



ASIC

Australian Securities & Investments Commission

REPORT 41

Market assessment report: Stock Exchange of Newcastle Limited

June 2005



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C) report

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

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Contents

Contents	2
Executive summary.....	3
How we conducted the assessment.....	3
Compliance by NSX	3
Key findings and recommendations.....	4
Section 1: Background.....	5
1.1 NSX.....	5
1.2 ASIC's assessment	5
Section 2 : Recommendations	7
2.1 Conflict handling arrangements	7
2.2 Supervision of the market	13
2.3 Financial resources.....	21
2.4 Other matters.....	22
Appendix 1	24

Executive summary

This report summarises ASIC's assessment of compliance by Stock Exchange of Newcastle Limited (NSX) with its obligations under s792A(c) and its financial resource obligations under s792A(d) of the *Corporations Act 2001* (the Act). This is our third assessment of NSX.

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

How we conducted the assessment

In conducting our assessment, we:

- reviewed the books and records of NSX, including records produced in relation to its application for listing on ASX; and
- interviewed NSX staff and the managing director.

We also considered NSX's Annual Regulatory Report 2003-2004, submitted to ASIC in accordance with s792F of the Act, and had regard to our ongoing interactions with NSX. We also considered how well NSX might comply with its obligations in the future.

Compliance by NSX

In Section 2 of this report, we set out in greater detail our findings and corresponding recommendations. We have formed these views based on our assessment undertaken in February 2005 as well as interaction with NSX since the time of our last assessment. In our view, based on NSX's operating conditions at the time we conducted our inspection of NSX's market (including trading volumes and financial products traded on its market), NSX had:

1. adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c); and
2. sufficient financial resources to continue to operate the market in accordance with its obligations under s792A.

Prior to listing on Australian Stock Exchange Limited (ASX) on 13 January 2005, NSX raised \$12 million in additional capital via a prospectus. As a condition for listing on ASX, NSX is required to make quarterly announcements about its net tangible assets to the market. The concerns expressed in our second assessment report in relation to NSX financial resources are significantly reduced. Our ability to monitor

NSX's financial position is enhanced now that NSX is subject to ASX's listing conditions and the continuous disclosure and periodic reporting requirements.

Key findings and recommendations

In our view, at the time of our assessment NSX had adequate operating rules, structures and policies for the supervision of its market and handling its existing conflicts, but has yet to establish, produce and fully implement procedures for the disciplining of participants and listed entities, including procedures for notifying ASIC of disciplinary action taken.

In ASIC's view, although NSX has attended to nearly all of the inadequacies identified in our second assessment report, it nevertheless needs to:

- Implement its planned additional conflict handling arrangements, including 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 NSX supervisory staff, and develop procedures for its meetings.

We set out the specific details of our concerns in Section 2 of this report.

We have included details of improvements NSX plans to make to its arrangements for the supervision of the market. Indeed, we consider that NSX has structures that, once fully implemented, will ensure adequate separation of supervisory functions from profit-making imperatives.

Prior to January 2005, NSX did not have (in our view) sufficient resources to implement plans for functional separation of its regulatory and for-profit roles. Notwithstanding the then lack of resources, the NSX board committed NSX to proceed with the separation, manifested by the December 2003 appointment of a respected independent compliance officer to chair the Listings and Compliance committees. This key appointment has resulted in a significant improvement in both compliance procedures documentation and in some areas of listed company supervision. Some key procedures still need to be documented.

Since our second assessment, in which we expressed concerns about the adequacy of resources available to NSX for supervision of its market, NSX has raised substantial further capital. There has also been a significant change in NSX's operating performance - in the quarter ended September 2004, NSX recorded a net cash flow of more than \$92,000. As noted, NSX conducted a further capital raising in late 2004 and listed on ASX on 13 January 2005. As a result of these changes, our level of concern regarding sufficiency of NSX's resourcing for market supervision is substantially reduced.

Section 1: Background

1.1 NSX

NSX is continuing to pursue its business strategy of providing a stock market for small and medium size companies. It is actively seeking listing applications from companies throughout Australia, and from New Zealand and China. NSX has one company on its list that is also listed on the New Zealand Exchange Limited (NZX) market and proposes to extend its trading hours to encourage other companies listed on NZX to obtain a dual listing on NSX. NSX has also appointed the first of a new class of recognised agents for NSX listings, known as a 'facilitator', to promote China listings. Most of the companies now on its official list could be described as 'venture capital' businesses. Many of these companies do not have a history of profitable trading, or are investment companies that have raised money on the basis of prospectuses. Some of these companies have invested in financial vehicles that hold assets offshore, or are businesses that have raised funds with defined but nonetheless broad investment mandates.

At the time of our February 2005 inspection visit, NSX had 24 listed entities (controlling 35 listed securities) and 10 participant organisations. Less than two years ago, in July 2003, NSX had 8 listings, with market capitalisation of approximately \$89 million, and negligible trading volumes and values. By 30 June 2004 it had 27 listed securities, with a market capitalisation of more than \$232 million and monthly total value of trading of over \$1 million. In the financial year ended 30 June 2004, the value of securities traded on the NSX market was approximately \$3.9 million.

