**

ASX currently does not have a centralised system for recording and handling complaints about trading, participants and listees on its market. In our view a centralised system would give it an important source of intelligence for identifying emerging supervisory issues. Existing practices for recording and responding to complaints are inconsistent, and many areas do not formally record complaints. Only Customer Service, which logs complaints about participants and provides a summary of those complaints to Compliance and Information, has any formal complaint recording and handling procedures.

Although ASX's annual regulatory report shows that it received 45 complaints for the year ended 30 June 2002, this only reflects complaints about participants sent to the Client Relations unit and held on its central database. It does not reflect, for example, complaints about listed companies or trading behaviour. In our view the

number of complaints received, as shown in the Annual Regulatory Report, should include all complaints received by ASX.

We recommend that, consistent with our views in PS 172, ASX should institute a centralised system for recording and tracking all complaints. As a minimum, ASX should record all complaints received and all responses to those complaints.

### **Decision-making**

ASIC has some concerns about consistency of decision-making across ASX, particularly in issues that arise across business units. Some inconsistency also seemed to show up across various ASX home branches, although interviews with relevant State Managers revealed a common understanding of practices and a generally consistent approach to supervision. During our assessment, we observed some instances where strongly different views were expressed about the outcome or appropriate action on matters referred by Market Surveillance to other ASX business units. There is no clearly defined escalation procedure if Market Surveillance does not agree with the interpretation or finalisation of matters referred to other business units. ASIC also identified some instances where Market Surveillance has formally referred a matter to ASIC, but other business units have decided, on the basis of an internal referral, that no action was appropriate. This suggests some inconsistency in interpretation of ASX business rules within ASX.

In a number of instances during the year, ASIC received separate referrals from Market Surveillance and the Companies Department on the same facts at different times.

With respect to consistency across the home branches, the National Manager, Continuous Disclosure, Admissions and Waivers asked ASX staff to carry out an analysis of the type and frequency of queries raised with listed entities by different home branches during the 2001/2002 financial year and to compare the level of activity and type of result obtained. This is a positive step and was the most comprehensive example we found of internal analysis being conducted by an ASX business unit of its own performance. It must be noted that the results of that analysis indicated some significant differences across home branches. As the analysis concluded, many of these differences result largely from the different types of listed entities in the respective States. In our view, however, some inconsistencies were not fully explained by these differences. At present ASX relies generally on a series of internal meetings as its major way of promoting consistency across the business. We recommend that ASX develop more detailed procedures for monitoring decision-making across business units and home branches to promote consistency in interpretation of its business and listing rules and in supervisory decision-making. We also recommend that ASX introduce detailed procedures for making supervisory decisions in cases where relevant managers from different business units take a different view on whether ASX should take supervisory action, or on whether it should refer a matter to ASIC.

ASX has told us they are reviewing any inconsistencies in approach between their Surveillance and Companies areas and to ensure that referrals from these areas do not duplicate issues and are internally consistent. ASX anticipates amendments to internal procedures to be in place by the end of September 2003.

### **Approach to compliance**

ASX does not currently have a centralised compliance approach to its licence obligations. The degree of systematic risk analysis and planning for supervision varies widely between business units.

While ASX has advised and we accept that some variation between business units is inevitable (depending on their various responsibilities), in ASIC's view, ASX's current practices fall short of the guidelines in [PS 172]. These guidelines need to be applied with some flexibility but, in our view, they provide a useful model for considering how a market licensee should go about planning for and evaluating its own compliance with its licence obligations. At present, it is in some areas difficult to test ASX and ASXF's compliance with the licence obligations, and this testing could be made more effective. In making our detailed assessment, we relied heavily on our own discussions with key staff and scrutiny of extensive underlying material, rather than on ASX's annual regulatory report or on specific internal reports.

We note that ASX is in the process of improving its coordination and planning for supervisory activities. ASX has a draft group compliance plan and is drafting a regulatory plan which, when complete, will go some way to addressing these issues. ASXSR has also had a positive influence in driving procedures documentation and better capturing supervisory actions.

ASX has agreed to review its overall approach to demonstrating compliance with its statutory obligations and is still considering the appropriate structures to achieve this. Revised measures will include the appointment of a compliance manager, tasked to ensure compliance with statutory licence obligations. The compliance manager will also be given responsibility for development of a framework for reporting against statutory obligations by the end of September 2003.

ASX is also proposing to undertake a more rigorous trend analysis of supervisory matters.

### **Documentation of supervisory procedures and decisions**

ASX does not have consistent protocols for recording supervisory decisions and the extent to which supervisory decisions are formally recorded across ASX business units varies widely. Although we accept the need for a degree of flexibility in how matters are recorded (given the varied supervisory responsibilities and structures of business units), we think it is important for ASX to continue its push to better capture and record its supervisory activities.

This issue is particularly important in the key supervisory areas of Investigations and Enforcement, Compliance and Information and Companies, where it was sometimes difficult for ASIC to clearly understand the reasons for supervisory decisions on the basis of the information reviewed. It is of lesser concern in areas where responsibilities are more operational than supervisory, although to the extent that key supervisory discretions are exercised, we think it is still important that those matters are recorded. It is clear that ASX has been developing and improving its recording and capturing of supervisory activities over the past eighteen months. Requests for information from ASXSR has in part driven this process. That work should continue.

In ASIC's view, all significant supervisory activities and decisions, whether or not they result in a disciplinary or other outcome, should be recorded. Recording procedures should be sufficient (within the demands of each business unit) to facilitate appropriate scrutiny of all significant supervisory activity, both for internal ASX evaluation purposes and by ASIC as part of our assessment.

ASX has said it agrees with the need to record all significant supervisory decisions and that changes, to the extent they are required, are being discussed with the relevant business units.

### **Rule changes, use of rule waivers and new products**

In our assessment, we identified some instances where ASX has relied upon long-term rule waivers (rather than rule amendments) to facilitate the introduction of new products or the development of particular markets. The most significant examples were in the rules for warrants and admission to trading of exchange-traded funds (ETFs). In the case of warrants, ASX had recognised the need for a review of the business rules and it was underway, but it had not been finalised due to priority being given to other rule changes such as those associated with FSR implementation. Those rule amendments have now been informally lodged with ASIC. Similarly, a series of routine rule waivers currently govern admission to trading of ETFs. Listing Rule amendments in relation to ETFs are now expected to be released for public comment in May 2003.

We recommend that, in all cases where new products are being introduced, ASX review its rules and submit any necessary amendments for ministerial disallowance, rather than relying on rule waivers for a protracted period. We also recommend that ASX routinely consult key supervisory areas when introducing new operating rules or products, and ask these areas to update their policies and procedures, so that supervision is adequate.

### **ASX annual regulatory report**

ASX's annual regulatory report is largely a statement of activity. We would like to see the report provide a more systematic assessment against defined objectives. Generally, the report would benefit from more analysis of trends in the market and

in supervisory activity. We believe the use of comparative year-to-year measures would be helpful in assessing some aspects of ASX's effectiveness.

For example, price queries generated by ASX's Market Surveillance Unit appear to be decreasing over recent years, while overall queries to listed companies are increasing. It would be useful if such issues were more comprehensively dealt with in ASX's report.

We encourage ASX and ASXF to develop more comprehensive criteria for assessing compliance with their obligations as an Australian market licensee to facilitate more useful reporting against their regulatory obligations.

### **2.3 ASIC—ASX memoranda of understanding**

In its annual report, ASXSR noted that the memoranda of understanding (MOUs) between ASIC and ASX are now out of date. We agree that the MOUs do not properly reflect the current applicable law, nor the operating arrangements that now exist between ASIC and ASX in practice. We expect that these MOUs will be updated and renegotiated this year.

## **Appendix: Individual business units**

This appendix explains in more detail our assessment process for individual ASX business units and our specific observations and recommendations about those units. Where possible, we have not repeated matters already dealt with in our overall recommendations and accordingly, the points set out below we regard as more narrowly focused on those business units.

We note that many of these business units undertake functions relating to the supervision of the clearing and settlement facility licences held by the ASX group. Our assessment does not cover those activities.

We also note that our assessment of ASXF did not include the following business units:

- the Companies Department;
- Companies Announcements Office;
- SEATS Market Control;
- Interest Rate Market; and
- Structured Products.

Accordingly, observations and recommendations about these business units are not part of our assessment report for ASXF.



## **A1 ASX Supervisory Review Pty Limited**

### **Role of ASXSR**

ASXSR is a wholly owned special purpose subsidiary of ASX. Becoming operational on 14 March 2001, the entity has been established to operate as an independent review body within the ASX group. ASXSR has an independent board of directors that reports periodically to the board of the ASX. It plays a significant role in ASX's arrangements for handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner.

ASXSR has described its role and function as being to review:

- the policies and procedures of those areas within the ASX group that have supervisory functions;
- the level of funding and resourcing devoted to supervisory activities; and
- ASX's conflict handling arrangements.

The terms of ASXSR's mandate are contained in an agreement dated 21 June 2001 between ASXSR and ASX Operations Pty Limited (ASXR Support Agreement). This agreement says that ASXSR will:

- review the policies and procedures of the areas in the ASX group that have supervisory functions. This would include a review of the level of funding and resources for supervisory functions;
- provide reports and express opinions to the ASX board on whether appropriate standards are being met and whether the level of funding and resources for supervisory activities are adequate;
- provide a copy of its annual reports to ASIC;
- oversee supervision of Review Group Entities who select this option.

The agreement goes on to say, "the purpose of ASXSR in performing these functions is to provide assurance that the ASX group adequately complies with its ongoing responsibilities as a market operator and clearing house, is conducting its supervisory activities ethically and responsibly and is maintaining appropriate controls against employee conflict of interest".

