



ASIC

Australian Securities & Investments Commission

REPORT 35

Market assessment report: Bendigo Stock Exchange Limited

November 2004



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C) report

Bendigo Stock Exchange Limited
ACN 087 708 898

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Executive summary

This report is an assessment of compliance by Bendigo Stock Exchange Limited (BSX) with its obligations under s792A(c) of the *Corporations Act 2001 (Cth)* (Act). This is our second assessment of BSX.

Section 794C of the Act requires the Australian Securities & Investments Commission (ASIC) to assess how well a licensed market operator is complying with its obligations as the holder of a markets licence and, in particular, whether a market operator has adequate arrangements for supervising the market it operates.

In this report we also consider the recommendations we made in last year's assessment. We comment on whether, and to what extent, BSX has acted to rectify shortcomings identified then.

How we conducted this assessment

In conducting this assessment, we:

- reviewed BSX's books, including policies and procedures for the conduct of its markets in general and its supervisory responsibilities in particular; and
- interviewed selected BSX directors, management and staff.

We also considered BSX's *Annual Regulatory Report 2002–2003* (submitted to ASIC on 30 September 2003 under s792F of the Act).

We also considered how well BSX might comply with its obligations in future.

Compliance by BSX with statutory obligations

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

- 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 (now market) rules.

Key observations and recommendations

Overall, we assess that BSX has put in place most of the necessary policies and procedures to ensure that it adequately meets its statutory obligations under s792A(c) of the *Corporations Act*.

Subject to some improvements to ensure accountability for compliance with conflicts of interest policy (which it is making), BSX has addressed adequately the recommendations on specific conflicts of interest that we made in last year's assessment.

ASIC makes some observations and has recommendations for improving BSX's handling of conflicts of interest and its enforcement of operating rules.

Section 1: Background

1.1 BSX Group

BSX was granted a transitional Australian market licence when the *Financial Services Reform Act 2001* (FSR Act) commenced on 11 March 2002.

BSX is a wholly owned subsidiary of BSX Group Holdings Limited (ACN 081 973 293), the major shareholders of which are Small Cap Holdings and Bendigo Bank Ltd (Bendigo Bank). Bendigo Bank is the principal source of debt finance to BSX, providing BSX with an overdraft facility to fund operating costs. Bendigo Bank is also a stakeholder in a significant proportion of the listings on the BSX market.

As at October 2003, BSX had 6 listings. At one time in 2003, BSX had 12 listings, but a restructuring involving eight listed entities resulted in their amalgamation into a single entity. As at November 2004, this had increased to 14 listings. In the financial year ended 30 June 2003 the value of securities traded on the BSX market was \$23,640. The value of securities traded in the financial year ended 30 June 2004 was \$3,850,636.

At the time we made our inspection visit in October 2003, BSX was not yet subject to the full range of *Corporations Act* obligations. In particular during the transition period that ended on 10 March 2004, BSX was not required to have operating rules and written procedures which met the content requirements of s793A or compensation arrangements which met the requirements of division 3 of part 7.5 of the Act. During the transitional period BSX was required to have adequate arrangements for monitoring and enforcing compliance with its then applicable business and listing rules. Accordingly it should be noted that BSX's rules and procedures have subsequently been changed in order to comply with s793A pursuant to the expiry of the transition period.

1.2 The assessment process

Section 794C(2) of the Act requires ASIC to assess whether BSX complies with its obligations in s792A(c) of the Act.

In addition, s794C(1) permits ASIC to extend the scope of its annual report to assess how well BSX complies with any or all of its obligations under Ch 7 of the Act.

We have extended the scope of this report to consider whether BSX is complying with s792A(d), which requires an Australian market licensee to have sufficient resources both to operate the market properly and to provide the required supervisory arrangements.

