



ASIC

Australian Securities & Investments Commission

REPORT 82

Market assessment report: Stock Exchange of Newcastle Limited

September 2006



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Annual assessment (s794C) report

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

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Executive summary

Section 794C of the *Corporations Act 2001* (Act) requires ASIC to assess how well a licensed market operator is complying with its obligation to have adequate arrangements for supervising the market(s) it operates.

This report summarises ASIC's fourth assessment of compliance by Stock Exchange of Newcastle Limited (SENL) with its obligations under s792A(c) of the Act.

Our last report about SENL was publicly released on 29 June 2005.

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

Generally our assessment report focuses on suggested areas of improvement in SENL's arrangements rather than on the more positive aspects that support our overall conclusion. It is important to make clear that none of the suggestions for improvement in this report detract from our conclusion that SENL's arrangements have met and continue to meet their statutory obligations.

Compliance by SENL

We conclude that SENL continues to have adequate arrangements for supervising its market, including arrangements for:

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

Our approach

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

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

The regulatory report SENL provided to ASIC and the Minister under section 792F of the Act reviews the supervisory activities it undertook during the year and provides support for our conclusion that SENL is complying with its supervisory obligations.

Section 1: Background

1.1 The NSX group

SENL is a subsidiary of NSX Limited (NSX), a company listed on Australian Stock Exchange Limited. During the period of the assessment, two companies within the NSX group held Australian market licences – SENL and Bendigo Stock Exchange Limited (BSX). ASIC has undertaken a separate assessment of BSX pursuant to section 794C of the Act.

The SENL licence permits SENL to operate a market in the financial products described on its licence. A copy of SENL's market licence is available on ASIC's website at www.asic.gov.au/markets.

1.2 The assessment process

ASIC's role

Section 794C of the Act requires ASIC to assess at least once a year how well a market licensee is complying with certain of its obligations as a market licensee. The assessment must consider whether the licensee has adequate arrangements for supervising the market, including arrangements for handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market it operates is a fair, orderly and transparent market.

A market licensee's obligations are ongoing, and whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance. We therefore use the assessment process to:

- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market in accordance with its obligations under the Act at the time of the assessment; and
- identify issues that in our view need, or may need, to be addressed to ensure ongoing compliance.

Assessment process

ASIC's assessment and the views expressed in this report are a combination of processes - the ongoing interaction we have with SENL in our role as regulator of companies and financial markets, an on-site inspection of books and records and interviews with SENL personnel, and the discussions we have with SENL about the issues that have arisen from our previous assessment processes.

In conducting our assessment we have particularly considered:

- the annual regulatory report given to ASIC by SENL dated 30 September 2005 as required under s792F of the Act;
- information we received from and about SENL in the ordinary course of our dealings with SENL as a market licensee, including:

- information received as part of applications for relief; and
- SENL's most recent annual report;
- information from external sources, including media commentary;
- the operation of the market throughout the period, particularly in relation to issues of disclosure and trading;
- internal SENL material, including information collected by SENL on a continuous basis;
- discussions with senior SENL management; and
- comments made in interviews or discussions with a range of SENL personnel.

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

On 14 and 15 February 2006 we attended NSX Group/SENL offices in Newcastle. During this on-site phase of the assessment we reviewed SENL operational records and spoke to a range of NSX Group/SENL management.

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

1.3 Focus of this assessment report

Our assessment involved a review of various changes made by SENL in response to the key recommendations and other issues made in our previous assessment report.

In April 2005 NSX acquired BSX. Staff changes occurred during the assessment period. We sought to appreciate whether redistribution of duties had had any impact on SENL's performance of its supervisory obligations.

We continued to focus on the quality of SENL's arrangements for managing conflicts and in particular looked to ensure that enforcement of listing rule disclosure obligations of listed disclosing entities, and associated contract-based requirements binding the entities' nominated advisers (NOMADs) and directors, was effective.

We looked in particular at the quality and consistency of supervisory outcomes to assure ourselves that SENL is meeting its statutory obligations to supervise its market.

We also considered specific events that occurred during the relevant period.