### **Comparison with ASIC's role**

In preparation for our assessment of ASX and ASXF, we obtained copies of the underlying documents utilised by ASXSR in the preparation of its report, including its detailed resourcing model. We reviewed ASXSR's annual report dated September 2002 and met with the Executive Officer of ASXSR to discuss their review methodology, their observations generally and their key findings.

In our view the obligations imposed on ASIC by s794C of the Act are different from, and wider than those created under the ASXSR Support Agreement. In the context of the new role envisaged for ASIC in relation to the supervision of

market operators under the Act, it would not have been appropriate, at least at this stage, for ASIC to rely solely on the work undertaken by ASXSR in discharging its own legislative responsibilities. That said we have considered the ASXSR report and other information obtained from ASXSR and have found it to provide a very useful background to our own assessment of ASX and ASXF.

### **Observations**

The ASIC assessment methodology differed from that of ASXSR in that it more closely resembled an audit of the supervisory activities of the ASX group rather than a review of the adequacy of the adopted policies and procedures. Understandably, given its level of resourcing and its contracted mandate, ASXSR's own review appears to have involved a less extensive review of ASX's operations in practice. It is reassuring however to find that the general conclusions formed by ASIC are not inconsistent with those expressed by ASXSR.

In our assessment of the ASX Companies Department we examined the operational case files of all Review Group Entities. We observed no issues that caused us to be concerned about the administration by ASX of the listing rules as they apply to those entities. It is clear that ASXSR is taking an active role in reviewing supervisory decisions in relation to Review Group Entities and we are comfortable with the arrangements in place in this regard.

The ASXSR review process appears to have stimulated considerable effort on the part of ASX to develop a more rigorous standard of procedures and supervisory documentation across the ASX group. In particular, it is clear that some new policies and procedures were written or updated as a result of this process and that there has been considerable development in the recording of ASX and ASXF supervisory activities. It appears that the ASXSR process has made a positive contribution in this regard.

Another important initiative undertaken by ASXSR has been the development of a model, in conjunction with ASX, to quantify the resources expended by ASX on its supervisory activities. Previously, ASX budgetary processes and internal accounting practices had not attempted to quantify this expenditure. We believe the basic model developed is sound and provides a reasonable methodology for testing the level of ASX resourcing given to supervisory activities. Some more work needs to be done to refine the model. In some cases, amounts allocated to supervision may have been overstated, as it can be particularly difficult in some areas to separate supervisory activities from activities that might be better characterised as a function of the ordinary operation of the market. Nonetheless, based both on our review of the model and our overall assessment of the supervisory operations in place, we agree with ASXSR's conclusion that the resources allocated to supervision by ASX are substantial and are adequate for the present level of activity.

## A2 Market Integrity

### Role of unit

Market Integrity's role is to facilitate timely information flow to ASXSR from the ASX group, and more generally to co-ordinate and promote the diverse supervisory activities members of the ASX group conduct.

According to ASX's annual regulatory report, the specific responsibilities of the National Coordinator, Market Integrity include:

- reviewing and benchmarking supervisory process and procedures;
- coordinating forums to discuss supervisory issues;
- managing cross-divisional supervisory issues;
- coordinating and publishing reports (including to ASXSR, ASIC and the Minister) on ASX's supervisory activities and compliance with its supervisory obligations; and
- developing a communications strategy to inform and educate about ASX supervisory activities.

The National Coordinator, Market Integrity specifically oversees and provides assurance in the following areas:

- policies and procedures designed to ensure that supervisory decision-making is undertaken impartially, ethically and in the best interests of market integrity;
- corporate commitment to ethical behaviour in the Code of Ethics;
- specific codes of conduct adopted by supervisory areas; and
- separation of specific supervisory functions (the Companies Department, Market Surveillance Unit, Compliance and Information Unit, Investigations and Enforcement) from ASX's business functions.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents during the assessment:

- Market Integrity's current policies and procedures manual, including:
  - rules for dealing in financial products by ASX employees;
  - approaches to conflict management; and
  - a list of market integrity activities;
- quarterly reports prepared by ASX for ASXSR; and
- "Capturing the cost of supervision" covering 6-month budget actuals (to December 2001 and June 2002) and 12-month budget forecasts.

*On-site visit*

We interviewed the National Coordinator, Market Integrity to gain a better understanding of the unit's role in the supervisory functions of ASX.

**Observations***Interaction with other ASX business units*

Market Integrity advised us that it does not perform an operational supervisory role and is not responsible for managing operational supervisory activity. It collates reports on the supervisory activities of operational business units, prepares policy and procedure documents, and is responsible for coordinating the regulatory reporting obligations of the ASX group. The unit does not have any authority to make supervisory decisions on an operational level, although it may provide assistance and advice in some matters.

We were advised that Market Integrity coordinates a group known as the Regulatory Space Review, which meets on a fortnightly basis to promote informed debate and a common understanding of supervisory issues, including the FSR Act and how ASX will adapt to the new regime.

*Policies and procedures*

Market Integrity ensures that relevant business units have in place documented policies and procedures. Particularly, Market Integrity coordinates the drafting of executive summaries for policy and procedure documents to provide some consistency across business units. The units themselves are responsible for the detail of policies and procedures. It appears that policies and procedures across ASX and ASXF are a combination of long standing documents written within individual business units and more recent documents drafted by Market Integrity.

*Relationship with ASXSR*

Market Integrity is the liaison point between ASX and ASXSR. It:

- coordinates the quarterly and 6-monthly reports given to ASXSR on supervisory activities;
- provides policy and procedure documents for supervisory business units;
- addresses particular issues as they arise; and
- provides a supporting role to the ASXSR function.

If ASXSR picks up an issue, Market Integrity is responsible for seeing that it is resolved, but is unlikely to take on direct responsibility for resolving the issue, because it has no direct decision-making role.

*Conflicts of interest*

Market Integrity wrote the policies and procedures that address conflict or perception of conflict situations (such as project specific conflicts or Chinese

walls) and a general conflicts policy “Approaches to Conflict Management” that is updated as required.

*ASX group regulatory plan*

We were advised that Market Integrity is coordinating development of an ASX group regulatory plan that should be completed by early 2003. Currently, divisional business planning is done in April and regulatory planning is a part of this process.

**Recommendations**

ASIC has no specific recommendations for Market Integrity.

## A3 Markets Surveillance Unit

### Role of unit

The Markets Surveillance Unit is responsible for identifying, investigating and, where appropriate, making referrals to other ASX business units or to ASIC about unusual trading patterns in the financial products traded on ASX markets that may indicate a breach of the ASX business rules and the Act. Market Surveillance uses electronic systems to alert it to unusual trading activity (eg the Survey of Market Activity or SOMA) and to enable it to store large volumes of data as a reference base (SEATSCAN). It also monitors electronic media and broker research reports.

Every alert generated by SOMA is analysed by an analyst. If an analyst receives an alert that they are unable to explain within the parameters of lawful trading, the analyst could take one or more of the following avenues:

- notify the Companies Department;
- refer the matter to the Companies Department;
- contact the broker; and/or
- commence formal enquiries into the trading.

To commence formal enquiries into the trading, the analyst must obtain the approval of either the Senior Analyst, the Assistant Manager or the National Manager of the unit. Market Surveillance investigators also analyse the matter to decide whether or not to refer it to the Investigations and Enforcement unit and/or ASIC.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents and information during the assessment:

- all Market Surveillance policy and procedure documents; and
- all current SOMA parameters.

We also sought to review a sample of files on matters the unit examined from 1 July 2001 to 30 June 2002. Within this potential group, we endeavoured to review two types of matter:

- those that lead to no further action being taken; and
- those that lead to referral to another ASX supervisory unit or to ASIC.

We reviewed a total sample of 153 files in the following sub-categories:

- 49 NMA files (no more action);
- 30 NFA files (no further action);
- 38 outcome files (reached an outcome after initial proceedings);
- 6 FNS files (file notes sent to ASIC and the Investigations and Enforcement unit for their information);

- 11 Companies Department files (referred to the Companies Department);
- 5 I&E only files (referred only to the Investigations and Enforcement unit);
- 11 ASIC only referrals (referred only to ASIC);
- 3 ASIC and I&E files (referred to both ASIC and the Investigations and Enforcement unit).

#### *On-site visit*

The review team received a demonstration of Market Surveillance operations, and an explanation of how the unit uses other non-electronic mechanisms to detect unusual trades (eg monitoring of media, broker research and retail investor websites).

In addition, a Senior Market Analyst made a brief presentation to the review team, clarifying the referral process, the function of SEATSCAN (replay facility), and how reports are generated.

We talked with each SOMA analyst, with particular focus on how they dealt with system generated alerts. In addition, as part of the assessment, we reviewed a sample of system alerts coded by analysts as explainable, and a sample of electronic communications between Market Surveillance and the Companies Department about continuous disclosure issues.

We talked with the Systems Coordinator about tracking and reporting issues, and with the SOMA Programmer about alert parameters. We also interviewed the National Manager and Assistant Manager to discuss general workflow processes and clarify specific issues, and attended a daily team meeting in which current surveillance issues were discussed.

## **Observations**

### *Alerts*

The electronic alert system generates approximately 65% of the unit's work, with the balance driven by individual analysts or as directed by Market Surveillance management. Alerts may arise after reviewing media, broker research, or after discussion with market participants. Market Surveillance is gradually becoming less reliant on system-generated alerts in favour of other sources to identify potential trading anomalies or other rule breaches.

### *Record-keeping*

Both physical and electronic files are generally of a high standard. The Market Surveillance files allowed ASIC's assessment team to track through an issue, work undertaken and the final result.

Referrals made to Investigations and Enforcement or to ASIC follow a fairly standard format, and follow-up on these items can be easily tracked. Referrals and

other forms of interaction with the Companies Department, while documented, appeared to be more fluid in their approach.