NSX has arrangements in place with an ASX subsidiary, ASX Settlement and Transfer Corporation Pty Ltd (ASTC), for settlement of transactions that take place on its market, and is registered as an Approved Exchange with ASTC for the purpose of CHESS settlements. NSX does not yet provide for 'delivery versus payment' (DvP) instantaneous clearing. NSX plans to implement DvP, which will require it to lodge a security deposit of \$500,000 with CHESS. NSX has advice that this deposit will not significantly increase costs either for NSX or its participants.

As a consequence of its December 2004 capital raising, and subsequent listing on ASX, the original key shareholders of NSX who at the time of our first and second assessment reports were also directors of NSX, are no longer substantial shareholders of NSX. The dilution of their shareholdings has lessened the severity of conflicts of interest we identified in our second report.

1.2 ASIC's assessment

Section 794C of the Act requires ASIC to conduct an annual assessment of each Australian market licensee's arrangements for the supervision of its market. This involves making a judgement not only as to sufficiency of process documentation but

also whether the market operator is committed to applying the processes. ASIC may also conduct an assessment of how well a market licensee is complying with any or all of its obligations under the Act.

This is the third assessment by ASIC of NSX's compliance with its statutory obligations. Our previous assessment reports elaborated on NSX systems and processes. Discussion of staff roles and a detailed description of business unit processes, except where we have identified concerns, are not repeated in this report. Our assessment is based on ASIC 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.

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.

In conducting our assessment we:

- analysed information we received from and about NSX in the ordinary course of our dealings with it as a market licensee, including NSX's annual regulatory report under s792F;
- monitored the operation of the market throughout the period, in particular in relation to issues of disclosure by listed entities;
- interviewed a range of NSX personnel, including the Managing Director; and
- reviewed internal NSX material, including board minutes, compliance committee minutes, policies and procedures and files in relation to listed entities and participants.

From 24 to 25 February 2005, we visited the NSX office in Newcastle and spoke to the CEO, General Manager, Compliance Officer and the Trading and Settlement Officer.

Section 2 : Recommendations

2.1 Conflict handling arrangements

In its Annual Regulatory Report 2004, NSX states that it has the following arrangements in place for handling conflicts:

- Functional separation of bodies accountable for supervisory decisions - that is, the Listing Committee and the Compliance Committee - from the staff and board of NSX;
- Compliance Officer identification to the NSX board of actual and potential conflicts of interest; and
- Documentation of procedures to address conflicts of interest.

2.1.1 Directors

Independence of directors

In our first assessment report, ASIC recommended that NSX appoint "...at least one more independent non-executive director to its board as soon as possible given its statutory obligation to have adequate arrangements for handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner...."

In our second report we noted that as at the end of May 2004 NSX had only one independent director on the board. We stated in our second report that the continued failure to attract and retain independent directors was becoming a critical issue that must be addressed by NSX as soon as possible.

During our inspection visit to NSX for this report, NSX advised that it expected that following its fundraising, listing on ASX and mooted takeover of BSX Group Holdings Limited and its controlled entities (BSX), it expected that at least three new directors would be appointed to the board to represent the interests of parties associated with BSX.

As at 25 February 2005 NSX has 39,420,003 million shares on issue. A further 1,500,000 partly paid securities, and 2,925,000 options, have also been issued. The total number of shares, if full dilution occurs, will be 43,845,003. Following NSX Limited shareholders' approval of the takeover of BSX on 11 April 2005, a placement of 10,000,000 ordinary shares will be made to BSX, which will result in a full dilution total of 53,845,003 shares. Directors who were substantial shareholders of the company, including the Executive Chairman¹ and the CEO², now each hold less than 5% of NSX shares on issue. As at February 2005, the largest BSX shareholder was Bendigo Bank, which held 55.86% of issued BSX shares. It also had large unsecured

¹ Mr Ray Whitten

² Mr Michael Cox

loans to BSX, which are to be capitalised. Following the takeover, Bendigo Bank will hold more than 11% of the merged entity. If three new directors are appointed in 2005, and provided existing NSX directors do not increase their shareholdings to take them beyond the 5% threshold, NSX will still have two independent non-executive directors.³

Recommendation 1

ASIC recommends that NSX has at least two independent directors at all times. We consider that "independent" means 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. If NSX establishes a board audit and risk committee, independent directors should constitute the majority of committee members. We note however that the requirement in ASX listing rule 12.7 to establish an audit committee is not mandatory for NSX at this time as NSX is not included in the S&P All Ordinaries Index.

2.1.2 Listing Committee

NSX now has a Listing Committee. In our first assessment report, we raised the issue of NSX not having a separate listing committee and of the General Manager reporting directly to the board on new listing applications. We noted in the report that "*..in ASIC's view, the General Manager should cease reporting to the board on his supervisory and commercial activities in relation to listing applications. Such reporting arrangements may be inadequate in the context of handling conflicts of interest. In this regard, ASIC considers that a separate Listing Committee consisting of a majority of independent members...could be established, or additional staff could be employed..*".

In our second report we noted that the approval to recommence operation of the NSX market was given on the basis that there would be a Listing Committee operating separately to the board. The reasons for this condition were that the shared roles of a number of individuals involved in the operation of the market gave rise to an actual conflict of interest between the commercial interests of the licensee and its obligations to conduct its market in accordance with the requirements of the Act.