In conducting our assessment, we took into account the matters set out in ASIC Policy Statement 172 'Australian market licences: Australian operators'. PS 172 explains how ASIC will assess how well a market licensee is complying with its obligations. This is ASIC's second s794C assessment of BSX. Our previous assessment considered BSX systems and processes. Those systems and processes have not changed substantially since that inspection. Discussion of staff roles and business unit processes, except where we comment on improvements or assess them to still be inadequate, is therefore not repeated in this report.

In conducting our assessment under s794C, we:

- analysed information we received from and about BSX in the ordinary course of our dealings with the licensee, including BSX's most recent annual report and BSX's annual regulatory report under s792F;
- analysed information from external sources, including media commentary and material on the BSX website;
- monitored the operation of the market throughout the period, in particular in relation to issues of disclosure;
- interviewed a range of BSX personnel; and
- reviewed internal BSX material, including disciplinary and investigation files, internal reports and information collected by BSX.

Following receipt and analysis of books obtained under notice, from 1 to 2 October 2003 we visited BSX offices in Melbourne and Bendigo and spoke to BSX directors, senior officers and staff. We discussed our preliminary findings with BSX directors and executive management. We have also discussed the final results of our assessment with BSX management, seeking their comments on both the factual matters set out in this report and our conclusions.

Section 2: Recommendations

2.1 Overall Compliance

After making our assessment, ASIC concludes that BSX 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:

1. No serious market failures or disruptions came to our attention.
2. In most instances the business rules, listing rules and guidance notes provide an adequate framework for a fair, orderly and transparent market.
3. Supervision and monitoring of the conduct of participants and trading are conducted adequately, and are guided by policies and procedures consistent with statutory obligations.
4. During the course of our interviews, key management and staff responsible for supervision demonstrated a strong commitment to their supervisory role, and we saw no evidence that undue influence from commercial interests was directed at supervisory staff when making supervisory decisions.
5. Our review of operational records on supervisory decisions showed that:
 - decision making on supervisory matters is decisive; and
 - BSX conducts ongoing supervision of its participants and listed entities.
6. BSX has sufficient market infrastructure (including technology) to support its obligation to maintain a fair, orderly and transparent market.
7. BSX demonstrated a strong commitment to educate its listed entities in their obligations under the listing rules.

2.2 Recommendations arising from our first assessment

In our first assessment report we recommended that BSX:

- more formally structure the way it plans for and assesses the allocation of resources for conducting supervisory activities; and
- periodically report its financial position to ASIC.

BSX has responded adequately to both these recommendations.

BSX action in response to the other recommendations made in our previous report was generally adequate, although some further action is still required.

BSX has addressed recommendations relating to conflicts of interest arising from the business interests of its individual employees, managers and directors. Fine tuning is needed for governance structures and to address systemic conflicts of interest that flow from BSX's business plan.

2.3 Focus for our second assessment

Although s794C of the Act says ASIC should report on an Australian market licensee's compliance with s792A(c), it also permits ASIC to extend the scope of its report to assess how well a licensee complies with other obligations under Ch 7 of the Act. We have decided to consider whether BSX meets s792A(d) of the Act, the obligation to have sufficient resources for the operation of the market in a fair, orderly and transparent manner, including sufficient resources for the supervision of the market. This is important as BSX is a start-up market, and therefore does not generate an operating profit. We wanted to test that it nonetheless has adequate resources for the operation and supervision of its market.

s792A(c)(i)

Under s792A(c)(i) of the Act, BSX must have adequate supervisory arrangements for 'handling conflicts between [its] commercial interests ... and the need to ensure that the market operates [in a fair, orderly and transparent way].'

At PS 172.87 – PS 172.91 we state that an Australian market licensee will have met its statutory obligation to have adequate arrangements to handle conflicts if it:

- complies with regulations under s798E;
- identifies reliably, and appropriately responds to, actual or potential conflicts; and
- separates, with appropriate organisational and reporting structures to a significant degree, its commercial activities from its supervisory activities.