#### *Supervision and training of analysts*

Analysts are split into various specialities, and they appeared to be well versed in the way the alert system operates and the requirements of their position. Performance/efficiency indicators appeared to be generally achieved. Training and development of analysts usually consists of on-the-job guidance from more experienced team members and management. Continuous cross training among the team members was evident. Emphasis is placed on the ability of individual analysts to interpret the trading and decide if it is unusual and requires further investigation.

#### *Conflicts of interest*

Markets Surveillance appears to have a strong culture in managing potential conflict situations, with appropriate reporting arrangements and controls in place to manage conflict situations. The high level of autonomy given to the Markets Surveillance Manager and staff also reduces the risk of conflicts arising with ASX commercial objectives.

#### *Warrants and futures supervision*

Supervision of warrants and futures trading receives only minor attention in Market Surveillance policy and procedure documents. We note that in their report, ASXSR has said that they have received but not reviewed policies and procedures on derivatives. We have received a copy of those procedures from ASXSR. We were not provided by ASX with any separate policies or procedures for the monitoring of trading in derivatives and futures.

Alert parameters for the ASXF market are not as developed as those for the ASX markets, although there is active monitoring of trading on ASXF.

### **Recommendations**

Other than the matters covered in our general recommendations, we have no specific recommendations for Market Surveillance.



## A4 Investigations and Enforcement

### Role of unit

Investigations and Enforcement (I&E) investigates suspected breaches of the ASX business rules by participating organisations, affiliates and responsible executives and of suspected breaches of the ASXF business rules by participants. I&E is also responsible for initiating formal disciplinary action for such breaches by referring matters to the National Adjudicatory Tribunal (NAT) or the ASXF Disciplinary Tribunal for determination. The NAT has the power to impose a variety of penalties (including fines) on participating organisations, affiliates and responsible executives. The ASXF Disciplinary Tribunal has similar powers.

I&E also plays a similar role for designated trading representatives and enforcement action of breaches of the SCH business rules and the derivatives clearing rules.

I&E does not play an active role in initially identifying breaches of the business rules. I&E acts primarily on referrals from other units of ASX group of suspected breaches. On occasion, I&E will act if it becomes aware of a relevant matter through other means (eg via ASIC, its own intelligence or from media reports).

A key part of ASX and ASXF ensuring compliance with the business rules is taking appropriate action on breaches of those rules. I&E therefore plays a central role in how the ASX group fulfils its licence obligations.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents during our assessment:

- I&E's documented policies and procedures;
- guidance notes: ASX Investigations (2/01), ASX Disciplinary Proceedings (3/01), and Issue and Publication by the Exchange of Management Letters (13/01);
- 122 (65% of total) of the investigation case files from 1 July 2001 to 30 June 2002;
- copies of all decisions made by the NAT (13 files) from 1 January 2002 to 30 June 2002;
- a selection of reports generated by the I&E database system:
  - I&E register—all referrals (abridged);
  - referrals and notifications received by ASIC from I&E from 1 July 2001 to 30 June 2002;
  - management letters;
  - NAT penalties, circulars issued or board notified; and
  - complaints/self reported matters.

None of the matters we reviewed involved a suspected breach of the ASXF business rules.

#### *On-site visit*

We interviewed the I&E National Manager about the general operations of the unit, and the Assistant Manager and a number of analysts about specific matters arising from our review of case files. Topics included:

- the supervisory role and functions of I&E;
- the unit's relationship and interaction with other ASX business units;
- job tracking and reporting practices, how decisions are made to resource matters, investigative processes and documentation;
- the process and practises associated with a referral to the NAT; and
- the resources available to the unit.

I&E provided an on-site demonstration of its job tracking database and record-keeping systems. We also interviewed staff in other ASX business units about the referral of supervisory matters to I&E.

### **Observations**

#### *ASXF*

None of the material reviewed involved suspected breaches of the ASXF business rules. (I&E reported that, at the time of our assessment, it had only recently received its first referral of an ASXF matter)

Accordingly, our observations are based on I&E's dealings with ASX business rule referrals. We understand that similar policies and procedures would apply to referrals for suspected breaches of the ASXF business rules.

#### *Investigation process*

When a matter is referred to I&E for investigation by another ASX business unit, I&E makes an initial assessment as to the seriousness of the allegations and decides whether the matter warrants investigation. The National Manager decides whether a formal investigation should commence. A decision to take no further action on a matter will only occur after the matter has been assessed.

If a matter is progressed, information is obtained and any report of findings is discussed with the participating organisation involved. Results of an investigation may include a management letter, a referral to NAT for a full hearing, or referral to NAT on a "fast track" basis. I&E also has administrative duties, such as collecting fines, for NAT proceedings.

At any point during this process, I&E may form the view that the matter should not progress further or that, rather than formal disciplinary action, a "management letter" should be issued.

A “management letter” is a tool used by I&E that aims to ensure that the senior management of a participant signs off on and takes responsibility for addressing their firm’s compliance failures. ASX Guidance Note 13/01 explains the circumstances in which a management letter may be sent.

#### *Policies and procedures*

I&E practices and processes appear to accord with their documented policies and procedures and the published ASX guidance notes describing the operations and conduct of the unit.

I&E creates a file for each referral received, and also maintains an electronic system for tracking the life cycle of a matter. The completed file usually includes a summary of key steps in the matter.

The files examined appeared to be relatively complete, although there was often no record setting out the reasons why particular enforcement decisions were taken. Decisions to take no further action are recorded on the team’s electronic records, although the level of detail in those records varies.

#### *Staffing and supervision*

Each matter is assigned to an analyst who is primarily responsible for progressing the matter. Analysts generally work alone under the direct supervision of the Assistant Manager. No decision is taken about proceeding or not proceeding with a matter without the approval of the National Manager. The Assistant Manager or National Manager review reports and other documents before they are dispatched by an analyst.

Market Integrity does a quarterly reconciliation of referrals with referring units. The ASX board is notified of finalised matters. There does not appear to be any systematic review of the work done by I&E outside the unit itself.

Turnover of staff in I&E has been relatively high, although the National Manager and Assistant Manager are very experienced.

#### *Sources of matters investigated*

The majority of the files reviewed were sourced from the Compliance and Information Unit and related to self-reported trust account breaches. In the period under review, 92 matters were self-reported to ASX by participating organisations; the majority of these matters involved trust account breaches. Though significantly less in number, the next most common category was manipulative or insider-trading matters referred by the Market Surveillance Unit.

Referrals are generally for similar types of breaches of the operating rules. From 1 July 2001 to 30 June 2002, I&E received no referrals about trading on ASXF markets.

*Investigation outcomes*

I&E appeared to investigate matters in a thorough manner and to generally progress matters efficiently. However in the absence of more thorough documentation, it is difficult to be conclusive about decisions made on individual matters.

Outcomes of the cases reviewed included fines imposed by NAT and the use of management letters. With regard to management letters, the unit relies on action undertaken or to be undertaken by the participating organisation to avoid further breaches. Although ASX reserves the right to publish management letters, it has yet to do so.

NAT decisions from 1 January 2001 to 30 June 2002 were reviewed and penalties imposed by the NAT appeared low in some instances. Significant penalties are the exception rather than the norm and often penalties were less than \$5,000. A significant proportion of matters taken to NAT followed the “fast track” process, one consequence of which is that neither party makes submissions in relation to penalty. The NAT penalties appear to follow precedents.

During the review period, a number of participating organisations were investigated more than once, often for similar breaches of the business rules. There was documentation on file to suggest that past breaches would go to the penalty imposed, but it was not clear from the files reviewed that this did in fact occur. There does not appear to be any mechanism for taking more serious action for a pattern of less serious breaches.

*Conflicts of interest*

I&E operates independently as a supervisory area and its supervisory decision making practices do not appear to be influenced by the concerns of other ASX business units or broader ASX group commercial considerations. The National Manager indicated that the conduct of matters was entirely at his discretion, including decisions as to whether to investigate or not investigate. The ASX board is not notified of matters until those matters are finalised.

**Recommendations**

In addition to our general recommendations, we have the following specific recommendation in relation to Investigations & Enforcement.

*Effectiveness of disciplinary action*

In view of the number of repeat offenders during the review period it appears that the action taken is not always having the desired result. We understand that NAT, rather than I & E, decides on any penalties imposed for breaches of the business rules. We recommend that ASX review NAT penalties and outcomes to satisfy itself that the Tribunal continues to be effective in providing a disincentive to breach the business rules.

ASX have advised that Tribunal policies and procedures are currently under review and that ASX proposes to release guidance as to the circumstances in which past conduct will be considered and the likely impact of this upon the penalties which the Tribunal will hand down. This, together with other procedural issues relating to the function of the tribunal, is expected to be actioned by October 2003.

## A5 Compliance and Information Unit

### Role of unit

The Compliance and Information Unit (C&I) is responsible for monitoring and promoting compliance with the ASX business rules, ASXF business rules, SCH business rules, derivatives clearing rules and the Act by persons bound by those rules including participants in the ASX and ASXR markets.

Consequently, C&I performs a key supervisory role within ASX, including:

- coordinating recognition and admission of participants (in association with the Risk Management Unit and Client Relations unit);
- withdrawing or suspending rights of trading and recognition;
- monitoring ongoing compliance with business rules;
- granting or refusing waivers from business rules;
- referring potential rule breaches to Investigation and Enforcement;
- conducting self-assessment and inspection programs; and
- providing various education activities.

A primary focus of C&I is education. Education is used to promote the benefits of effective compliance and internal control systems, and is ultimately intended to facilitate compliance by participants. The unit seeks to foster a compliance culture among market participants and to develop lines of communication between participants and ASX to allow for prevention, or early identification and solution, of any problems.

Where a potential breach of the business rules or the Act is identified, a referral is made to I&E.

