



**ASIC**

Australian Securities & Investments Commission

**REPORT 141**

# **Market assessment report: Bendigo Stock Exchange Limited**

**ACN 087 708 898**

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## **About this report**

This report summarises ASIC's fourth annual assessment of Bendigo Stock Exchange Limited (BSX) under s794C of the *Corporations Act 2001* (Cth) (Corporations Act).



**ASIC**

Australian Securities & Investments Commission

# **Annual assessment report**

## **s794C of the Corporations Act 2001**

**Bendigo Stock Exchange Limited  
ACN 087 708 898**

**May 2007**

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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 Bendigo Stock Exchange Limited (BSX) with its obligations under s792A(c) of the Act. In addition, s794C(1) permits us to extend the scope of our annual assessment to review how well BSX complies with any or all of its obligations under Ch 7 of the Act. We have extended the scope of our assessment to consider whether BSX is complying with s792A(d) of the Act, which requires an Australian market licensee to have sufficient resources to operate its market.

Our previous report about BSX was publicly released on 22 July 2005.

This report describes our assessment, conclusions and key recommendations.

## Compliance by BSX and subsequent action

### BSX compliance with s792A(c)(ii) & (iii)

In ASIC's view BSX did not have adequate arrangements for monitoring the conduct of participants in the market and enforcing compliance with its listing and market rules at the time of our assessment. We based this conclusion on the following findings:

- a. The BSX board was not demonstrating sufficient accountability for its market licensee obligations, although this was part of the board charter. BSX's ultimate parent entity, NSXL Limited (NSXL) appeared to be making decisions regarding BSX's supervisory arrangements without reference to the BSX board. Similarly, the BSX board did not appear to actively seek to inform itself about changes in BSX's supervisory arrangements or its resourcing.
- b. The responsibility of staff for certain key supervisory activities on BSX's market was not clear at the time of our assessment. Information about staff responsibility contained in documents such as board papers and BSX's policies and procedures were contradictory and did not accord with the explanations we obtained from BSX and NSXL management.
- c. There were some significant oversights in listed entity supervision. For example, we noted instances where it appears that financial results of listed entities were materially different from prospectus forecasts but those entities failed to update the market.
- d. Supervision of BSX participants was generally problematic. In particular, there was no ongoing active monitoring of participant compliance with BSX business rules and there were no processes for monitoring or assessing the performance of its outsourced functions.

## Response to findings

ASIC gave its findings and recommendations to BSX in April 2006. Given our concern about the adequacy of BSX's supervisory arrangements, we sought a decisive set of proposals about how BSX would address the serious problems we had identified. ASIC's subsequent discussion with BSX and its parent NSXL in June 2006, resulted in our agreement to a proposal put forward by NSXL to transfer the entities listed on BSX (BSX entities) to the Stock Exchange of Newcastle's market. The Stock Exchange of Newcastle was renamed the National Stock Exchange of Australia Limited (NSX) on 20 December 2006. Our assessment of NSX's market did not raise similar concerns with the adequacy of supervisory arrangements. As a result, the BSX market would have no remaining listings and would remain dormant for a period of time.

As part of the proposal, NSXL, as a joint venture partner with COM-AGEX ASIA, also intended to apply to have the BSX market licence varied to facilitate the development of an international derivatives exchange.

In late June 2006, we received a draft set of transitional operating rules that would facilitate the transfer of the BSX entities to the NSX market. Since that time, we have been discussing the content of these transitional rules. We also sought to ensure that NSXL had proper communication plans in place to effectively manage the proposed closure of the BSX market and the resultant impact on BSX entities. As at 20 November 2006, ASIC was satisfied with most aspects of the proposed amendments to NSX's rule proposals, apart from the matter of the termination date for the transitional operating rules.

Following expiration of the transitional rules, transitioned BSX entities would need to comply with all of NSX's operating rules, including the appointment of an external nominated adviser (NOMAD). NOMADs are responsible for assisting listed entities in complying with NSX's listing rules.

NSX initially proposed a transitional rule termination date in late 2009. In our view, this was too long, and the appointment of NOMADs should not be drawn out as significant lapses in BSX listed entities' disclosure had been observed in our assessment. ASIC resolved that a termination date before 30 June 2008 should apply.

## Subsequent developments

On 21 December 2006, NSXL announced that it had agreed to terminate its joint venture arrangement with COM-AGEX ASIA for the development of an international derivatives exchange using the BSX market licence. As a result, we have since been advised that NSXL is unlikely to submit the final draft of the transitional rules. Rather, the NSXL board proposed to maintain the BSX market licence and its listed entities as a trading stock exchange. It also advised that its rules and business will be developed to target the listing of small to medium sized enterprises that may have very low trading levels. ASIC is now in discussions with BSX about the repositioning of its market and the adoption of appropriate amendments to its operating rules. BSX has indicated that it will provide a submission to ASIC in June 2007.

Given NSXL's suggestion that it will maintain the BSX market and our concerns about the adequacy of BSX's supervisory arrangements contained in this report, we will closely scrutinise the action BSX has taken in response to our findings during our current assessment.