As recorded in our second report, NSX advised ASIC in March 2004 that a Listing Committee comprising the CEO, the General Manager, the Compliance Officer and a panel of at least 3 independent reviewers with appropriate backgrounds was approved to be established at NSX's board meeting of 18 March 2004. However, the scope of the Listing Committee's task was limited to recommending appropriate disclosure of publicly available offer documents provided as part of the listing application. In our second report we noted that in ASIC's view the Listing Committee should have responsibility for deciding whether to admit companies to the market's official list.

NSX has gone some way towards meeting our suggested improvements. In particular, NSX is considering issues related to enforcement of its listing rules, how it should

³ Mr Kelvin Clarke and Mr Paul Seymour

deal with the question of whether a company is 'suitable' for listing on its market and how the Listings Committee should conduct its business. We consider these separately below.

Enforcement of listing rules

NSX now has the power to convene a disciplinary committee to hear an action against both a listed entity for breach of the listing rules and against the sponsors and directors of listed entities for breach of contract. Prior to the creation of the Listing Committee the power to discipline participants, listed entities, directors and sponsors lay with the Compliance Committee. During our inspection visit in February 2005, NSX said it was considering whether to make the Listing Committee responsible for the disciplining of listed entities, their directors and sponsors, with the Compliance Committee remaining responsible for disciplining of participants. Subsequently, NSX advised ASIC that "it expects that the compliance committee [and not the Listing Committee] will have the mandate to discipline listed entities [and] advisers."

To ensure that NSX has the power to discipline companies indirectly through pursuit of actions against sponsors, NSX will further clarify direct obligations on the sponsors of a prospective listed entity and may amend and increase the obligations contained in sponsorship agreements. NSX has briefed its legal advisers to prepare contracts that more clearly define advisers' responsibilities.

In relation to listing rule enforcement, NSX does not yet have written policy and procedures for the conduct of disciplinary hearings although the listing rules provide for private censure, public censure and fines.

No breach of the NSX operating rules has so far been considered sufficiently serious by NSX as to require convening a disciplinary panel, or to refer the matter to ASIC. NSX has used its power to suspend the securities of listed entities from trading but this measure was adopted to end a disorderly market, rather than as a disciplinary action against the listed entity. We note too that NSX has levied automatic fees on participants for failure to complete settlement within T+3. Because certainty of settlement goes to the question of whether a market operator is running a fair, orderly and transparent market the levying of these fees can be considered a form of disciplinary action. Whatever the taxonomy and regardless of whether fail fees are to be characterised as disciplinary measures, we note below that the obligation to notify ASIC of all disciplinary actions under section 792B(2)(b), as at the time of our inspection visit, had not been addressed in NSX procedures. NSX has undertaken to review the relevant procedures to ensure that the obligations pursuant to section 792B(2)(b) are clearly set out.

NSX stated that even if significant contraventions of the market's continuous disclosure obligations were to be formally referred to ASIC for enforcement of the listing rules or civil and criminal law obligations (although no such referral has occurred to date), the Compliance Committee would also consider acting to discipline listed entities, and their directors and the company's sponsor, for breach of the market's listing rules.

Decisions as to suitability for listing

The NSX Compliance Officer, who in addition to being chairman of the Listings Committee is also ex officio chairman of the Compliance and Audit Committee, stated that NSX will continue to vet every prospectus in order to make an independent judgement about whether it would be able to run a fair, orderly and transparent market for those securities. NSX's view is that "fair, orderly and transparent" means different things in differing market risk environments. The added assurance of prospectus vetting of applications to list was required, in NSX's view, due to the need to maintain public confidence in its predominantly micro-cap market.

All NSX staff we interviewed said that NSX acknowledges that it needs to make a judgement about whether the companies it admits to its official list have made sufficient base line disclosures, and are in a position to continue to make effective continuous disclosure of material information to the market.

In addition to disclosure in prospectuses, when assessing listing applications, NSX considers the minimum 25% free-float levels, escrow of certain promoters' shareholdings, and material related-party transactions. These requirements were considered to be minimum requirements that could not be waived. Since our second assessment report, NSX has refused to list applicants because it made the judgement that they were unsuitable.

NSX staff do vet all listing applications to ensure that the applicant would be able to comply with the listing rules, and in particular whether the company will be able to make continuous disclosure of material information. NSX records demonstrate that it paid particularly close attention to listing applications by Listed Investment Companies (LIC) with general investment mandates, companies whose investments were not readily capable of being valued continuously, and China listings, where accounts were not prepared in the first instance by Australian-based accountants.

Applications for listing are submitted to the NSX General Manager who analyses the application against the criteria in the Listing Application Procedures and the Listing Analysis Template. If the applicant is not able to meet minimum listing criteria, it may be asked to submit a formal request for a waiver. If the listing application appears to be generally consistent with the listing criteria it is submitted to the Listing Committee, together with any requests for waivers to be granted.