### Assessment process

#### *Documents reviewed*

We reviewed the following documents and files during our assessment:

- C&I's policies and procedures (Volumes 1 and 2);
- 25 participant files (from approx 93 total ASX and ASXF participants), including big and small, American, European and Australian owned and RIOTS;
- general correspondence file between ASX and the Financial Industry Complaints Service (FICS);
- ASX-FICS MOU file;
- National Inspection Register (from 1 July 2001 to 30 June 2002);
- complaints register (from 1 July 2001 to 30 June 2002);
- self-assessment related material; and
- ASX business rules waiver register.

*On-site visit*

We interviewed the National Manager and several compliance advisers to gain an understanding of the internal systems and operations of the unit.

**Observations***Admission of participants*

It appears that ASX's Client Relations unit plays a leading role in coordinating the assessment of admission applications from potential participants. The National Manager of C&I reviews and signs off on admission applications before they are approved.

We were advised that C&I did not review or sign off on any of the initial applications for participation on ASXF. This issue appears to have been raised internally and C&I were involved in the most recent application to ASXF.

*Staffing and supervision*

Each participant is assigned one C&I compliance adviser who is intended to be the first point of contact for compliance matters. We observed that compliance advisers had considerable knowledge of the affairs of their participants. Compliance advisers are encouraged to have an open and close relationship with participants. C&I believes this approach facilitates preventative compliance work.

There are weekly C&I staff meetings, where issues such as waivers, referrals and general compliance matters are discussed. It was apparent that the effectiveness of the unit relies on the collective knowledge of the compliance advisers.

*Self-assessments and on-site reviews*

C&I activities included self-assessments (industry wide and participant specific), spot checks, guidance notes and case studies, on-site visits and informal communication. Self-assessments and on-site reviews appeared effective and involved considerable research, planning and analysis on the part of the C&I personnel. When conducting on-site reviews, compliance advisers use checklists that are then analysed. Overall, C&I commits a large amount of time to planning and developing its compliance effort.

The National Manager expressed and demonstrated a clear preference for a preventative approach to compliance, and our overall observation is that the combined use of these strategies appears to provide for adequate supervision of market participants.

*Interaction with other ASX business units*

C&I interacts with several other business units through a combination of formal meetings and informal interactions. The unit's key relationship is with Investigation and Enforcement (I&E), with whom they meet once a month. The referral process to I&E is fairly formal, using a standardised referral form that includes a rating of the severity of the matter. C&I routinely meet with

Derivatives Market Control and the Structured Products unit. It also maintains a relationship with ASX's Customer Service and Client Relations units about complaints and applications for admission respectively.

#### *Documentation*

Information is stored through a combination of hard copy files, management information systems, and general electronic files. Hard copy files consist of two folders for each broker, one with inspections and referrals and the other a general folder including such things as complaints, waivers, and notifications.

#### *Complaints handling*

Customer Service is the first point of contact at the ASX for complaints about participants. It is responsible for logging a complaint and is generally responsible for handling the complaint. C&I are automatically emailed a summary of the complaint where a participant is involved. C&I may get involved in the handling of the complaint when specific rule breaches are identified or as considered necessary.

The information systems of the unit capture a history of complaints for each participant. However, the hard and soft copy files reviewed lacked documentation dealing with follow-up action on complaints about participants. ASIC was informed that complaints are discussed in the weekly C&I meetings and that the National Manager reviews the complaints register every 2 months to ensure that no serious issues are overlooked. We were further advised that compliance advisers refer to all of the complaints about a particular participant when preparing for a programmed on-site inspection.

### **Recommendations**

In addition to our general recommendations, we have the following specific recommendation in relation to Compliance and Information.

#### *Documentation and file management*

C&I should consider implementing a more systematic approach to recording compliance activity to assist other compliance advisers or new compliance advisers who may not have the same level of familiarity with a participant as its assigned adviser. Although C&I maintains a file for almost all participants it was often unclear whether follow-up work on referrals was conducted, or if any other work resulted from a referral. We recommend that C&I ensure that records with regard to referrals include information (or file notes) on follow-up activities conducted or required, and the subsequent results. ASX have indicated that they propose to adopt this suggestion.



## A6 The Companies Department

### Role of unit

The Companies Department has primary responsibility for ensuring that entities listed on the ASX comply with the listing rules. The unit promotes and facilitates compliance with the listing rules, makes decisions on the application and waiver of the listing rules, and assesses prospective new listings.

The point of contact for each listed entity with the ASX is the Company Adviser in the entity's designated home branch. There are home branches in Sydney, Melbourne (which also takes responsibility for Tasmanian based entities), Perth, Brisbane and Adelaide. A State Manager heads each home branch.

When we started our assessment, 1489 entities were listed on the ASX.

### Assessment process

#### *Documents reviewed*

We reviewed the following documents during our assessment:

- procedures on how ASXSR oversees ASX's supervision of Review Group Entities;
- monthly ASX waiver reports for the year ending 30 June 2002;
- referrals from the Market Surveillance Unit on alleged listing rule breaches;
- Companies Department policies and procedures;
- files from the Listing Appeals Committee;
- reports on "soft supervisory activities" (ie activities that did not result in a formal ASX query letter);
- or Companies Department quarterly reports;
- a report on internal analysis of supervisory referrals from the Market Surveillance Unit;
- a report on internal analysis of queries raised by the Companies Department (by home branch and category); and
- the exposure draft on proposed ASX listing rule amendments enhanced disclosure, July 2002.

In particular, we sought to review a cross section of operational case files. We reviewed 150 files in total selected from three categories:

- new listing applications;
- listing rule waiver applications; and
- general ongoing case files for specific listed entities (this was the largest category).

*On-site visit*

We conducted on-site visits and interviews in Sydney, Melbourne and Perth. We interviewed the State Manager in Sydney (who is also the National Coordinator, Issuer Integrity), State Managers in Melbourne and Perth, and the National Manager, Continuous Disclosure, Admissions and Waivers. This person also serves as the State Manager in Adelaide, and we took the opportunity discuss matters relating to supervision in South Australia.

We also attended a Companies Department team meeting in Sydney (held daily) and a National Management Meeting (held twice weekly).

**Observations***Staffing and supervision*

All listed entities are assigned a Company Adviser. The Company Adviser is responsible for monitoring disclosure by and liaising with their assigned listed entities. They also serve as the contact point for other ASX business units in relation to concerns about listing rule compliance. The background knowledge of the individual Company Adviser and the relationship developed between them and the listed entities for which they are responsible, is a significant element in the supervisory strategy adopted by the Companies Department. Company Advisers report directly to the State Manager of their home branch.

The National Manager, Continuous Disclosure, Admissions and Waivers is responsible for coordinating the various home branches. There is also a National Coordinator, Issuer Integrity. While we identified some instances where each of these National Managers was involved in matters of some significance, their roles do not appear to be clearly defined in either the unit's procedures or other documents.

Internal ASX Legal Counsel and a Senior Adviser on accounting issues also provide support to the Companies Department.

*Education of listed entities and others*

The unit's staff stressed that they seek to engender a "culture of compliance" amongst listed entities. They pursue this objective by conducting an ongoing program of education and liaison with listed entities and market professionals. During the 2002 financial year, 118 companies attended orientation programs organised and conducted by the Companies Department. A further 1000 industry professionals attended educational events organised by the unit.

*New listing applications*

New listing applications are processed using a checklist. There is active liaison with the legal representatives of entities considering a listing application, and in-principle advice is frequently given. All final decisions on listing admissions are made at a National Managers Meeting, generally attended by:

- the National Manager, Continuous Disclosure, Admissions and Waivers;
- the National Manager, Issuer Integrity;
- Legal Counsel;
- the Senior Adviser on accounting issues; and
- the relevant Company Adviser.

Management memos, prepared by the Company Adviser, are detailed and include background information, precedents and submissions made by the entity or their legal representatives. Applications also contain the prospectus (and any supplementary prospectuses), constitutions, material contracts and any relevant agreements. Processing of applications for new listing is very structured, and therefore appears to achieve a high level of consistency.

#### *Listing rule waiver applications*

Listing rule waiver applications are processed with the assistance of a checklist. There is active liaison with the legal representatives of entities' in relation to waiver applications and in-principle advice is frequently sought. Some decisions (where there are precedents) tend to be made at State Manager level, while others are discussed at the National Management Meeting. Management memos are detailed and include background information, precedents and submissions made by the entity or their legal representatives. All listing rule waivers are published on the ASX website. This process appears to ensure a high level of consistency and transparency for waiver decisions.

#### *Ongoing monitoring of compliance with listing rules*

Companies maintains review checklists for annual, half year and quarterly reports. There are also checklists available for the assessment of notices of annual general meetings, explanatory memorandums and constitutions. Reminder letters are generated and dispatched to entities by the Companies Announcement Office in advance of periodic reporting lodgement deadlines.

Company Advisers monitor media reports on listed entities daily and review other disclosures made, including periodic disclosure, to detect potential non-compliance with the listing rules. They are also assisted by referrals from the Markets Surveillance unit, which monitors share price movements, electronic media and broker reports. According to ASX's annual regulatory report, there were 220 matters referred to the Companies Department from the Market Surveillance Unit during the 2001/2002 financial year.

The Companies Department also works closely with the Companies Announcement Office (CAO). In some specified circumstances, the unit is advised by CAO of any announcement being lodged by particular entities. In such instances, the CAO will contact the relevant Company Adviser who will then vet the announcement before its release to the market. This process must and does appear to work with minimal delay. It enables the unit to monitor and respond

immediately to disclosures being made by those entities that, for whatever reason, are subject to this level of supervision.

#### *Conflicts of interest*

Each Companies Department home branch appears to operate in a fairly autonomous manner. There was no indication that operational influence was being exerted on the unit by other areas of the ASX. With regard to the monitoring of compliance and enforcement of the disclosure provisions of the listing rules, we saw no indication that the broader commercial interests of the ASX group were influencing the work of the unit. As noted in our comments about ASXSR, agreed procedures for Review Group Entities are actively followed and appear to be adequate.