Currently no regulations under s798E apply specifically to BSX.

Conflicts

Has BSX fully identified the various types of potential or actual conflicts of interest that it must deal with?

Any Australian market licensee must address conflicts of interest between its commercial interests and the need to ensure that the market it supervises operates in a fair, orderly and transparent manner. As with any shareholder-owned market operator, BSX faces the potential for conflict between its commercial interests, with the objective to maximise profits for its shareholders and its obligations as an Australian market licensee to supervise its market. In addition, the potential for actual or perceived conflicts also arises from some of the specific characteristics of the way BSX has structured its ownership and operations. Its arrangements for handling conflicts of interest need to identify all such potential conflicts.

Identifying general conflicts of interest

In its "Issues Paper on Exchange Demutualisation", the IOSCO Technical Committee stated that:

The commercial role of an exchange is to provide services to generate revenues from listing, trading services, settlement fees, fees for membership and charges for the sale of market information.¹

As with any for-profit exchange with public supervisory responsibilities, BSX faces the potential for actual or perceived conflict, and may be less willing to commit resources to enforcement, or to take action against market users and listed companies, who are a source of income for the exchange.² In determining its allocation of resources, in setting its rules and in undertaking its supervision, BSX must balance those interests, and ensure that it continues to meet its obligations as a market operator under the Act. The potential for conflict may be heightened for a start-up market, which may seek to impose lighter regulatory burdens than its competitors.

BSX also faces the potential for actual or perceived conflict arising from the fact that a bank, Bendigo Bank, is a significant shareholder and has a policy of encouraging its community banks to list on BSX. In these circumstances, it is particularly important that conflicts are first, identified, and, second, dealt with by appropriate policies and procedures. Conflicts of interest may also arise when key market licensee directors and executive staff hold substantial shareholdings in a listed business, or

¹ Report of the Technical Committee of the International Organisation of Securities Commissions, "Issues Paper on Exchange Demutualisation", June 2001 (IOSCO 2001), p.6

² IOSCO 2001p.7

are participants in the licensee's market, or have a commercial interest in listed disclosing entities or those applying to list.

In its regulatory s792F annual report, BSX identifies some of its conflicts of interest.

Although BSX does not specifically address its overarching conflicts of interests, such as the temptation to seek competitive advantage through adopting lesser supervisory standards, or permitting itself to be a mechanism for marketing the products of controlling shareholders, it does implicitly recognise their existence through its creation of measures to anticipate and address their possible effect. The need to more explicitly identify general conflicts and the efficacy of these measures to deal with conflicts is discussed below.

Identifying concrete/individual conflicts of interest

A number of specific conflicts of interest were examined in some detail in our first s794C assessment, and their existence was acknowledged by BSX in its response to our report. They are, therefore, now identified adequately.

At the time of our inspection and in documents given to ASIC BSX identified some specific conflicts.

- Mr Michael McCartney is a director of one of the two BSX participating organisations: AR Stratagem Investment Services Pty Ltd. He is also a director on the BSX Group Holdings Ltd board, chairman of the subsidiary licensee BSX board, and a member of three of the four BSX board committees (the Regulatory Policy, Listings, and Review committees).
- Mr Geoff Green, who is a major shareholder of BSX through the entity Small Cap Holdings Ltd, was also a director of BSX Group Holdings Ltd and a member of its subsidiary, the BSX Regulatory Policy Committee. ASIC notes that Geoff Green has now resigned as director of BSX Group Holdings Ltd and is no longer a member of the aforementioned committee.

In a presentation to ASIC on 2 October 2003, BSX recognised there might be perceptions of ongoing key staff conflicts and demonstrated that it continues to fine-tune arrangements to neutralise these perceptions.

Identification of conflicts at present is adequate.

How does BSX respond to conflicts it has identified?