Section 2: Observations and recommendations

2.1 SENL is meeting its obligations

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

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

1. No serious market failures or disruptions came to our attention during the course of our assessment;
2. The operating rules and guidance notes provide an adequate framework for a fair, orderly and transparent market;
3. Supervisory staff that monitor the conduct of participants and trading have adequate procedures in place to achieve this;
4. During the course of our interviews, key managers responsible for supervision demonstrated a strong commitment to their supervisory role and expertise in the operations of the market;
5. Our review of operational records on supervisory decisions showed that:
 - o decision-making on supervisory matters is based on sound principles;
 - o SENL conducts ongoing supervision of its participants and listed entities; and
6. SENL has contracts in place to ensure access to good market infrastructure (including technology) to support its obligations to maintain a fair, orderly and transparent market.

2.2 Other observations and recommendations for future action

Conflict management

Corporations Act s792A(c)(i) requires that SENL "have adequate arrangements for handling conflicts of interest between its commercial interests... and the need to ensure that the market operates" in a fair, orderly and transparent way. In our previous assessment report, we indicated that in ASIC's view SENL needed to implement a more effective structural or functional separation of business and supervisory roles and reconstitute its Listing Committee so that its members are all either independent or SENL supervisory staff.

The SENL board has identical membership with the parent NSX board and the two, understandably, hold combined sittings. In the past the SENL board has played a role in

deciding operational supervisory matters (eg approving listing applications) and ASIC recommended that the SENL board be comprised at all times of at least two independent directors as part of its conflict management arrangements. Since our last assessment special supervisory committees (the Listings Committee and the Compliance & Audit Committee (CAC)) now undertake much of the supervisory decision-making. The SENL board has mandated power to make supervisory decisions to the two SENL supervisory committees, and to the three NSX group supervisory managers: the general manager-operations, the companies manager and the group compliance manager.

The general manager-operations is responsible for market supervision, including trading operations, market surveillance, listed entity disclosure supervision and participant supervision. Together with his staff, the general manager-operations supervises daily trading and clearing and settlement. The NSX group companies manager, based in Melbourne, analyses applications for listing and submits his recommendations to the Listings Committee. In addition to chairing the CAC, the group compliance manager reviews policy documentation and procedures, and conducts inspections of participants.

In our last assessment report we recommended that SENL should ensure that all members of the Listing Committee are independent or SENL supervisory staff. We defined independent to mean a person who has no executive role or interest in the market licensee, whether as a substantial shareholder or as an associate of an entity that is a participant, nominated adviser/sponsor or service provider on or to the market licensee or an employee of those entities. Our view remains that where a mandate to make supervisory decisions is conferred by SENL's board on a committee, the committee should be constituted from independent persons and supervisory staff appropriately shielded from business development influences.

The Listing Committee determines by consensus whether criteria for admission to listing, including the question of "suitability", discussed below, have been met. Since our last assessment SENL has produced a mandate for the Listing Committee and endeavoured to improve documentation regarding Listing Committee decisions. All applications for waivers from listing rules are referred to the CAC for decision. The CAC has rejected applications for waivers despite them having been submitted to it with a recommendation that they should be granted. This indicates that it exercises independent judgement. The CAC also considers monthly reports from the Exchange Examining Accountant (EEA) on participant returns and from the compliance officer following his on-site inspections of participants. It makes final decisions on applications to become a SENL participant, nominated adviser or facilitator. It considers complaints and issues involving contact with ASIC.

The SENL Listing Committee at the time of our on-site visit to SENL was made up of the CEO/managing director, together with the general manager - operations and the group compliance officer. SENL's CEO is centrally involved in business development and owns a little less than three percent of NSX's issued capital. The other two members of the committee at that time did not have a business role at SENL.

The NSX Group compliance officer, who does not have any business development responsibilities, chairs the CAC. No member of the CAC is involved in developing business strategies.

On 4 July 2006, following our onsite review and provision of findings to SENL, NSX Limited announced that its board of directors had approved and mandated two separate committees, the NSX Listing and Admissions Committee and the NSX Compliance Committee, to manage listing and admissions and to manage compliance. Both committees have a majority of independent members and are comprised of people external to the NSX and BSX operating entities.

Supervision

The statutory supervision obligations of a market licensee are framed in terms of requirements to monitor the conduct of participants and to enforce compliance with both the rules addressed to participants and those relating to listed entity obligations.

Participants and market conduct

In our last report we recommended that a log of participant rule breaches and other referrals to the compliance officer be kept, that policies be prepared to identify matters that should be dealt with by the CAC and those that needed to be referred to ASIC, and that a register be maintained of action taken following identification of breaches.

During our assessment we examined participant files maintained by SENL to ensure that monthly filings by SENL's participants had been lodged as required with the contracted EEA (McCosker & Partners Pty Ltd), that the returns addressed the reporting obligations contained in the business rules, and that where failures were identified, appropriate follow-up by SENL supervisory staff was undertaken.