#### *Policies and procedures*

Share price queries are in a standard format and specific questions are added as required. Specific query letters to companies about compliance with Listing Rule 3.1 tend to be more case specific. The unit also uses a standard format for ASIC referrals. Referrals to the Companies Department from the Market Surveillance Unit are normally made through emails.

A file is maintained for each listed entity. The Companies Department has no written protocol that sets out what activities or documents are to be recorded on an entity's file. Filing processes appear to be largely at the discretion of the particular Company Adviser. In the extensive sample of files reviewed, there was no consistency in the file maintenance practices across the unit, nor does it endeavour to maintain a complete record of the supervisory activity for an entity. Accordingly, reviewing a case file is not a reliable means for understanding the supervisory history of an entity.

Monthly internal reports of supervisory actions taken are compiled and these are a better record of the supervisory work undertaken. It is clear that the standard and consistency of internal reporting on supervisory matters has improved significantly during the course of the year under review, although it is still not uniform.

Our conclusion that the level of supervision of listed entities is appropriate is to a significant degree reliant on our overall impression that the personnel involved are knowledgeable and that the processes for monitoring disclosure appear satisfactory. This is supported by our review of monthly and other internal reports.

#### *Complaints handling*

Complaints by shareholders are assessed by Company Advisers, sometimes in consultation with senior management. There is no register of complaints about listed companies and no uniform protocol on how they should be managed. While some complaints are given considerable attention, others are not. The way in which a matter is handled appears to be largely at the discretion of the Company Adviser.

## **Recommendations**

Other than the matters covered in our general recommendations, we have no specific recommendations in relation to Companies Branch.

## A7 Risk Management Unit

### Role of unit

The Risk Management Unit (RMU) is responsible for monitoring the capital requirements of participants in the ASX equities and derivatives markets and the ASXF futures market. This includes the use of reporting mechanisms designed to ensure that the financial strength of each participant is measured and monitored. Therefore, RMU largely views its business unit as the prudential supervisor of participants. RMU also has a role in managing the financial risks of ASX group entities conducting clearing and settlement operations.

Central to the capital liquidity regime is ASX Business Rule 1A (Rule 1A), which requires participating organisations to ensure that their level of regulatory capital, known as “liquid capital”, at all times exceeds the measure of their risk, known as “risk requirement”. If a participant’s ratio of liquid capital to total risk requirement equals or falls below 1.2, the participant must report their ratio and calculation to ASX immediately. Subsequently, depending on the exact ratio level, daily or weekly reporting may be required under Rule 1A. Most ASXF participants are also required to comply with Rule 1A with the exception of two, who comply with an alternative net tangible asset test in the ASXF business rules.

The core requirement under Rule 1A is that participants lodge detailed monthly capital returns. This information is then analysed by RMU using data interrogation software, known as CARS, which acts as a filtering system. Through customised parameters, CARS creates several “Exception” and “Information” reports, which help to highlight potential capital adequacy issues, possible reporting errors, and the financial risk profile of each participant.

Following this analysis, queries may be sent out to participants about calculations or, on a more serious level, capital adequacy issues. RMU also creates a monthly “Executive Summary” of the industry’s capital status.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents during our assessment:

- RMU’s policies and procedures; and
- CARS analysis files for Sept 2001, and from April 2002 through to and including September 2002

#### *On-site visit*

We interviewed the National Manager, Risk Management, a unit Manager and a Business Analyst. The key focus of the interview was to gain a better understanding of the day-to-day activities of RMU, and its approach to monitoring the capital adequacy of participants. Topics included:

- how CARS is used by RMU in their daily job functions;

- referrals to the Investigations and Enforcement unit;
- intra-day monitoring of the financial adequacy of participants;
- suspensions or cancellations of participants (due to capital liquidity issues); and
- the general approach to monitoring capital adequacy of participants.

RMU gave our review team a demonstration of how a participant uses the monthly return software to lodge its monthly returns and explained the different types of reports generated through the CARS system.

The CARS system is also used to capture correspondence with participants and provides a general picture of the capital adequacy profile and capital history of each participant.

## **Observations**

### *Documentation*

RMU's policies and procedures are adequately documented. The use of checklists and a clear managerial approval process was apparent from the files.

The file maintenance and structure RMU uses was detailed and thorough. Monthly hard copy files record information on the capital returns of every participant as well as intra-month reviews, correspondence, exception and information reports. The documentation on file gave ASIC's review team a clear picture of the how RMU monitors capital adequacy.

### *Supervision of Rule 1A*

There is substantial use of automated computer based surveillance such as the exception and information reports generated by CARS. RMU not only monitors the capital adequacy and reporting at month-end but also on an intra-month basis using projections and statistical analysis.

Intra-month analysis and use of projections make it possible for RMU to be proactive in its supervisory work, rather than reactive. RMU appears to have good techniques to provide early warning about participants who may have capital adequacy problems. The process of actively querying participants about calculations or capital issues appears to be effective, indicated by the decreasing number of "queries" each month.

### *Interaction with other ASX business units*

Referral to Investigation and Enforcement is mandatory when there is a breach of Rule 1A. The referral process for rule breaches is clear, formalised, and adequate.

## **Recommendations**

ASIC has no specific recommendations for RMU.

## A8 SEATS Market Control

### Role of unit

SEATS Market Control (SMC) has the day-to-day responsibility for the operation of the electronic trading system employed by ASX, known as SEATS. SMC assists designated trading representatives (DTRs) in the use of SEATS from an operational perspective. Section 2 of the ASX business rules relates to acceptable behaviour and the overall trading rules for SEATS. Compliance with the ASX business rules is to some extent automated through the operation of the system, which will reject or provide an alert when trading activity will or may breach ASX business rules. SMC also has responsibility for training and licensing DTRs.

SMC acts as a conduit between the DTRs and the rest of ASX. It assists DTRs with passwords and username logons, facilitates changes to the SEATS system on behalf of DTRs and brokers (ie adding or deleting SEATS users), and provides guidance to DTRs on new SEATS enhancements and general trading rule interpretations.

### Assessment process

#### *Documents and information considered*

We reviewed the following documents during our assessment:

- SEATS policies and procedures (provided by ASXSR);
- SEATS Market Control Procedures Version 3.1 (provided by SMC);
- file of facilitated specified size block special crosses (or “delayed reporting trades”);
- files of exchange traded fund special trades and portfolio special crossings (or “special trades”);
- late trade reporting file;
- file of special liability request forms; and
- file of registration information of each DTR.

#### *On-site visit*

We interviewed the General Manager of Trading, National Manager of Equities Trading, Manager of SMC and the Assistant Manager, Equities Trading. Topics included:

- how SMC monitors the marketplace for illegal trades;
- trade-reporting breaches and rules regarding short sales; and
- how the unit monitors the conduct of DTRs.

We also requested and received a tour of the unit’s operations.



## Observations

### *Operational rather than supervisory role*

ASX website says that “SEATS Market Control is the ASX department responsible for monitoring trading and ensuring that trading on SEATS takes place according to ASX business rules”. It goes on to say that “when Market Control observe any breaches of ASX business rules, they contact the DTR responsible and query their actions”.<sup>1</sup> From our observations and interviews with relevant personnel, it appears that SMC plays a relatively restricted role in supervision.

A number of factors contribute to the limited direct supervisory work of SMC. First, the monitoring and surveillance of trading that takes place through SEATS is largely a function of the Market Surveillance Unit. Second, the SEATS system itself provides a degree of automatic compliance with the ASX business rules and there is therefore limited intervention in trading issues by SMC personnel.

SMC is, however, responsible for training and accreditation of DTRs. It is also the first point of contact with DTRs and may become aware of improprieties from market participants themselves, before other ASX business units.

### *The SEATS system*

As noted, the SEATS system itself does to some extent regulate trading. Therefore, there is an overall reliance on the built-in parameters provided by SEATS.

SMC plays a significant role in implementing periodic enhancements to SEATS because the unit is responsible for getting information to the marketplace about changes (via SEATS announcements and circulars), helping to train DTRs and providing assistance with any inquiries about new enhancements.

SMC described itself as a “helpdesk” of sorts, where assistance is provided to the DTRs with functional information on SEATS, as well as help on compliance with ASX business rules for equities trading.

### *Interaction with other ASX business units*

As first point of contact with DTRs, SMC will occasionally receive complaints from brokers of alleged rule breaches by other brokers. In such cases, the matter is usually referred to the Market Surveillance Unit. For repeat offences, SMC may issue management (or warning) letters to DTRs and their compliance departments. We were advised that more than 90% of referrals made by SMC to other business units are made to the Market Surveillance Unit. However, SMC advised that it makes few such referrals and does not keep a log of referrals it makes to Market Surveillance.

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<sup>1</sup> [http://www.asx.com.au/markets/14/SEATSMarketControl\\_AM4.shtml](http://www.asx.com.au/markets/14/SEATSMarketControl_AM4.shtml)

*Cancelling trades*

The ASX business rules do not provide ASX with the power to cancel trades. Instead, SMC relies on the relevant parties to an erroneous trade to agree to cancel or amend the trade. In some cases the absence of an ability to cancel trades may inhibit the ability of the ASX to ensure the fair and efficient operation of its market, as it is unable, for example, to cancel clear error trades without the agreement of the relevant brokers.

*Training, testing, and licensing of DTRs*

One of the main functions of SMC is the administration of the application process of DTRs, which includes the testing, and subsequent licensing, of DTRs.

*Policy and procedures*

SMC provided ASIC staff with the “SEATS Market Control Procedures version 3.1” (Version 3.1). These procedures differed from the SEATS procedures document titled “SEATS policies and procedures” (ASXSR document) produced under an earlier notice to ASXSR, covering procedures considered by them in the course of the preparation of their report. In our interviews, we were told that both sets of procedures are followed, however Version 3.1 is considered more reflective of the unit’s daily work.