ASIC's concerns about conflicts of interest generally were outlined on page 11 of our first assessment report (dated July 2003), where we stated:

‘BSX needs to establish more comprehensive arrangements to handle ... conflicts.

We believe that BSX should allocate responsibility for identifying conflicts and developing adequate arrangements to handle conflicts to an appropriate person or decision-making body of BSX.’

BSX responded, in a letter dated 15 April 2003, that:

‘BSX has commenced a more detailed written description and documentation of the protocols regarding conflict of interest in its organisation and management’s view is that a chapter of the procedures manual will be developed to address this issue.’

On 7 July 2003 BSX appointed a Markets Manager, at executive management level, to have responsibility for compliance matters. The Markets Manager reports to the BSX Managing Director, but may also take matters directly to the BSX board Regulatory Policy Committee.

In last year’s annual assessment we expressed concerns about unidentified and unaddressed individual conflicts of interest potentially affecting BSX directors, managers and employees. We suggested that clear accountability be established for identifying and dealing with these potential conflicts.

In response to our report, BSX has drafted a Corporate Governance Policy document that squarely addresses the matter. The document states that conflicts of interest must be disclosed:

- where the interest of an employee as a private individual interferes or appears to interfere with the interests of the company as a whole; or
- where the Board, in advance of committing, must approve contracts with directors, or entities in which directors have a significant interest and/or influence.

Further, BSX employees may not take advantage of information or opportunities that arise through their BSX responsibilities.

ASIC’s view is that this shows that in general BSX now responds adequately to individual conflicts. Some minor matters still need attention, and these are elaborated in our recommendations below.

We consider that some further fine-tuning is required to address general conflicts of interest involving Bendigo Bank and general conflicts that arise from BSX’s business imperative to increase the number of its listings to reduce its dependence on Bendigo Bank debt finance.

We noted in our first assessment report that:

‘Bendigo Bank Limited (Bendigo Bank) is a significant shareholder and creditor of BSX with around 18% of BSX Group (the holding company for BSX). It is also a key stakeholder in the proposed listing of entities in the Bendigo Bank Community Bank network. Executives of Bendigo Bank are directors of BSX Group and an executive is a member of a BSX committee.’

‘BSX has no particular arrangements for dealing with potential conflicts involving Bendigo Bank’s role in BSX.’

‘BSX was also unable to identify where responsibility for considering BSX’s obligations under s792A(c)(i) rests within the BSX organisation.’

BSX’s response was to give the newly appointed Markets Manager reporting access to the BSX board’s Regulatory Policy Committee. We note that the charter of the Regulatory Policy Committee does not currently include policy relating to conflicts. The board committee that does have a formal mandate to consider conflict issues in the context of business risk is the BSX Group board’s Remuneration Committee. At its meeting of 2 July 2003 the Remuneration Committee discussed conflict of interest policy.

The Remuneration Committee, however, is not a sub-committee of the licensee board, and included as one of its three members the CEO of Bendigo Bank.

We are satisfied that the BSX Group Holdings board and the BSX board are both aware of their statutory responsibility to identify and deal with general conflicts of interest stemming from its business model. However, BSX has still to put fully into place policies, board structures and procedures, and redraft manuals, to explicitly identify general conflicts, especially those involving the commercial interests of Bendigo Bank.

A start has been made, but we believe it has not gone far enough. BSX has responded thus far to these types of conflicts in various ways. These include the division of responsibilities between the BSX board and the BSX Group Holdings board, with the latter having responsibility for business development issues and the former having responsibility for regulatory issues; BSX staff key performance indicators determining accountability for compliance matters; and the composition of BSX board committees with a requirement for BSX directors to absent themselves from board committee discussions when their interests are affected in a regulatory context.