For most SENL participants SENL has comfort that where an SENL participant is also a member of the ASX they are allowed to submit their ASX returns instead of an SENL return. To provide further assurance, SENL has an MOU with ASX that requires ASX to share information about market participants that they have in common. Some SENL participants, however, are not also ASX participants. Under the SENL business rules, participants who do not lodge a copy of their return prepared for ASX are required to lodge a monthly statement with the EEA demonstrating that they have not less than \$50,000 in surplus liquid funds or 5% of adjusted liabilities, whichever is greater. They are also required to lodge a list of aged debtors and, upon renewal, a copy of their professional indemnity insurance certificate.

During the on-site visit we checked that annual on-site inspection visits to individual participant premises were performed by the compliance officer and shortcomings identified both by the EEA and from analysis of returns lodged in response to SENL's annual self-assessment questionnaires were addressed. We noted that when the EEA had reported late lodgements, these omissions were registered and remedial action was taken by the compliance officer, including reporting for information to the CAC. Some non-ASX SENL participants did not report aged debtor information and this did not appear to have been addressed. SENL have advised us that the EEA has now been informed of the need for this information to be lodged in monthly reports and that, in future, reports of on-site inspection

visits conducted by the SENL compliance officer will record in greater detail participant compliance with the full range of their obligations.

Generally, there has been some progress since our last assessment towards addressing our concerns about identification of business rule breaches and registration of action taken in response. SENL has created a Log of Breaches for Participants or Listed Issuers and a Register of Disciplinary Actions, which the compliance officer reviews. It has also produced a policy document on its compliance activities, which distinguishes between the various executive officers' accountability for supervisory determinations and consequential reporting obligations including for notifications and referrals to ASIC. Documentation on participant files has improved and the minutes of the CAC serve as a record of action.

Recommendation 1

SENL should continue to improve its record-keeping in relation to identification of business rule breaches and SENL supervisory responses and reporting of matters to the CAC. In particular, on-site inspection visits to participants should be recorded in greater detail or, alternatively, if inspections are discussed at meetings of the CAC, the minutes of the meetings should be more detailed.

Market Surveillance

In our previous report we noted that SENL had improved its market surveillance capabilities. SENL has continued to improve these capabilities. SENL now produces a daily report on not only volume and price movements but also each bid, offer, system purge, cancelled trade, amended bid, amended offer and completed trade. In August 2005, SENL deployed new surveillance software that has improved record keeping functionality. SENL now uses a web-based system for detection of intra-day trading anomalies in price, volume and value. The SENL general manager sets the system parameters. Trades that fall outside the parameters generate an alert. We examined the parameters and believe they are appropriate. Alerts are filed in date order and may be retrieved for subsequent analysis. If a breach is identified, SENL procedures require that ASIC be immediately notified.

Listed entities

Admission criteria

The SENL listing rules set out the criteria for admission to the SENL official list. For start-up entities the requirements, among other things, are that there be a free float of 25%, a minimum of 50 shareholders and an initial market capitalisation of \$500,000. For entities that have an established trading history, they are required to be suitable for listing and have an adequate track record. For entities with a trading history, to a considerable degree, determination of suitability for listing remains a matter for judgement on a case by case basis.

Since August 2005, the NSX group's companies manager has processed applications for admission to the SENL official list. The companies manager now analyses all listings for the SENL and BSX markets. Given the current size of the two markets, and the volume of new listing applications, we accept that a single employee is presently sufficient for this purpose.

Only if the companies manager is satisfied that an applicant meets the criteria for listing, and is suitable for the SENL list, will the application as a whole be forwarded to the Listing Committee for their consideration, with the Listing Committee in its turn forwarding waiver requests to the CAC for determination. The Listing Committee also considers, in making its decision, the suitability of an entity for listing.

In our last assessment report we said that SENL needs to make a positive determination that an entity is suitable for listing on the market rather than considering an entity suitable as soon as other significant listing criteria are met. During this inspection visit, we saw evidence that the companies manager had rejected applicants for listing on the basis that they were unsuitable. So filtering on the basis of "suitability" is occurring.