From a review of these procedures, in our view, Version 3.1 is more operational, while the ASXSR document covers only the supervisory work of SMC. On the basis of our interviews with SMC staff and our review of their operations, a relatively small percentage of their day-to-day work might be categorised as purely supervisory. It was the estimate of SMC staff that less than 5% of their work might fall into the category of supervisory activity. We were advised that the ASXSR document was created in response to the ASXSR review. As the majority of SMC’s duties and responsibilities are operational, the unit in practical terms follows the more operational procedures, namely Version 3.1.

**Recommendations***Clarification of SMC’s supervisory role*

In our view, there would be some benefit in ASX better articulating internally the extent to which the SMC Business Unit contributes to ASX’s responsibilities to supervise its market so that it operates in a fair, orderly and transparent manner. This may best be done as part of its development of a more ASX-wide compliance framework, including in its Group Compliance Plan and in any revised policies and procedures for SMC.

*Record-keeping*

While we recognise that it would be impractical for SMC to document all of its day-to-day activities, we recommend that SMC does keep a log of referrals to other business units of ASX (ie referrals to the Market Surveillance Unit and Investigations and Enforcement).

*Business rule amendment*

We recommend that ASX consider an amendment to its business rules to give itself the power to cancel error trades in the interests of a fair, orderly and transparent market.

ASX have indicated that that a proposal to introduce a cancellation power in circumstances where market integrity warrants it is currently being developed.

*Policies and procedures*

As discussed above, the unit maintains two sets of policies and procedure documents. In our view it would be preferable to have a single set of procedures covering all activities performed by SEATS Market Control in order to avoid confusion or inconsistency in processes.

## A9 Derivatives Market Control

### Role of unit

Derivatives Market Control has the day-to-day responsibility for the supervision of trading conducted through ASX's derivatives trading facility. (This facility is also referred to as CLICK because it is a modified version of the OM CLICK system developed by OM Technology AB.) The CLICK system facilitates the trading of ASX exchange traded options (ETOs) and trading of futures contracts on the ASXF market. The CLICK electronic trading system allows opposing orders for the same terms to be automatically matched on a price/time priority.

In the options market, in order to trade options, a trading participant must be an authorised participant organisation or a Registered Independent Options Trader (RIOT). In the futures market, a trading participant must be an authorised broker participant or local participant. The persons actually using the CLICK system are representatives of the trading participants and are known as designated trading representatives (DTRs).

Derivatives Market Control assists DTRs with their use of the CLICK system and with fulfilling their trading instructions from an operational perspective. Compliance with the business rules to a large extent is facilitated automatically through the operation of CLICK, which will reject or provide an alert when trading activity will or may breach business rules. It is important to note that Derivatives Market Control has supervisory responsibilities related to the maintenance of fair and orderly options and futures markets. Such responsibilities include monitoring compliance with business rules, referring rule breaches, and the amendment or cancellation of trades.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents during our assessment:

- policies and procedures manuals held by Derivatives Market Control;
- policies and procedures on derivatives provided by ASXSR;
- fault reports;
- all files relating to supervisory concerns referred by Derivatives Market Control to other ASX business units from 1 July 2001 to 5 November 2002;
- 2 files on potential pre-arranged trades that were being investigated by Derivatives Market Control;
- the most recent ASX participant dispute notices (from 2 February 2002 through 16 July 2002); and
- a file of referrals to Investigations and Enforcement.

*On-site visit*

We interviewed the General Manager, Trading and the Manager, Derivatives Market Control, Derivatives Trading Operations to discuss the specific supervisory functions of Derivatives Market Control. We also requested and received a tour of the unit's operations.

**Observations***Operational v supervisory role*

The unit does not see itself as primarily a supervisory area. However it performs a range of operational functions, such as accreditation and training of DTRs and some monitoring of compliance with ASX business rules, as well as administering the CLICK system, that make a significant contribution to the ability of the ASX to conduct a fair, orderly and transparent market in derivative products.

*Documentation and record-keeping*

Derivatives Market Control has a good record keeping system. Any trade from as far back as 1997 can be re-created electronically and a manual trade report is run on a daily basis. The unit also maintains files on potential business rule breaches (such as pre-arranged trades) that set out the relevant documentary evidence.

*DTR training and accreditation*

The accreditation, training and re-training of market makers and participants is a priority for Derivatives Market Control. This is reflected in the re-training of DTRs undertaken by Derivatives Market Control after the introduction of tailor-made combinations in April 2002.

*Systemic monitoring of compliance*

The CLICK system itself is a source of automated compliance in that it will automatically report irregular transactions for market makers, and will not allow certain trading activity that will breach the business rules (such as the standard crossing rules).

The conversation with Derivatives Market Control concentrated on supervision of trading in ETOs, which appeared to be the area's main focus.

*Interaction with other ASX business units*

The unit coordinates with other ASX business units (ie the Market Surveillance and Compliance and Information units) through regular meetings. Any suspicious trades are referred to Investigation and Enforcement and the unit keeps a record of such referrals.

*Enhancements to CLICK*

Derivatives Market Control is involved in training market makers in new rules related to system enhancement and in ensuring the efficient introduction of system changes. It was, for example, involved in the introduction of the tailor-made

combinations in April 2002. The introduction of tailor-made option combinations necessitated changes to CLICK that in May 2002 caused a series of system outages (3 in total). The unit was involved in resolving the system glitches and keeping the market informed.

*Policies and procedures*

The “Derivatives Market Control Procedures” (DMC procedures) provided during our on-site visit differed from those provided to ASIC by ASXSR, “Derivatives policies and procedures” (ASXSR derivatives procedures). The DMC procedures were far more comprehensive and appeared to be the main operational procedures. The ASXSR derivatives procedures were restricted to issues that might be categorised as more purely supervisory in nature. It appears that these procedures may have been created as part of the process, or in response to, the review undertaken by ASXSR. It is not clear that they are a significant reference point for the day-to-day operations of the unit.

## **Recommendations**

*Policies and procedures*

In ASIC’s view, it is preferable to have a single, up-to-date set of procedures for the business unit that are accepted as the operating procedures for that unit. Those procedures should cover all of the relevant functions of the unit, including the supervisory functions. In our view, creating separate supervisory procedures risks developing inconsistent procedures and creating procedures documents that are not used operationally.

ASX has indicated that while they are thinking about consolidating these documents, the separate procedures have not presented any issues in effectively operating and supervising the market.

## A10 Structured Products

### Role of unit

Structured Products (SP) is part of the Issuers and Market Integrity Division of ASX. SP approves new warrant issuers, admits new warrant series to trading status and monitors many of the ongoing obligations of warrant issuers. These processes require SP to ensure that issuers comply with, or are granted waivers from, Section 8 of the ASX business rules (warrant rules).

SP also includes a group of ASX staff whose role is solely to educate investors and promote investment in warrants. We did not review the work of this group.

SP is not responsible for monitoring compliance by participating organisations with the accreditation and client agreement rules. Compliance with these provisions is the responsibility of the Compliance and Information Unit.

As with all ASX and ASXF markets, the Market Surveillance Unit is responsible for monitoring trading activity. Accordingly, our comments on these business units also reflect on the adequacy of ASX's supervision of the warrants market.

However, SP is responsible for monitoring ASX requirements on warrant issuers to follow effective market-making practices. In this regard, SP monitors the relevant SEATS screens and liaises when necessary with warrant issuers.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents and information during our assessment:

- the business rules for warrants;
- relevant guidance notes (Warrants Decisions 6/98, Business Rule 8.17A—Warrants 4/99, Warrants: Electronic Distribution of Offering Circulars 4/00);
- SP's documented policies and procedures and additional material that SP indicated is used for procedural guidance;
- the files for each application for a new warrant series received in July 2001 (11 files) and June 2002 (14 files); and
- files on adjustments from July 2001 to June 2002. These files cover adjustments to warrant terms due to events that affect the underlying security of the warrant (eg a capital reconstruction).

#### *On-site visit*

We interviewed the SP Manager and discussed:

- the overall role of SP, its structure and its resources;
- the supervisory functions of SP;
- the admission process for warrant issues;

- SP's interaction with other ASX business units, particularly on referrals and disciplinary actions;
- the steps SP takes to ensure compliance with the warrant rules;
- whether the practices adopted by SP differ from the warrant rules; and
- SP's document filing and database system.

## Observations

### *Responsibilities of SP*

As noted, SP appears to take on a primary role for monitoring compliance with the warrant rules (except those rules for brokers advising on warrants). SP is also responsible for the ongoing monitoring of compliance by warrant issuers with their market making undertakings. For this purpose, SP reviews SEATS warrant screens on an ad hoc basis.

### *Liaison with issuers and supervision*

Because there are relatively few issuers (presently less than 10) and SP liaises with them frequently on new warrant series and adjustments, SP is often the initial point of contact for issues raised by warrant issuers. The unit also receives complaints or helps direct complaints from participants in the market.

Although it was not evident from the files we reviewed, SP advised that they send out an email to warrant issuers alerting them to a possible need to adjust their warrant terms if an adjustment is made to the underlying security for their warrants. In the folder of adjustments, it was clear that SP liaised with warrant issuers, kept records of what action issuers were taking and noted whether appropriate announcements had been made.

SP relies primarily on media information or communications from issuers to determine whether an event affecting the underlying security may result in an adjustment to warrant series.

We note that the ASXSR report contains extracts from a letter from ASX asserting that SP is primarily an operational area with only a limited supervisory role. In ASIC's view, supervision encompasses monitoring compliance with the ASX business rules or equivalent undertakings that aim to ensure warrant markets operate in a fair, orderly and transparent manner.

### *Documentation*

SP maintains only limited documentation. The application files we reviewed were complete and well ordered. However, the adjustments folder did not contain all correspondence. SP does not maintain files for each warrant issuer. We were informed that the approval as a warrant issuer is kept on the first warrant series file for the issuer and is not separately maintained. However, the SP Manager indicated that reviews are performed to ensure that the requirements for an approved warrant issuer continue to be met.