At the time of ASIC's visit, the charter to consider the risk of regulatory failure was sheeted to a board subcommittee of the parent BSX Group board, rather than to a subcommittee of the licensee BSX Limited board. The anomaly in this structure was that the three-person subcommittee of

the BSX Group board with the mandate to deal with conflicts of interest, the BSX Group board Remuneration subcommittee, may itself have been considered unavoidably conflicted due to the presence on that subcommittee of the Bendigo Bank Group Managing Director who is also the key driver of Bendigo bank's Community Bank initiative.

We believe that in order for there to be effective accountability for both avoidance of conflicts of interest, and risk of regulatory failure, responsibility should better rest with an independent committee of the board of the licensee company rather than with its parent entity.

One example illustrates why we recommend that BSX Group Limited transfer to a subcommittee of the licensee board the formal charter to consider its statutory obligations and risk of regulatory failure: BSX has entered into a formal memorandum of understanding (MOU) with Bendigo Bank for the handling of the planned listing of up to 155 Bendigo Bank–franchisee community banks. Listing of community banks will involve granting standard waivers from BSX listing rules to permit: limits on the voting rights of shareholders; powers to deny registration of change of legal interest in shares; and potentially for prospectuses through reissue to remain open for more than 13 months after listing. Although Bendigo Bank does not control Community Banks or have any shareholding in Community Banks (except in one company), and each of the Community Banks has its own board of directors, Bendigo Bank remains the franchisor and is, accordingly, a key stakeholder in all the community bank listings on the BSX. There is, therefore, a systemic risk that waivers will be more readily granted to entities linked to BSX stakeholders, such as Bendigo Bank, that seek listing, than to wholly independent applicants.

In the interests of transparency and in order not to subvert the Ministerial disallowance process in relation to changes to its operating rules, we recommend that BSX take steps as soon as possible to formally amend its rules, rather than rely on systematic waivers, to permit the listing of community banks.

BSX advises that the conflict of interest involved in the community bank listings will be dealt with through enhanced disclosure to investors. Participating organisations will be required to obtain signed declarations from investors that they appreciate the unique nature of community bank listings. BSX has placed on its website a gateway that requires acknowledgement by those seeking market information on community bank listings that they understand that community bank investments have a 'one-shareholder-one-vote' constitution and BSX brokers will require those wishing to buy shares in community banks to complete a declaration acknowledging their understanding of disclosures relating to embedded control.

BSX should formally identify general conflicts of interest inherent in its business plan and respond to these conflicts by empowering its most senior market supervision manager(s) to report directly to a board committee, preferably a subcommittee of the licensee board, which has a mandate to deal with risk of regulatory failure. That board committee should be made up of independent directors.

In addition, as the BSX market grows we would expect BSX to put in place barriers to exchange of information between its supervisory and business development staff.

Other governance structure comments

The appointment, during the period under review in this assessment, of a dedicated Markets Manager, in effect a chief regulatory officer, reinforces accountability and gives added assurance that BSX will continue to address its statutory obligations. In our view the Markets Manager should be empowered to raise directly with the licensee board committee responsible for regulatory risk any concerns that regulatory obligations are being overborne by commercial interest.

As for the other overarching general conflict of interest—the temptation of a start-up exchange to seek competitive advantage through applying lighter regulatory standards than its competition—we saw clear examples of enforcement of listing rules by BSX that demonstrated that BSX had not succumbed to this temptation.

s792A(c)(ii)

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

At PS 172.92 – PS 172.101 we say that adequate arrangements will include continuous electronic monitoring and/or physical inspections of participants’ offices to ensure compliance with the business rules (i.e. those relating to brokers’ capital liquidity and trust accounts).

In October 2003, when we conducted our inspection visit, BSX had two participating organisations admitted to its market: AR Stratagem and ABN AMRO Morgans. ABN AMRO Morgans is also a participant in ASX’s market; AR Stratagem is not. (A third participant, AFS Investment Services, resigned as a BSX broker on 20 May 2003.)

BSX requires that participants keep a complaints log, which BSX inspects on compliance visits.