Proceedings of the Listing Committee

The Listing Committee, which was constituted following a board decision in March 2004, relies heavily on the analysis and recommendations of the General Manager who is a member of the three-person committee. The three members do not meet in formal session, conducting discussions on an ad hoc basis usually by telephone, and do not keep minutes. The application papers, together with the General Manager's analysis and recommended additional disclosure requirements to be imposed on listings such as those of LICs, mining companies and entities with particular impediments to immediate disclosure of material developments, are circulated to the

other two members of the Listing Committee – the CEO and the Compliance Officer. Decisions are reached by consensus. The Compliance Officer, as the only member of the committee without a direct interest in securing new listings, in effect has a veto power. In the recent past NSX has rejected two applicants as unsuitable for listing on its market.

If a listing application involves a request for a waiver of a listing rule that does not go fundamentally to the determination of suitability for listing, the application for a waiver is referred by the Listing Committee to the Compliance Committee for independent determination.

As noted above, the decision whether to approve a listing is made by Listing Committee consensus, with its chairman having a de facto power of veto. Only if the listing committee approves entry of an applicant to the official list is the application on-forwarded to the NSX board for final approval.

NSX said that it was seeking to obtain the services of independent prospectus reviewers to assist it to make determinations about suitability for listing, but those approached so far had insurmountable concerns about indemnity insurance.

The NSX Board at its meeting of 18 March 2004, when it determined to create a Listings Committee made up of three NSX executive officers, also said it should have at least three independent reviewers. The Committee's scope is described as being limited to "[recommending] ... appropriate disclosure of publicly available offer documents provided as part of the listing application." The work of the Listing Committee now is substantially broader than this, but there is still no formal mandate in place to guide its work.

Comments made to us during our inspection visit suggested that NSX was still to formally decide whether the Listing Committee should be responsible for application and enforcement of the listing rules, or whether some of these roles should remain with the Compliance Committee or the board.

NSX has since decided that the listing rules will remain "owned" by the NSX board rather than the Listing Committee, and enforcement of the listing rules through disciplinary proceedings will continue to be managed by the Compliance Committee. Because the licensee board will retain ownership of the listing rules, management of conflicts necessarily will be more difficult and the duty of NSX directors to avoid conflicts of interest will remain more onerous than need be. But, in ASIC's view, intrinsic conflicts between for-profit imperatives and public interest duties will nonetheless still be manageable provided functional separation of supervisory and business development staff is maintained. Following the acquisition of BSX, NSX proposes to ensure this functional separation by having the NSX general manager undertake supervisory responsibilities, while the former BSX CEO takes on business development matters. In our next assessment report we will test the efficacy of this bifurcation of roles and whether it indeed effectively shields the integrity of the Listing Committee and supervision from for-profit drivers.

The positions of Listings Committee independent reviewers as envisaged by the NSX board have not yet been filled. NSX said that they had been unable to obtain two genuinely independent members to sit on the committee, and to secure independent consultants to vet prospectuses, due to concerns that NSX's indemnity insurance would not extend to third party contractors or would impact adversely on other non-NSX indemnity policies. NSX stated that following its recent fundraising and takeover of BSX, the merged entity will have more flexible staffing arrangements, and this would facilitate reconstituting the Listing Committee so that it was made up entirely of independent members.

Recommendation 2

The NSX board should approve a mandate for the Listings Committee which expressly defines the Listing Committee's functions. The Committee should conduct formal meetings and minute its discussions and decisions.

Recommendation 3

NSX should ensure that all members of the Listing Committee are independent, and that the committee is constituted in the manner envisaged by the NSX board. As noted below this does not rule out NSX business development staff attending meetings to provide expert advice.

2.1.3 Compliance Committee

The NSX Compliance Committee is chaired by the NSX Compliance Officer, and has four members, two of which are independent. The NSX Compliance Officer is not functionally involved in NSX business development. The fourth member is a promoter for a number of new listing applicants and a principal of a market participant.

The Compliance Committee has a charter, and meets formally and regularly. Minutes of its meetings are produced. When first established, the Compliance Committee's primary responsibilities included managing the progress of identified and suspected breaches of listing rules and business rules; co-ordination of the activities of all parties, internal or external, with a compliance function (such as the Exchange Examining Accountant, Market Control, and the Compliance Officer); and initiation of recommendations for action to the NSX board on the basis of reports received.

Recommendation 4

Policies and procedures that support the conduct of disciplinary proceedings against listed entities for breaches of the listing rules, and actions against listed entity

directors and sponsors for breaches of their undertakings to NSX at the time of initial listing, should be written. To assist NSX supervisory staff and committees, guidance regarding policy for gradation of penalties, which the operating rules presently list as private censure, public censure and fines, should also be prepared. In addition, NSX may consider it useful to issue policy guidance for its own staff as to whether and in what circumstances it will pursue its own contract-based remedies to enforce its listing rules, in which circumstances it will identify a matter as being a significant contravention of law that requires there to be a referral to ASIC for civil penalty or criminal law enforcement action, and in which circumstances it will both refer a matter to ASIC and persist with its own parallel disciplinary action.

2.1.4 Compliance Plan

As we noted in our second assessment report, NSX has developed a compliance plan, which includes NSX expectations of how participants should comply with their obligations, procedures concerning settlement of trades and timeliness of settlement, and monitoring the Exchange Examining Accountant's performance in monitoring participants. In June 2003 an NSX Assessment Program was forwarded to all NSX participants.