ASIC recommended in the last assessment report that SENL should develop policy to guide the determination of whether an entity is suitable for listing. SENL has advised that it considers its existing listing rules, Listings Committee mandate and document entitled "NSX Policy on Suitability for Listing" to be sufficient to guide its supervisory staff. Despite this, we continue to have some reservations about determining the suitability for listing of mutual entities, companies that do not issue a fund-raising document in conjunction with their listing application or entities whose main business is in jurisdictions that do not have similar financial reporting, audit and other reporting standards to those that prevail in Australia. SENL have undertaken to further review its procedures and practice notes in light of recommendations two and three below.

During our on-site inspection we noted that an entity had been admitted to the official list without a concurrent capital raising. In determining whether the entity was suitable for listing and whether it met the criteria for admission to the official list, SENL examined audited accounts and material submitted to SENL to support the application. Upon commencement of trading, despite the lack of a recent prospectus or product disclosure statement, arguably SENL possessed sufficient background information to monitor continuous disclosure obligations of such an entity. This information was not, however, made available to the investing public through publication on the SENL announcements platform.

Recommendation 2

SENL should revise its procedures to guide staff analysing listing applications, especially for "compliance listings" (usually involving the listing of demutualised entities that have retained restrictions on share ownership) or for entities operating predominantly in another jurisdiction. In particular, SENL should document in its internal procedures, and in its public guidance notes, how listing rules on "suitability" and "adequate track record" are to be interpreted and applied to these types of entities.

Recommendation 3

In order to establish a base-line disclosure document for entities that list without a concurrent capital raising, SENL should either require the entity to make the information available as an announcement prior to commencement of initial quotation, or should publish on its announcements platform prior to admitting the entity to quotation, audited financial reports and other material extracts from the listing application. This information is necessary to permit

investors to make informed judgements and for the market to gauge when developments affecting the listed entity's securities following its listing are material.

Monitoring continuous disclosure rules

SENL adopts a two-prong approach to continuous disclosure supervision. It monitors listed entities' material changes in circumstances both through surveillance of public media and research reports, and through NOMAD obligations to the exchange to monitor and advise their listed entity clients of disclosure obligations.

In response to concerns raised in our last assessment report, SENL now conducts daily rather than weekly checks of media using a range of search engines.

The listing rules require a listed entity to appoint a NOMAD to be responsible for advising the listed entity of its obligations under the listing rules. This latter form of delegated monitoring is effective when the NOMAD knows their client entity's business well though other advisory relationships with the listed entity.

To meet the requirements of Corporations Act s792A(c)(iii) and Regulation 7.2.07(g)(ii), SENL has elected to enforce its listing rules, and in particular its disclosure rules, through panels that may discipline either the listed entity, or its directors, or the NOMAD, or all three, for breaches of the rules. In addition to this exchange enforcement of listing rules, or instead of it, SENL may refer breaches of its continuous disclosure rule to ASIC for application of its continuous disclosure fining power or for civil penalty or criminal prosecution action. In the past, SENL has advised us that it may both refer a breach to ASIC and also proceed with its own disciplinary action against the entity, the entity's directors or the NOMAD.

Because most, if not all, entities on the SENL list are SME/micro-cap entities to which little or no research analysis or press attention is directed, SENL may contact NOMADS regularly seeking updates on developments involving the businesses of listed entities.

We examined SENL's record in monitoring the solvency of companies on its official list and poorly performing entities' continuous disclosure to the market. We were satisfied that SENL had maintained regular contact with the latter entities' NOMADS, and that the NOMADS had apparently performed their contractual duty to SENL to monitor client entities and advise the exchange of concerns. When NOMAD advice raised compliance issues, matters were referred to SENL's CAC for determination as to additional steps SENL should take to ensure investors in the entity, and the market generally, were kept informed of material developments. On one occasion, the SENL CAC determined that an entity be required to produce a quarterly cash flow report for publication on the SENL announcements platform.

Listed entity compliance with periodic disclosure requirements

SENL reviews the periodic disclosure of listed entities. It contacts listed entities to remind them when half-yearly and yearly financial statements are due. If financial statements are not lodged on time, SENL automatically invites the entity to seek a trading halt or suspends the entity from trading until the report is announced to the market.

We examined how these policies and procedures were applied in practice. Periodic financial reporting non-compliance by listed entities gives rise to a requirement for more intense

continuous monitoring of the entity following identification of a breach of periodic disclosure obligations. As noted above, SENL's use of NOMADS to monitor listed entities' continuous disclosure obligations following an entity's failure to lodge a half-yearly or annual financial report is in our view an adequate means of identifying breaches of this listing rule.