BSX had conducted a compliance inspection visit to AR Stratagem, but had not yet inspected ABN AMRO Morgans, which was admitted as a BSX broker on 4 June 2003.

We have examined BSX records relating to inspection visits to its participating organisations, and studied the BSX Brokers Surveillance Plan and BSX Procedures Manual. We assess them to be adequate.

MOU with other market licensees re participant capital liquidity

One issue needs comment. BSX, when admitting ABN AMRO Morgans to its market, exempted it from reporting its capital liquidity position under Chapter 3 of the rules, provided that the company supplied its ASX returns to BSX. We expect that in future BSX market participants that are already admitted to the ASX will also seek this waiver.

BSX capital liquidity requirements are based on balance sheet items, whereas the ASX takes a somewhat different approach. BSX tests for surplus liquid capital, and has a broad test for current assets, an absolute acceptance of approved subordinated debt, and a lack of margining (or 'haircutting') on house positions. ASX methodology is to apply liquid capital against specified risks to settlement arrangements.

In terms of absolute base minimum requirements, the ASX regime specifies a larger base minimum liquid capital than that specified by BSX. Our view is that the ASX system offers the market good assurance.

The Financial Requirements of the Australian Financial Services Licence, set out in ASIC Proforma 209, will bind ABN AMRO Morgans and future BSX participants also admitted to ASX.

Accordingly, ASIC views as adequate the projected BSX arrangements for monitoring the minimum liquid capital of brokers that are admitted to both its own market and that of ASX. In our view there is no clear regulatory benefit in imposing both ASX and BSX liquidity regimes on the one participant.

BSX informed us that it was seeking a formal agreement with ASX for providing, on request, risk management analysis of the capital liquidity of organisations participating in both markets. We agreed with this suggested course of action and judge that it will resolve this issue, provided ASX agrees to release to BSX 'early warning' notification of breach events. We have seen a draft of this MOU, and understand it was finalised between NSX, ASX and BSX in May 2004.

s792A(c)(iii)

Under s792A(c)(iii) of the Act, BSX must have adequate supervisory arrangements for 'enforcing compliance with the market's operating rules'. Regulation 7.2.07(g)(ii) requires that, from March 2004, BSX must have arrangements in place, if appropriate, for disciplining listed entities that breach its operating rules.

On the subject of participants, PS 172 says we will have regard to whether there:

- are disciplinary panels for participants breaching business rules; and
- is transparency of disciplinary findings against participants.

PS 172.86(d) states that ASIC will assess a licensee's compliance with its statutory obligations by considering how it deals with actual or suspected breaches of the law or the market's operating rules, including remedial, disciplinary and other deterrent measures.

We have examined BSX arrangements for enforcing compliance with its business rules and conclude that they are adequate.

In relation to listed disclosing entities, market licensees in this country have not generally used disciplinary panels to enforce listing rules. We accept that enforcement of listing rules may be achieved through use of a number of 'soft compliance' tools, such as publication to the market of a listed entity's response to a 'please explain' letter, and through possible use of the suspension power. However, we consider that the principal function of the suspension power is as a means of ending a disorderly market rather than as a means of enforcing listing rules, although its use may have disciplinary effects.

BSX recently used its suspension power as a disciplinary tool. Three listed entities were suspended for failure to disclose half yearly results. In response, the required disclosures were made and all entities reinstated within 24 hours of suspension.

At this stage in the growth of the BSX market, we believe BSX has demonstrated that it is able to effectively enforce its listing rules against listed disclosing entities, using existing tools.

As at the date of this report, we assess that BSX procedures do permit it to enforce its listing rules adequately.

Some further examples will demonstrate how BSX has enforced its listing rules despite the absence of disciplinary tribunals. One instance involved BSX taking the initiative to suspend a listed entity that resolved to change its constitution without prior sufficient market announcement. The constitutional change initiated by the companies involved the entrenchment of responsible entities, and the redemption and reissue of securities. When contacted, the companies involved declined to request a trading halt. BSX imposed a suspension from trading until the reconstruction was finalised.