NSX continues to have a high degree of related parties, shared roles and actual conflicts of interest affecting individual directors. For instance, NSX relies substantially on nominated advisers to introduce to the market potential new applicants for listing. Many of these nominated advisers are major shareholders, NSX participants, existing and former NSX directors or related parties. During the period since our second assessment visit, NSX revised and issued a number of policy and procedure documents to assist NSX to avoid conflicts and improve supervision of its internal arrangements and supervision of its market. These included a corporate governance statement; a board charter; a code of conduct and ethics; a director and employee manual; shareholder communications policy; policy and procedures for dealing in securities by directors, officers and employees of NSX; procedures for managing conflicts of interest; procedures for the maintenance of the conflicts of interest register; a conflicts of interest register for directors; a securities register for staff shareholdings; and procedures for the provision of services by directors and director-related parties.

In ASIC's view, NSX has taken positive steps to ensure it continues to have adequate arrangements for dealing with the potential conflicts of interest that may arise through the relationships described above. We will continue to closely monitor the development and application of NSX's arrangements to ensure that NSX is meeting its obligations under the Act.

2.2 Supervision of the market

The key arrangements NSX has in place to detect potential or actual non-compliance with the Act or NSX's operating rules are as follows:

- Scrutiny of the suitability for listing of all new applications;
- Monitoring of continuous and periodic disclosures made by listed entities;
- Monitoring trading activities conducted through NSX; and
- Monitoring the conduct of participants in relation to the market.

At the time of our assessment visit, it appeared that the practices of NSX with regards to the supervision of disclosure on its market had substantially improved. Our comments and note of residual concerns are detailed below.

2.2.1 Scrutiny of the suitability for listing of all new applications

In our first assessment report, we noted that apart from the "sign off checklist for new listing applications", there was no demonstrable analysis or substantive recommendation prepared for a new listing application and it was unclear on what basis the board approved such applications.

In our second report we noted that NSX had developed two documents in relation to listing applications called "Listing Application Procedures" and "Listing Analysis Template", respectively.

We said in our second report that the "Listing Application Procedures" contained the essential steps and information that a staff member of NSX should follow and look for in the application process. In particular, section 3.8 provided that an issuer has determined to have met the listing requirements once the "Listing Application Analysis template" has been successfully completed.

In our second report we noted that the "Listing Analysis Template" was in the form of a table that is to be completed to determine whether an applicant can comply with the listing requirements. Section 3.5 of the template provided that both the issuer and its business must, in the opinion of NSX, be suitable for listing.

As at February 2005, applications for listing with NSX are prepared and lodged with the assistance of a promoter, who is usually an NSX participant or a facilitator. The applicant is required to have a 'nominated adviser' who is contractually responsible to NSX for advising and ensuring compliance by the entity with the market's operating rules.

We reviewed all the listing applications lodged with NSX since our last assessment. In general, we note that NSX staff have followed the procedures as stated in the "Listing Application Procedures", including the completion of the checklist and the "Listing Analysis Template".

In our second assessment report, we stated that, even though the Listing Analysis Template required information as to whether an issuer and its business are suitable for listing on NSX, only very superficial information had been recorded in the template. Our view following our February 2005 inspection visit is that record keeping has substantially improved. Documents reviewed demonstrate that NSX conducts an

analysis of whether an issuer and its business meet and are able to continue meeting the requirements for listing on NSX. However, as noted above, this analysis appears to be done by the NSX general manager who, as at the time of our February 2005 inspection visit, has some business development responsibilities. The other Listing Committee members consider this analysis prepared by the general manager and it is not clear to ASIC, due to the absence of minuted committee discussion, whether the Compliance Officer, who chairs the committee, has sufficient information to make an independent judgement.

NSX said that when making a determination as to whether an applicant for listing on its market was suitable it took comfort from ASIC's review of prospectuses, and only commenced its consideration of applications for listing after ASIC had had opportunity to examine a prospectus. However, it is not clear that the Listing Committee separately considers the issue of suitability. NSX must be in a position to make a decision about whether an entity is suitable for entry to its official list without relying on ASIC's examination of the entity's disclosure document.

Between June 2003 and February 2005, of the 27 applications for the listing of new entities, ASIC applied interim stop orders (ISO) on six occasions to the prospectuses of entities that were being considered for listing on NSX. One of these entities was rejected by NSX as being unsuitable for listing subsequent to ASIC imposition of an ISO.

As we noted in our second report, a prospectus is usually the most comprehensive source of information regarding a new applicant at the time of the listing application, and we expect NSX to review this document to assess in particular whether the disclosures and mechanisms for meeting continuous disclosure obligations by the applicant is adequate. ASIC therefore has some concerns about the degree of rigour NSX brings to its assessment of new listing applicants.

NSX advises that its intention following the BSX acquisition is to restructure and strengthen the delineation between those staff performing supervisory duties and those charged with business development.

Recommendation 5

The NSX Listing Committee should develop policy to guide its determination of whether an entity is suitable for listing. A determination as to suitability should not rely on ASIC examination of fundraising disclosure documents. Nor should it be a reflexive or default assumption that an entity's securities are suitable for listing as soon as the other significant listing criteria have been met.