### **Inadequate listing rules framework**

In previous assessment reports, we have noted that BSX routinely waived admission criteria for the listing of 'community type' enterprises. We recommended that BSX should introduce an appropriate listing rule framework for 'community type' listings, to remove the need to issue standard waivers. BSX has been developing listing rule amendments to facilitate a community board that has a lower NTA threshold amongst other requirements for these entities. ASIC had considered a number of draft versions of the proposed rules since October 2004, but as at June 2006 remained of the view that the proposals were problematic largely because the proposed rules might permit entities without commercial substance to list and might also be exploited by other entities seeking to avoid the market for control, because of the provision of one vote per member voting rights. When the transition of BSX entities to NSX's market became an active proposal, this arrangement became redundant.

Given that NSXL's current plans for the BSX market focus on listing small to medium sized enterprises with very low trading levels, the creation of an appropriate listing rule framework for these kind of entities is imperative. In particular, we do not think it is appropriate that BSX should continue to list small community type enterprises without adequate listing rules to ensure that only entities suitable for public listing are admitted to BSX's market. The listing of an entity on a public exchange operating in Australia gives rise to certain expectations in the minds of investors about the nature of the entity listed and the obligations by which an entity will be bound. It is not appropriate, in our view, to admit small community enterprises to listing on the basis of waivers from a set of rules that conceivably will never be applied in full to the types of entities BSX, by its own admission, is now seeking to attract. The listing rules as they stand create an expectation that the entities listed on BSX are able to meet the standards set out in those rules. Consequently the listing of community type enterprises on a public exchange, if done without appropriate admission thresholds and ongoing requirements, may result in investor confusion and the erosion of the reputation of Australian markets.

NSXL and BSX have indicated to us that they will not seek additional community bank listings on BSX until agreement has been reached on the listing rules (with the exception of community banks which have already applied or are significantly along the process of applying for admission to BSX). ASIC considers that we have given BSX ample opportunity to address our concerns by making the necessary changes to its rule framework. BSX has failed to do this in any substantive way and accordingly, we will now be recommending to the Minister that more formal measures be required, either in the form of an additional condition on BSX's market licence or a written direction, pursuant to the Minister's powers under s796A and s794(A)1 of the Act, respectively.

**BSX compliance with s792A(i)**

In relation to BSX's 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, we concluded that BSX had adequate arrangements.

**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 BSX paying particular attention to how NSXL's acquisition of BSX's parent entity, BSX Group Holdings Limited (BSX Group) in April 2005, affected BSX's processes for managing conflicts of interest and supervising its market. We also assessed whether BSX had sufficient resources to operate its market and considered the extent to which BSX has responded to issues we raised in our third assessment report.

# Section 1: Background

## 1.1 The BSX group

The BSX market licence permits BSX to operate a market in the financial products described on its licence. A copy of BSX's market licence is available on ASIC's website at [www.asic.gov.au](http://www.asic.gov.au).

During the assessment period, BSX's ownership structure changed. On 11 April 2005, the shareholders of NSXL, which is listed on the Australian Securities Exchange (ASX) and also controls NSX, agreed to purchase the shares in BSX Group, the holding company of BSX. Employees of BSX and NSXL staff were therefore employed by NSXL. As a result of this transaction, BSX became a wholly owned subsidiary of NSXL.

## 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 BSX in our role as regulator of companies and financial markets, an onsite inspection of books and records and interviews with BSX personnel, and the discussions we have with BSX about the issues that have arisen from our previous assessment processes.

In conducting our assessment we have:

- analysed information we received from and about BSX in the ordinary course of our dealings with the licensee, including BSX's annual regulatory report under s792F;
- reviewed information from the media, BSX's website, ASIC's complaints management records and other sources;
- considered the operation of the market throughout the period, in particular in relation to issues of disclosure and trading;
- interviewed BSX personnel including senior NSXL and BSX management;
- reviewed policies and procedures for the conduct of BSX markets in general and their supervisory responsibilities in particular; and
- reviewed extensive material provided by BSX under the Australian Securities and Investments Commission Act 2001 (ASIC Act) including disciplinary and investigation files, internal reports and information collected by BSX on a continuous basis.

From 1 March 2006 to 3 March 2006 we attended BSX offices in Melbourne. During this onsite phase of the assessment we reviewed BSX operational records and spoke to BSX management.

After our onsite visit was completed, we provided written findings to BSX and had extensive follow up discussions. Where appropriate, our report reflects these discussions and BSX's responses to our findings and recommendations.

### **1.3 Focus of this assessment report**

The focus of this assessment was to review the impact that NSXL's acquisition of BSX had on BSX's arrangements for conflict handling and for market supervision.

We reviewed changes made by BSX in response to our previous assessment report dated July 2005 and also sought reassurance generally about the adequacy of BSX's practices, in particular the quality and consistency of supervisory outcomes, to seek assurance that BSX is meeting its statutory obligations to supervise its market. We also reviewed whether BSX has sufficient resources to operate its market.