Another instance demonstrating active enforcement of listing rules occurred when BSX identified late lodgement of s205G disclosures of

changes in a listed entity's director's share holdings. BSX immediately contacted the company to put it on notice, and consequently obliged it to remedy the situation on the basis that disclosure of potentially price-sensitive information was required.

Announcements of changes in directors' interests

Any dealing in the securities of entities listed on the BSX market by directors of those entities is likely to be considered by investors to be material information. There is no listing rule at present that requires the listed entity to obtain this information from its directors and, where it is material, to disclose it to the market immediately. We recommend that BSX consider requiring listed entities to disclose changes of interest by directors in the listed entity's securities.

Insufficient or delayed announcements

BSX Procedures Manual, Part 5, page 5-3, sets out the procedures to be followed by the Listings Manager when clearing announcements before publication to the market.

BSX actively vets announcements for accuracy and completeness before their publication to the market to ensure that investors are not misled or deceived. This lessens the prospect that BSX will need to discipline listed entities that make incomplete announcements that mislead the market. Because of the small size of the BSX market, we assess that this active monitoring of announcements is likely to be effective. BSX advised us that, if its monitoring failed, it would use its suspension power as a means of disciplining a company that made an incomplete announcement that led to a disorderly market.

Our inspection visit established that BSX followed these announcement-vetting procedures in practice. In the case cited above, where companies had commenced restructuring without calling a trading halt or announcing their intention to the market, BSX suspended the company as soon as it was aware that the market was uninformed of the material event.

Some BSX practices contributed to an uninformed market. We noted tardy postings on the BSX website of announcements, particularly of directors' shareholdings upon initial market listing, and a lack of procedures for announcing the lifting of trading halts and suspensions. These are not significant issues at this stage, but will require attention. BSX acknowledged the need to improve procedures to address these matters.

In our view, given the current size of the BSX market, its current policies and procedures are adequate.

Resources to operate the market and provide supervisory arrangements

Under s792A(d) of the Act, BSX must have sufficient resources to operate the market properly and provide the required supervisory arrangements. Although not required by s794C of the Act, we have assessed BSX compliance with this statutory obligation as a separate and ancillary matter.

At PS 172.102 – PS 172.106, we said the measure of compliance (in relation to s792A(c)) would be that BSX must assess the amount it spends, and that resources must be sufficient to fund on-going supervisory costs.

In its annual regulatory report for 2002–2003, BSX stated that it spent \$220,000 on supervision of its market, an increase of \$120,000 on the preceding financial year. This amount reflects salaries for staff with compliance and market supervision roles. As a start-up market, BSX's systems and technology costs are not yet substantial.

In response to a recommendation in our first s794C assessment, BSX has agreed to provide ASIC with a quarterly cash flow report. This gives us confidence that we will be able to assess regularly BSX's capacity to continue to fund on-going supervisory costs.

BSX has increased its overdraft facilities to ensure it has sufficient working capital to maintain its business, but it will need to raise additional capital over the coming year.

After completion of our inspection visit to BSX it came to our attention that, when BSX had sought approval to operate a stock market, it had made an undertaking to have insurance backing for a scheme to compensate retail clients for the fraud and defalcations of BSX participants, but that this had not been effected.

This appears to have been an oversight. No claims have thus far been made on BSX's fidelity fund, and the oversight has now been made good by introduction of a compensation scheme, required by Part 7.5, Division 3 of the *Corporations Act*, which took effect with a variation to the BSX Australian market licence at the end of the BSX licence transition phase on 11 March 2004.