2.2.2 Monitoring continuous and periodic disclosures made by listed entities

Continuous disclosure

In our first assessment report, we commented that although NSX had a procedures manual relating to processing of incoming announcements, it did not contain procedures for identifying and dealing with price-sensitive information.

We noted in our second report that NSX has issued a 'Practice Note on Continuous Disclosure' and a 'Company Announcements' booklet since our first assessment.

In the second report we noted that the 'Company Announcements' booklet contained a list of the types of information that should be disclosed to the market that may have been construed as being exhaustive, whereas there were other items omitted from the list which could be considered to constitute price sensitive-type information - for example, a change in the entity's financial forecast or expectation; the appointment of a receiver, manager, liquidator or administrator; or a proposal to change the entity's auditor. During our most recent inspection visit we confirmed that the 'Company Announcements' booklet had been revised.

Both the General Manager and the Trading & Settlement Officer are able to directly upload most company announcements by a listed entity onto NSX's company announcements platform.

During our February 2005 inspection visit the General Manager confirmed that he is the person primarily responsible for scrutinizing the content of announcements. He vets a majority of the announcements lodged with NSX before they are released to the market.

The General Manager said that when he is not in the office, the Trading & Settlement Officer has the authority to release announcements to the market, but that the General Manager can be contacted if there is any doubt regarding an announcement. He also indicated that he and the Trading & Settlement Officer do not consult directors of NSX regarding the content of announcements because this will delay the release of information to the market.

In our second report we concluded that NSX should stop its practice of embargoing the announcements of companies listed on two or more exchanges. NSX has a memorandum of understanding with ASX and BSX to coordinate announcements of dual listed entities. On the inspection visit for this report we formed the view that staff were still confused as to their role to assist to coordinate announcements by a listed entity that also had a New Zealand Stock Exchange (NZX) listing. As NSX is seeking to increase listings of entities with a dual listing on NZX this role needs to be clarified. NSX management has subsequently advised us that no uncertainty now exists and that its clear policy is that it is the responsibility of affected listed entities to announce immediately price-sensitive information that a reasonable investor would expect should be disclosed, and that if a dual listed entity wishes to coordinate an

announcement on markets that are simultaneously open for trading in different jurisdictions, then that is a matter for which the entity is accountable.

Of the 24 listed entities (with 35 listed securities), very few attract analyst or press attention. NSX does not make a daily check for press coverage of the business activities of listed entities to identify any potentially material issues. Instead, NSX makes a weekly check by means of electronic search engines.

Periodic disclosure

In our second report we noted that NSX had failed to properly enforce its listing rules relating to announcement of periodic financial reports and directors' statements on several occasions. In our second report we said that, when NSX moved to suspend trading in the securities of an entity in breach of its periodic disclosure obligations, NSX made an announcement that trading in these securities had been halted but nonetheless, trading in the securities occurred the next day. When queried about this, NSX said that it followed its procedures but that in this instance its procedures for putting in place a trading halt had failed to achieve their stated purpose.

Since our second report NSX has employed additional market control staff whose responsibilities include pre-emptive reminders to listed entities to make the required announcements, and whose role is check for compliance. If half-yearly and annual financial statements are not lodged on time, NSX's policy is to immediately suspend the company to prevent development of a disorderly market and to notify ASIC as soon as possible after this occurs. NSX procedures for imposition of trading halts and suspension of an entity are now scrupulously documented. On 1 October 2004, NSX forced four listed entities into trading halts due to non-lodgement of financial statements. In ASIC's view, this indicates there has been some improvement in NSX's procedures for identifying non-compliance with its listing rules.

Recommendation 6

NSX should commence a more regular review prior to the commencement of trading of press and electronic reporting on the entities that trade on its market.

2.2.3 Monitoring trading activities conducted through NSX

Market surveillance

At the time of our inspection visit, NSX continued to have a very low level of trading activity. The General Manager said he reviews every trade executed on NSX each day. In our second report we recommended that NSX should take steps to address the key-person risk that arises from the General Manager being the only person delegated to query a listed entity or a participant. In response to that concern, NSX has now employed additional Market Control staff who have the delegation to query both a company as to whether it is aware of material developments that may have affected its

value if NSX detects aberrant trading, and to query participants if NSX detects anomalous trading activity.

NSX is having discussions with third party market operators about the potential for other operators to deploy their sophisticated surveillance software to identify unexplained price movements in NSX stocks and possible underlying continuous disclosure breaches.

Having regard to the nature of the market, its participants and the participant conduct being monitored, we consider that the existing arrangements adopted by NSX in monitoring trading activities conducted through NSX have improved, particularly as the key person risk has been addressed. Nevertheless, if the NSX market continues to grow as anticipated these arrangements would need to be scaled up. We encourage NSX to continue to explore options for introduction of surveillance software as part of its market monitoring arrangements.

SEATS market control

In our second report we said that in late January 2004 ASIC requested that trading be suspended in a particular security until such time as the relevant listed entity had lodged its audited financial statements. NSX made an announcement that said "...NSX had imposed a trading halt" on the trading of the relevant securities and that the trading halt would continue until the entity had released its 2003 annual report to shareholders and NSX. However, NSX failed to prevent a participant undertaking an on-market trade of 18,000 shares in the listed entity the next day. NSX procedures had in fact failed to give effect to the trading halt that it had announced.