SP does not keep records on some supervisory decisions in any ordered manner. For example, in the case of a decision to suspend a warrant series from trading, an email, generally without reasons, is sent to SEATS Market Control. SP has indicated that common causes for a suspension are changes to the underlying securities, corporate actions, changes to the strike price (where there are no warrant holders), or occasionally technical difficulties of a market-making system. These causes have been characterised as administrative in nature with no supervisory precedent value.

However, in the above circumstances, if trading was not suspended, then the result would most likely be a disorderly market. In this sense, SP is playing a critical supervisory function even though the issues are routine.

#### *Policies and procedures*

SP uses a comprehensive checklist for applications for new warrant series. In other respects, its policies and procedures are less specific. However, SP does keep some records of issues that arise to help provide procedural guidance.

In addition, the policies and procedures for ongoing supervision of warrant issuers and warrant series do not have sufficient detail. There were no procedures about SP's communication and relationship with other ASX business units.

#### *Processing applications*

SP processes new warrant issue applications according to a checklist based on the warrant rule requirements. The SP team appear to thoroughly review new applications and follow the checklist. As part of this application process, ASX grants standard waivers of the warrant rules. After checks have been completed and necessary documentation received, the file goes to the SP Manager for approval to admit the warrant series to trading status.

From the files reviewed, we found that SP deals with applications in a consistent and efficient manner. Its use of checklists and sign-offs contributed to the ease with which files could be read and understood.

#### *Warrant rules*

The warrant rules are not applied as they are written. Any application for admission to trading involves a large number of standard waivers. In addition, some of the warrant rules are redundant, or SP has communicated to warrant issuers that the rules will apply in a way other than as written. More generally, the warrant rules do not reflect what happens in the market. For example, there is no market-making obligation delineated in the rules, yet routinely a warrant issuer is required to make markets in warrants by way of agreement.

#### *Announcements*

SP receives announcements from warrant issuers and arranges for these to be released to the market. It does not seem to maintain a central record of these

announcements, although announcements about adjustments are kept in the adjustments folder maintained by SP.

*Interaction with other ASX business units*

SP meets regularly with the Legal Division. In addition, any novel aspects of a new warrant issue are referred to Legal Division for their consideration. Apart from Legal Division, SP deals primarily with the Market Surveillance Unit. There is no formal liaison process in place. Although SP refers matters to Market Surveillance, no formal referral log is maintained.

**Recommendations**

In addition to our general recommendations, we have the following specific recommendations in relation to Structured Products.

*Policies and procedures*

SP needs to develop monitoring procedures for its supervisory activities where there are no current policies and procedures. This includes:

- suspensions sent to other business units (ie SEATS Market Control);
- complaints and referral of complaints to the Compliance and Information Unit; and
- the general referral process to the Compliance and Information Unit and Investigations and Enforcement.

*Record-keeping*

SP needs to improve its record-keeping system, in particular:

- a file for suspensions sent to SEATS Market Control (including reasons and results); and
- files for each warrant issuer, so that information on monitoring of warrant issuers is readily available.

ASX have advised that Structured Products will prepare further procedural documents to guide supervisory activity and the recording of this. ASX anticipates that this will be in place by the end of September 2003.

## **A11 Interest Rate Market**

### **Role of unit**

The Interest Rate Market (IRM) unit is part of the Trading Market Development Department, but also has close links to the Companies Department. The Business Analyst responsible for most of the supervisory work of the unit also performs some business development functions and reports directly to the National Manager, Trading Market Development.

IRM is responsible for processing applications by debt issuers for admission to ASX's official list and for monitoring compliance by debt-only issuers. IRM liaises and is jointly responsible for these functions with Companies Department.

The structure and purpose of the ASX "debt markets" has a bearing on the supervisory role of IRM. There are essentially two "markets"—the retail and wholesale. Retail debt trading is similar to equity trading in that it occurs on SEATS and is monitored by ASX. ASX's involvement in the wholesale debt market is restricted to a bulletin board published on a SEATS page. The bulletin board "quotes" securities but does not provide price information. Although there is a provision for entering bids, none have been received to date. No executed trade information is recorded, nor is it reported back to ASX. All wholesale trading is conducted over the counter.

### **Assessment process**

#### *Documents and information considered*

We reviewed the following documents during our assessment:

- IRM policies and procedures manual;
- IRM promotional material;
- Companies Department policies and procedures;
- all files on applications for admission to the official list from 1 July 2001 to 6 November 2002. Of these, 1 file related to a retail debt-only issuer while 7 related to wholesale debt-only issuers;
- a file recording communications with various issuers about suspected listing rule breaches and failures to lodge annual returns.

#### *On-site visit*

We interviewed the Business Analyst with primary responsibility for supervision. The interview covered the overall role of IRM, its structure, the extent of IRM's supervisory functions and the approval processes undertaken for new admissions, quotations and waivers.

As there is some overlap in the responsibilities between IRM and Companies Department, we also discussed the interaction between IRM and Companies and sought clarification about the respective responsibilities of each business unit in

relation to supervision of the debt market. Other issues included IRM's interaction with other ASX business units, particularly on referrals and disciplinary actions, the level of supervision of issuers in relation to on-going compliance with the listing rules and how the activities of IRM are documented. As this unit undertakes limited supervision, there were only a few files to review and our assessment relied heavily on information provided by the Business Analyst.

## **Observations**

### *New listings and waivers*

IRM is responsible for new debt issuer listings (ie admissions to the official list). From 1 July 2001 to 30 October 2002, there were 8 admissions—7 wholesale and 1 retail. No applications were refused. With applications for admission as new debt-only issuers, IRM vets the documentation for compliance with the listing rules and prepares a Management Paper for the National Management Meeting of the Companies Department. Decisions on admission are made at the National Management Meeting.

After admitted, an issuer (usually of wholesale products) is not required to quote products immediately. For instance, one issuer that was admitted in 1999 has not quoted any products.

When a company is ready to quote securities, it must lodge any updated documentation, pricing supplements as required, an update of the company's operations and the latest annual report. IRM vets these documents to ensure that they do not significantly deviate from those supplied with the application for admission.

IRM has limited discretion in recommending admission, but rather follows a checklist approach. On balance, the equity admission process (by the Companies Department) appears more stringent. However, as the final decision on admission is made at the Companies Department's National Management Meeting, a reasonable level of consistency should be achieved.

### *Rule waivers*

Rule waivers are not commonly granted for listing of retail products. For wholesale issues, a standard set of waivers is commonly granted (largely to do with CHES requirements).

### *Ongoing compliance*

IRM is generally responsible for monitoring the ongoing compliance of listed entities that have issued only debt securities. There are, however, some exceptions.

Where a debt issuer is already an existing listed equity issuer, or where an existing listed equity issuer uses a subsidiary to issue debt instruments, the Companies Department is responsible for monitoring ongoing compliance, as it already monitors the parent entity for compliance with the equity related rules. IRM

liaises closely with the Companies Department in carrying out its ongoing compliance supervisory function.

IRM's compliance monitoring appears less stringent in the case of wholesale issuers that do not have any products quoted.

IRM monitors periodic financial reporting requirements (ie whether the entity lodged its annual/half yearly report on time), reviews daily ratings reports and vets the media to monitor compliance with the listing rules.

Some Market Surveillance notifications of unusual price or volume trading (for SEATS traded debt securities) are directed to IRM, which then passes on the notification to the Companies Department to be assessed by the relevant Company Adviser. IRM does not appear to have documented procedures on its relationship with the Markets Surveillance Unit.

Only one notification was received from the Markets Surveillance Unit during the assessment period. This was referred to the relevant Company Adviser for follow up.

ASIC was advised that IRM had not identified any instances of non-compliance with the rules during the period. However, it was also stated that there were some instances where issuers had misinterpreted the meaning of a listing rule, particularly, the number of days between the record and payment dates for a debt security.

During our assessment, we saw an email to a company advising that it had not lodged annual accounts for the past three years. The company was a wholesale issuer and the oversight appeared to result from an absence of clear monitoring procedures. In the Business Analyst's view, the information was not price-sensitive and therefore no further action was taken. A checklist has now been prepared which should prevent a similar problem recurring.

IRM does not generate referrals and as such has no procedures for this function. There is not a strong recognition of the various supervisory responsibilities of IRM. There is no evidence of analysis of adequacy of disclosure by the entity, no reports were cited showing a review of the material disclosed by entities and no files relating to breaches of listing rules or procedures for dealing with breaches of listing rules appear to exist. Based on the information in files we reviewed, it does not appear that any systematic analysis of the adequacy of on-going compliance by an entity is undertaken.

Notwithstanding these comments, we agree with the unit staff that IRM's supervisory function is relatively minimal. The number of pure debt issuers is quite limited and many issuers admitted to listing have not quoted any products.

#### *Documentation*

IRM has no systematic or formal filing system. Individual files are not well maintained. Some relevant documents were not on file and there were few if any

file notes. IRM does not appear to generate any reports either for internal or external purposes.

*Conflicts of interest*

There is some crossover between the supervision and business development functions of the IRM staff and the direct reporting line to the National Manager, Trading Market Development. While this does not accord with [PS 172] (ie that employees whose responsibilities involve both supervisory and commercial activities should report to different people for each type of activity<sup>2</sup>), we found no cause for concern in this instance, given the relatively limited supervisory role.

**Recommendations**

In addition to our general recommendations we make the following specific recommendations in relation to the Interest Rate Market.

*Compliance with periodic reporting requirements*

Given the case of one wholesale debt issuer who failed to lodge its accounts for an extended period, we recommend that ASX conduct a review to ensure that all debt issuers comply with their periodic reporting requirements.

*Policies and procedures*

We recommend that policy and procedure documentation should be updated to cover the IRM processes for quotation of debt securities, passing on referrals/notifications to another business unit, dealing with trading halts or suspensions of securities, assessing compliance with listing rules by entities, dealing with breaches of rules (whether these need to be referred or not), and dealing with conflicts of interest.