Section 3: Conclusions and recommendations

3.1 Supervisory arrangements – s792A(c)

Our first s794C Assessment: Supplementary recommendations

Regarding compliance with s792A(c), in our last assessment we recommended:

‘As BSX seeks to increase its number of listings, its arrangements for handling conflicts will need to be strengthened. We also believe that BSX should amend its organisational structure to incorporate a coordination and oversight role in its arrangements for handling conflicts. BSX has indicated that it is reviewing its organisational protocols, including the detail in which its arrangements for handling conflicts are documented as written procedures.’

We are generally satisfied that BSX has acted adequately to remedy deficiencies.

We note that BSX, on 7 July 2003, appointed a dedicated Market Manager with responsibility to improve supervisory procedures, including those relating to participants.

BSX has restructured board committees, written board committee charters, and revised supervision policies, manuals and procedures. Some of these processes need to be fine-tuned, and below we note supplementary recommendations.

As noted above, BSX enforcement of its listing rules, and in particular its enforcement of continuous disclosure and examination of periodic announcements for accuracy and completeness, is adequate. As the BSX market grows, we expect that consideration will need to be given as to whether other tools to address breaches of BSX listing rules would be appropriate.

Our second assessment: Recommendations

We noted above that we did not believe BSX had, as yet, identified overarching or general conflicts of interest in its policy and procedures documentation. At the time of our visit, the Remuneration Committee of the board of the holding company, BSX Group Holdings Limited, was responsible for identifying and addressing conflicts impacting its subsidiary, the licensee. Because of the demarcation between the holding company board, which has responsibility for business development matters, and the Australian market licensee board (i.e. BSX Limited),

which has responsibility for regulatory obligations, we believe it would be more appropriate if all regulatory risk matters rested with a subcommittee of the licensee's board.

Recommendation 1

BSX's business model allows a less-than-adequate identification of fundamental conflicts of interest, (discussed above). We therefore recommend that one of the BSX board committees, preferably the licensee's audit committee, be given the responsibility of identifying conflicts of interest, and that the relevant board committee's charter be amended to reflect this. The selected board committee should be made up of independent BSX directors.

BSX has flagged to us that it intends to appoint more independent directors to its board. This should allow it to readily rectify this shortcoming.

Recommendation 2

The charter of the committee charged with identifying intrinsic general conflicts should also include a role for the committee to develop policy regarding escalation of matters to board level when situations arise where BSX management propose business developments which, in the view of the Markets Manager, will potentially undermine effective regulatory processes.

Recommendation 3

The Markets Manager should be empowered to raise directly with the licensee board committee responsible for regulatory risk any concerns that regulatory obligations are being overborne by commercial interests.

Recommendation 4

Listing rules should be introduced for community banks, and for other "community" business model listings, to remove the need to issue standard waivers. Community bank-specific listing rules should make provision for higher disclosure obligations.

Recommendation 5

Formal arrangements with ASX to exchange capital liquidity information about shared participants should be negotiated.

Recommendation 6

BSX should consider requiring listed entities to disclose changes of interests by directors in the listed entity's securities.

3.2 Sufficient resources

In our first assessment we said that BSX should report information about its financial position to us more regularly. This process has been put in place.

We are confident that, given the current size of BSX's market, and since the appointment of a dedicated Market Manager in July 2003, BSX has committed adequate resources to monitoring its market and to enforcing its operating rules.

3.3 BSX responses and changes

BSX were provided with a copy of a draft of this report and has advised ASIC of changes BSX has made or which BSX proposes to make in response to the recommendations set out above.

In particular, BSX has advised of changes to its conflict handling arrangements. The board of BSX has adopted a new charter to develop identify, monitor and manage conflicts of interest within BSX. The charter also provides for the Market Manager to report conflict issues directly to the BSX board. ASIC will consider the adequacy of the changes in its next assessment of BSX which will occur prior to 11 March 2005.

BSX has also drafted amendments to the listing rules in relation to the listing of entities in the Bendigo Bank community bank network. ASIC has discussed the draft amendments with BSX and we expect BSX to provide ASIC with a further version shortly.