The relevant procedures document, the 'Market Control Procedures Manual', has been redrafted with considerable added practical instructions. These procedures documents would potentially permit even Market Control staff with no experience of imposition of trading halts to effect a suspension. The recommendation in our second report to address these shortcomings has therefore been attended to adequately.

2.2.4 NSX participating organisations

Monitoring the conduct of participants in relation to the market

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

In ASIC Policy Statement 172 *Australian market licences: Australian operators*, at PS172.92 – 172.101, we say that adequate arrangements will include things such as continuous electronic monitoring and/or physical inspections of participants' offices to ensure compliance with the operating rules, including rules relating to capital liquidity and trust accounts.

At the time of our assessment in February 2005, NSX had 10 participating organisations admitted to its market, of which seven are also participants of ASX.

For the purposes of this assessment we examined the:

- NSX participant assessment program;
- Participant files;
- Minutes of the Compliance Committee meetings; and
- NSX policy in relation to participating organisations.

Compliance program

Since we conducted our last assessment, an independent Compliance Officer has been appointed by NSX. Since his appointment in January 2004, he has implemented compliance programs for participants and is an independent member and chairman of the Compliance Committee.

Self-assessments

A key arrangement adopted by NSX in monitoring the conduct of its participating organisations is to require lodgement of participant self-assessments as part of the NSX assessment program. The purpose of the assessment program is to understand the type of business operated by the participating organisation, the products and services the participating organisation provides or is proposing to provide, and what policies and procedures the participant has in place to ensure compliance with financial services licensee requirements under the Act. Another purpose of the assessment program is to highlight areas that require further review.

The self-assessment process had been implemented since our second report. Seven participant assessments occurred between March and June 2004. Those assessments consisted of meetings between the compliance officers of NSX and the participants, discussion of the self-assessment program, and examination by NSX of the participant's policies and procedures. We reviewed three of the participant files, all of which contained completed self-assessment programs.

During subsequent site visits to participants, the NSX Compliance Officer made hand written notes verifying responses to and supplementing the self assessment answers as well as reviewing the log of continuing education required to meet the conditions of an Australian financial services license ("AFSL"). A copy of the participant's current AFSL was obtained and kept on the files by NSX.

Policy documents of participating organisations, relating to behavioural conduct and conflicts of interest, were maintained on the participant files. To provide an overview

of the business and the services provided, in accordance with the AFSL, there were examples of the 'financial services guides' of participants also held on the files.

Exchange examining accountant

NSX continues to outsource monitoring of participants' surplus liquid funds to an exchange examining accountant (EEA). The current EEA is a chartered accounting firm. NSX requires participating organisations to lodge their surplus liquid funds returns with the EEA within twelve business days of the end of each month. The EEA is responsible for reviewing the returns to ensure that each participating organisation is meeting its ongoing capital requirements as set by NSX.

Previously the reporting by the EEA was done on an exception basis, however, since August 2004 this reporting has occurred on a monthly basis and the reports are circulated to the Compliance Committee. The documents reviewed for this assessment included a policy for obtaining and reviewing the monthly surplus liquid fund returns from the EEA.

There was correspondence from NSX to participants in circumstances of late lodgement of surplus liquid fund returns. This infers the process has been implemented effectively since the last assessment.

Management of compliance breaches

All compliance breaches by participants that are identified by NSX are referred to the Compliance Officer for determination of any necessary disciplinary action. The Compliance Officer resolves all minor breaches directly and will escalate only the significant breaches to discussion with the Compliance Committee.

There is no documented policy detailing the scope within which the Compliance Officer may deal solely with an issue and/or when an issue should be escalated to the committee as a whole. As a consequence, there is no log that captures all breaches that have been noted and referred. The committee, therefore, has no means of ascertaining the entire list of referrals to the Compliance Officer. Similarly, there is no policy regarding when a matter constitutes a 'significant contravention' and should be referred to ASIC under section 792B(2).

Finally, there is no register of actions taken in relation to compliance breaches, such that there can be no review for consistency of disciplinary action. Presently the only record of compliance actions is the minutes of the Compliance Committee meetings. While those minutes are essential and highlight the discussions involved in determining issues, they are not sufficient of themselves to review treatment of all breaches.

During the assessment we became aware that NSX was levying "fail fees" for failure to deliver securities to an on-market purchaser within the market rule-stated period for settlement. NSX follows industry practice that describes these payments as immediate and continuing fees rather than fines and has therefore not reported these payments to ASIC. Our initial view was that this imposition of fees/fines was a form of

disciplinary action taken against participants, despite the fine being levied automatically. Because the fee or fine arose as a consequence of a breach of the business rules, our view was and remains that NSX has an obligation under section 792B(2)(b) of the Corporations Act to notify ASIC of any kind of disciplinary action against a participant. Market participants are now required as a consequence of their holding an Australian financial services licence (AFSL) to provide fair and efficient performance to their clients. Patterns of non-compliance need to be notified to ASIC to guide possible enforcement action, and past industry practice should no longer be conclusive of whether or not these fees/fines are to be classified as disciplinary.

Recommendation 7

To allow review of the nature of matters referred and to ensure that all matters were subsequently dealt with, referring employees should maintain a log of breaches/referrals to the Compliance Officer.