*Conflicts of interest*

At the time of our visit, Interest Rate Market did not have a staff code of conduct. We recommended that, as in other analogous areas of the ASX, a staff code of conduct should be developed in view of the combined commercial and supervisory obligations of the area. ASX have advised that a code of conduct has now been put in place.

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<sup>2</sup> See [PS 172.91].

## A12 ASX Legal Division

### Role of unit

ASX Legal Division provides in-house legal services to the ASX business units. Legal Division comprises four practice groups who report to the position of General Counsel:

- Trading;
- Issuers and Quoted Products (Quoted Products);
- Corporate and Commercial; and
- Clearing and Settlement.

Our assessment focused on Trading and Quoted Products practices. This is because these practices have responsibility for the ASX and ASXF business rules and the listing rules respectively, including in particular the rule amendment process.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents during our assessment:

- recent ASIC files on rule amendments lodged with ASIC under s793D of the Act;
- ASX documents about particular amendments to the business and listing rules;
- ASX documents about Legal Division's management of its rule amendment workflow;
- 3 files on the rule amendment process; and
- a worksheet that was Trading's primary means of managing its rule amendment workflow.

#### *On-site visit*

We interviewed the practice managers and a solicitor from Trading and Quoted Product. We also spoke to the managers of three ASX business units that are internal clients of Legal Division. Topics included:

- resources that Legal Division (and each practice) has;
- processes that Legal Division follows when amendments to the operating rules are identified as being required either by Legal Division or other business units;
- the role other business units have in the rule amendment process; and
- the ongoing arrangements to manage commitments made by Legal Division to stakeholders in the statutory rule amendment process (such as ASIC).

We also spoke to other selected ASX business units to understand the level of coordination between Legal Division and other business units in the rule amendment process.

## **Observations**

### *Rule amendment process and procedures*

The rule amendment process is not subject to a formalised set of procedures that is rigorously adhered to by Legal Division or by business units. There is internal material that documents the processes followed by Trading and Quoted Products, and this appears to be available to other business units. However it is our understanding that these do not operate as formal procedures for either the respective practices or the business units.

It appears that each set of rule amendments is project managed. There is not a clear guideline as to whether each project will be driven by the sponsoring business unit or by Legal Division. Normally, however, it appears that Legal Division drives the process and, in particular, the practice lawyer assigned to the applicable business unit.

Legal Division prioritises major amendments according to its business plan. The business plan is discussed with the business units before it is finalised. On occasions, business units can source legal services externally rather than use Legal Division resources, particularly where the proposed amendment is to address an issue outside the business plan and the business unit is able to finance external legal resources from its own budget.

The relationship between Legal Division and the business units in the rule amendment process is not highly structured. It appears that the business units rely on a range of formal and informal contacts involving in some cases regular meetings with the business unit and their assigned lawyer to keep themselves informed of developments relating to either the business rules or the listing rules as applicable. There does not appear to be a formal due diligence providing, for example, for a signoff process on amendments by each relevant business unit prior to amendments being adopted. Generally, the business units we spoke to, however, expressed comfort with the present arrangements.

## **Recommendations**

In addition to our general recommendations we make the following specific recommendation in relation to the Legal Division.

### *Internal consultation and process*

ASIC believes that Legal Division should consider a more systematic approach to consultation with ASX business units about proposed amendments to the ASX business rules. This would help to ensure that rule changes are appropriately taken



into account by all relevant supervisory areas and that policies and procedures can be updated to reflect any changes in supervisory processes which might result from rule changes.

## A13 Company Announcements Office

### Role of unit

ASX listing rules require a listed entity to release material information to the market by giving it to the ASX. The Company Announcements Office (CAO) is the key ASX infrastructure supporting release of information to the market.

CAO is responsible for:

- receiving, processing, releasing and storing company announcements lodged under the ASX listing rules and the Act;
- keeping the market informed of announcements in a timely manner;
- administering some compliance for periodic listing rule obligations; and
- communicating, advising and educating listed entities on meeting the above obligations.

### Assessment process

#### *Documents and information reviewed*

We reviewed the following documents and information during our assessment:

- companies office policies and procedures manual;
- “housekeeping” procedures document;
- documents about the Company Announcements Platform (CAP) re-engineering project;
- information about CAP in Listing Rule Guidance Note 14; and
- information on ASXOnline in Listing Rule Guidance Note 20.

#### *On-site visit*

We interviewed the Manager of the unit, received a demonstration of unit processes, and observed the operations of the unit. Topics included:

- how CAO updates its procedures for changes to the listing rules;
- the planning involved to cope with increasing number of announcements;
- benchmarks for measuring effectiveness;
- complaint handling procedures;
- processing and prioritising of announcements;
- vetting process for company announcements;
- follow up procedures for announcements released in error;
- classification of announcements and their documentation;
- interaction with the Companies Department and SEATS Market Control;
- summarising of announcements and dissemination through Signal G; and
- the procedures for announcements received from third parties.

## Observations

### *Procedural matters*

CAO receives announcements via facsimile, e-lodgement and post/hand delivery. Announcements are processed in order of receipt, regardless of their method of delivery to ASX, and are released and stored electronically.

Most announcements are received by facsimile, although e-lodgement has been available for approximately 2 years. E-lodgement is now mandatory for new listed entities and will become mandatory for all listed entities from 1 July 2003.

CAO relies heavily on electronic systems and is aware of the role it plays by receiving and releasing announcements in maintaining market integrity. ASX has acknowledged that the existing CAP infrastructure is increasingly out of date and the first phase of a CAP re-engineering project is currently underway.

### *Flagging information as “price sensitive”*

CAO flags announcements that it regards as “price-sensitive”. CAO can instruct SEATS Market Control to put a stock into “pre-open” after it receives a price-sensitive announcement.

The CAO manual gives examples of price sensitive information, but CAO personnel are expected to exercise their own judgement when processing announcements and seek assistance from other staff as required. CAO indicated it adopts a stringent approach to potential price sensitive announcements and believes it is well regarded in the market as making the correct decisions in these instances.

While ASIC has received some complaints about announcements that were not flagged as “price sensitive”, we also formed the view that, given the overall number of company announcements, the incidence of errors in appropriately flagging announcements is extremely low.

### *Monitoring of periodic disclosure*

CAO helps listed entities meet their periodic disclosure obligations by sending them reminder letters before periodic reporting deadlines. Under Listing Rule 17.5, CAO can initiate a suspension for failure to lodge documents, such as periodic financial reports.

### *Interaction with other ASX business units*

CAO frequently interacts with the Companies Department and Company Advisers on matters such as price sensitive announcements, companies on the “Watchlist” and suspended companies. CAO relies on other ASX business units to keep it informed of relevant changes in the listing rules and the Act.

## Recommendations

ASIC has no specific recommendations for CAO.

## A14 Production Services (Technology)

### Role of unit

ASX has a decentralised approach to information technology (IT). One of the stated reasons for this approach is to advance the integration of information technology and systems development with the needs of the particular business units that are being serviced. The Executive General Manager of each unit is responsible for the IT needs and development of their unit.

Production Services is responsible for all common technology infrastructure across ASX. This includes all hardware, operating systems, telecommunications, desktop devices, printers and trading platforms. The unit is responsible for the purchasing of all of the technology needs of the organisation and provides a central points for information technology oversight and coordination. Electronic security and disaster recovery are two other critical areas of responsibility. The group is also responsible for setting system standards and technology policy for all infrastructure needs. The major ASX systems are SEATS, CLICK, CHESS, DCS, CAP, NIPPA and Internet services.

### Assessment process

#### *Documents and information reviewed*

During our assessment, we reviewed ASX documents on business continuity and recovery planning.

#### *On-site interview*

We interviewed the Executive General Manager, Production Services and the Risk Manager, Financial Services. Topics included:

- the overall structure of the Group, how IT is incorporated into the ASX group and who is responsible for IT;
- IT budget allocation, particularly the determination of the supervisory component;
- the level of business continuity and recovery planning and testing;
- systems development planning and implementation;
- the degree of IT outsourcing; and
- IT security.

### Observations

#### *IT strategy*

Information technology strategy is determined by the ASX Technology Architecture Planning Group (ATAP). This group is composed of the key technology managers for each specific business division as well as the EGM Production Services, the Chief Operating Officer and the Deputy Managing

Director. This reflects the importance of IT to ASX's business. The EGM Production Services is responsible for the technology infrastructure components strategy including the hardware specifications, operating system standards and versions, security standards and communications directions. All other components of technology strategy have distinct owners. ATAP endorses these strategies and arbitrates on exceptions to the strategy. An individual business can request an exception to the standard for strong business reasons and ATAP will consider this. Each business unit is responsible for their specific applications with respect to development, testing and quality assurance of each.

#### *System changes*

All business units test changes to trading systems independently before they are implemented and go live. A Change Management Group meets every week. Updates occur on a monthly basis and are listed on a change register. ATAP is aware of all changes to the systems, and they are also mentioned at Executive Council meetings.

#### *Business continuity planning*

With respect to business continuity planning, testing is undertaken throughout the year. Recovery exercises, involving different scenarios, are conducted regularly to test recovery times.

#### *SEATS outage*

On 7 November 2002, ASX's SEATS trading platform went down for a period of approximately 4 hours. ASIC requested and received a report from ASX about the system outage and has asked ASX to implement revised procedures for advising ASIC of major system outages.

SEATS outages are very rare, however, and ASX's technology would appear to be generally a strong factor in contributing to its ability to operate a fair, orderly and transparent market. According to ASX's annual regulatory report, the SEATS trading platform recorded a system availability average of 99.94% and the DTS recorded a system availability of 99.88% for the year ended June 2002.

### **Recommendations**

ASIC has no recommendations on ASX's use of technology.