Some attention still needs to be directed to the monitoring of disclosure of entities' corporate governance practices. SENL has a structured program for ensuring that half-yearly and annual audited financial reports are announced formally to the market. At present SENL does not make a judgement about sufficiency of disclosure in financial reports of corporate governance structures. SENL's view is that it should not dictate what this statement should be as there is substantial literature available, particularly from the ASX Corporate Governance Council. We think there is scope for SENL to provide additional guidance as to minimum expectations so that it is able to make an objective analysis of whether listed entities have complied with their obligation to report the main corporate governance practices they have in place. SENL has agreed to prepare a practice note on corporate governance encompassing SENL's expectations that are especially appropriate for small to medium listed enterprises.

Recommendation 4

SENL should publish a guidance note to communicate SENL's expectations and to assist entities in complying with the corporate governance practice disclosures required by its listing rule 6.9(11). SENL should accordingly revise its procedures to assist staff in determining the adequacy of corporate governance practice disclosures.

Enforcing operating rules

To date, despite identifying breaches of the listing rules relating to periodic disclosure (addressed through suspension), SENL has not convened its disciplinary panel to enforce its listing rules against listed entities, the directors of listed entities, or NOMADS. Nor has SENL identified breaches of its business rules that would require it to take disciplinary action against a participant. The business rules indicate the types of breaches that may result in disciplinary proceedings. SENL needs to articulate when it believes it would be appropriate for it to discipline entities and to be ready to discipline entities, their directors and NOMADs when it forms a view that disciplinary action is appropriate. SENL has a policy document entitled "Policy on Disciplinary Powers", revised in September 2005, but outside the rules themselves there are presently no formal procedures for convening a disciplinary panel, no arrangements to identify a pool of suitable persons from which independent adjudicators may be empanelled, and no guidance material has been issued to the market to explain the disciplinary panel processes, including rules of evidence or the lack of a requirement for them.

Despite a recommendation that addressed this shortcoming in last year's s794C assessment report, as yet SENL has no formal policy and procedures and no public guidance material to give effect to its operating rules that relate to disciplinary arrangements. In our last assessment report we recommended that SENL develop policy and procedures for the conduct of disciplinary proceedings in relation to breaches of the listing rules and of undertakings made as a requirement for admission to the official list by listed disclosing entity directors and NOMADs. SENL has confirmed that it will prepare internal policy for gradation of penalties and issue publicly guidance material and practice notes on its disciplinary arrangements.

Recommendation 5

SENL should issue guidance material to listed entities, participants and the market as to when and how it will discipline entities, directors of listed entities and NOMADS, and participants and their responsible executives, that breach its operating rules, or contractual undertakings.

Recommendation 6

SENL should compile policies and procedures for the conduct of disciplinary panels. To assist SENL supervisory staff and committees, guidance regarding policy for gradation of penalties, whether private censure, suspension, public censure or fines (and the scale applied to different classes of breach), should be prepared.

Sub-boards

During 2006, the SENL board decided to create "sub-markets" for geographical groupings of listings, such as having separate segments of its official list for entities located at Wollongong, Hawkesbury, and so on.

In relation to the creation of "sub-boards" for geographical groupings, Wollongong-based entities that are to be listed on SENL are marketed through a separate website which was created as a consequence of a partnership between NSX Limited and the local chamber of commerce.

Although there is some disclosure on the website to the effect that the listing occurs on the market of SENL, we have some concern that the use of the business name "The Wollongong Stock Exchange" may be taken to infer that the Wollongong sub-list is a separate financial market and that an Australian market licence has been issued for the purpose of its separate operation. This is especially so because the SENL website (SENL official website announcement dated 11 November 2005) conflates licensed platforms with marketing descriptors when it states: "The NSX launched the Wollongong Stock Exchange (WSX) on October 27 and has already established the Bendigo Stock Exchange." If this is the case, then there is a possibility that SENL may be characterised as "holding out" that it is authorised to operate this market as a discrete concern.

In this regard we note that the Corporations Act prohibits an entity from holding out that it operates a financial market in circumstances where it is not authorised to do so and the conditions of SENL's Australian market licence restrict it to the operation of one market.

NSX management have addressed the above-stated concerns by reiterating to the Wollongong City Council and Illawarra Business Chamber that they should not hold out that The Wollongong Stock Exchange is a discrete licensed market.

Recommendation 7

SENL should ensure that marketing of its geographical official list segments does not encourage the assumption that any part of the geographical segment of its official list is a licensed market in its own right.