Recommendation 8

A policy should be developed and documented detailing precisely the nature of matters that are suitable to be dealt with by the Compliance Officer alone, which matters should be dealt with by the Compliance Committee and what constitutes a 'significant contravention of the operating rules or the Act' such as to warrant referral to ASIC under section 792B(2)(c) of the Act.

Recommendation 9

The Compliance Officer should maintain a register of all referrals from the listing committee, from NSX staff who conduct inspections of participants, and those generated through his own initiative, any action taken and whether that matter was referred to ASIC. That register should be available for review by the Compliance Committee and ASIC to ensure that any disciplinary actions are being reported under section 792B(2) of the Corporations Act.

2.3 Financial resources

Under s792A(d) of the Act, NSX must have sufficient resources to operate the market properly and to provide the required supervisory arrangements. Prior to this assessment, NSX had very limited financial resources and were providing ASIC with quarterly financial reports.

The audited financial accounts of NSX showed an operating loss of \$236,477 for the financial year ended 30 June 2004 (compared to an operating loss of \$543,237 in 2003). While NSX is still running at an operating loss, there has been improvement in its financial position.

Significantly, NSX undertook a capital-raising in December 2004 and it was successfully floated on the ASX in January 2005, with the share price rising

substantially above the issue price of 50c to almost \$1.00 before settling back in late March 2005 to approximately 80c. NSX's business plan and financial forecasts have relied upon the ability to attract and obtain further listings. NSX's goal of 21 listings by 30 June 2003 has been exceeded and it now has 29 entities with securities listed on the market.

NSX is now subject to the quarterly reporting regime in the ASX listing rules. Accordingly, ASIC has agreed that NSX can stop providing quarterly reports directly to ASIC and that we will review the reports given to ASX as part of our continuing oversight of NSX.

2.4 Other matters

2.4.1 Policies and procedures

During the assessment visit we reviewed NSX policy and procedure documents. ASIC notes that the documents requested were provided promptly and in accordance with the notices as issued.

Policies and procedures have been developed in relation to the powers of NSX to discipline participants, and to ensure that all staff understand the powers and duties they hold to censure non compliance with the operating rules by participants. As noted above, policies and procedures relating to enforcement of listing rules remain deficient. Although NSX's procedures for monitoring participants and enforcing the operating rules have improved since our second report, identification of the scope of the obligation to notify ASIC of disciplinary action taken under section 792B(2)(b) needs further attention. Nor is the obligation under section 792B(2)(c) to notify ASIC of suspected significant contraventions of the operating rules reflected in procedure documents.

The process for notifying ASIC of breaches by participants is detailed in the market surveillance procedures. That procedure, however, only requires that breaches identified by the Compliance Committee be reported to ASIC. This procedure is inadequate as all disciplinary action taken must be reported, not just that conducted by the Compliance Committee.

As noted above, procedures for effecting trading halts and imposing suspensions are satisfactory, and the employees required to perform those procedures have demonstrated awareness of their responsibilities.

Under the Act, NSX must have adequate arrangements in place for supervising the market, including arrangements for handling conflicts, monitoring the conduct of participants on or in relation to the market, and enforcing compliance with the market's operating rules. ASIC expects that those policies and procedures will be enforced and that written records of action taken will be maintained.

Recommendation 10

NSX must have procedures that ensure that all matters required to be referred to ASIC are referred, regardless of who at NSX identifies or considers the matter.

Recommendation 11

We recommend that NSX develop a policy detailing when a matter should be referred to the compliance officer and when that matter should be referred and or escalated to the compliance committee. Further, that policy should address the nature of breaches that may constitute a 'significant contravention' of the rules or the Act and should be reported to ASIC under section 792B(2)(c).

2.4.2 MoU with ASX and BSX

NSX, ASX and Bendigo Stock Exchange Limited (BSX) signed a Memorandum of Understanding (MOU) in May 2004 in relation to information sharing about common participants. We reviewed these arrangements during this assessment and consider them to be adequate at this time.

Appendix 1

**Table of director interests
as at 25 February 2005.**

Current directors	Position(s) with NSX	Related PO(s)	Related broker/ adviser	Director related entities which received income or other payments from NSX	Shares in companies listed on NSX
Mr Ray Whitten	Executive Chairman		Whitten Lawyers and Consultants	Whittens Lawyers & Consultants were the advisers for the listing applications of Rattoo Holdings Limited, Alternative Lending Australia Limited and Yang Yang China Holdings Limited.	
Mr Michael Cox	CEO and executive director				
Mr Francis Markham Menzies	Director Company Secretary	Tonkin Scorer Menzies	Tonkin Scorer Menzies	A.H. Hough Pty Limited payment for a loan guarantee during the 2002/2002 financial year. Tonkin Scorer Menzies were the promoters for the listings of Alternative Lending Australia Limited and R.J. Walsh & Son Limited.	
Mr John O'Connor	Director (Resigned wef			Forsythes Accountants for compliance committee services during the 2002/2003 financial year	

	25 May 04)				
Mr Paul Seymour	Director			Newcastle Capital Markets Pty Ltd for share registry services during the 2001/2002 and 2002/2003 financial years	Pegmont Mines NL Winpar Holdings Limited
Mr Kelvin Clarke	Director				