## Section 2: Observations and recommendations

### 2.1 BSX's obligations

BSX did not have adequate arrangements for monitoring the conduct of participants in the market and enforcing compliance with its listing rules and market rules in accordance with its obligations under s792A(c)(ii) and (iii) of the Act respectively.

This conclusion is based on the following observations:

1. The BSX board was not, in our view, demonstrating sufficient accountability for the licensee's obligations, although its charter included responsibility for BSX's market licensee obligations. The effective control of the BSX market appears to have been exercised by NSXL, BSX's parent. Decisions regarding BSX's supervisory arrangements were made without reference to the BSX board and the board did not actively seek to inform itself about supervisory activities.
2. Following NSXL's acquisition of BSX, and at the time of our assessment, it was unclear where responsibility for key BSX supervisory activities rested in relation to the staff of BSX and the NSXL Group as a whole.
3. There were serious oversights in listed entity supervision.
4. There was inadequate supervision of BSX's market participants. In particular, there was no ongoing active monitoring of participant compliance with BSX business rules and there were no processes for monitoring or assessing the performance of its outsourced functions.

We are, however, satisfied that BSX had 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 accordance with its obligations under s792A(c)(i) of the Act. No failures to adequately manage conflicts of interest were observed.

### 2.2 Other observations and recommendations for future action

#### General obligations

The BSX board is accountable for meeting the market licensee's statutory obligations. As a result of this it needs to ensure that it closely monitors the effectiveness of supervisory arrangements for monitoring and enforcing operating rules.

Since NSXL's acquisition of BSX Group in April 2005, we noted many instances where the parent entity, NSXL, made decisions affecting BSX's supervisory

arrangements without referring to the BSX board. For instance NSXL terminated a key supervisory staff member without consulting the BSX board as to whether it was appropriate. Furthermore, NSXL changed various staff responsibilities for supervising BSX's markets, without consulting the BSX board. There was no formal agreement or plan put in place between BSX and NSXL as to how supervisory arrangements services would be changed and, for instance, what relevant functions NSXL and BSX staff would respectively undertake in relation to supervising the market. We also noted that the BSX board did not get updated on an ongoing basis about the financial position of BSX.

The BSX board does not appear to firstly, be able to actively monitor and assess the extent of compliance with its obligations and secondly, have any input into the supervisory arrangements affecting its market, thereby making it difficult to continually assess compliance with these obligations that ensure a fair, orderly and transparent market. A related concern is that the BSX board did not actively seek information or question NSXL on issues effecting its supervisory arrangements.

**Recommendation 1**

We recommend that BSX and NSXL implement communication arrangements to ensure that BSX has access to adequate information to assess compliance with its licence obligations.

In response to this issue, BSX undertook a restructuring at board level that delivered commonality of membership to the boards of BSX, NSX and NSXL, with delegations to a Listing and Admissions Committee and an expanded Compliance Committee.

In our discussions with BSX management, we were advised that as a result of NSXL's acquisition and the closure of BSX's Bendigo office, responsibility for undertaking certain supervisory activities was now a mix between NSXL and BSX staff. During our assessment we noted that information about staff responsibility contained in documents such as board papers and BSX's policies and procedures was contradictory and did not accord with the explanations we obtained from BSX and NSXL management.

As a result of contradictory documents and statements, we concluded that at the time of our assessment there was a lack of clarity as to who was responsible for monitoring continuous disclosure, trading, periodic reporting and participant compliance issues. This is not acceptable. Information should be clear and easily identifiable as to who has responsibility for these particular supervisory functions.

**Recommendation 2**

We recommend that BSX enter into a service arrangement with NSXL that details the staffing arrangements and supervisory services that NSXL staff will provide BSX. Also refer to Recommendation 12.

With commonality now delivered at board level, BSX argue that documenting appropriate service arrangements is unnecessary. However, given that BSX is a separate licensee, these arrangements should still be documented in a service agreement.

**Recommendation 3**

We recommend that BSX should immediately review the allocation of certain supervisory functions to clarify responsibility to ensure accountability and also update their procedures accordingly.

In response to this issue, BSX has clarified responsibility and has undertaken to update its procedures manual to reflect the changes.

**Conflict handling arrangements**

During the assessment period, BSX managed its conflicts by structural separation at board level. Accountability for all regulatory duties rested with the BSX board, with business development the responsibility of the BSX Group board. As a result of NSXL's acquisition of BSX Group and BSX, and the resultant homogenisation of the respective boards, conflicts are now managed by delegating supervisory decision-making to special committees. Both committees have a majority of independent members and are comprised of people external to the NSXL and BSX operating entities.

At the time of our assessment BSX had partly addressed a recommendation from our previous assessment report that an independent non-executive director provide a regular conflict report to the BSX board, but it decided against appointing another independent non-executive director, as it previously alluded to. We were advised that this was because the board was composed of a majority of independent directors over conflicted directors.

In February 2005, the BSX board identified business pressures that would have the potential to unduly influence supervisory decisions, including the business relationship between BSX and its most significant stakeholder at the time, Bendigo Bank.

Since NSXL's acquisition of BSX Group in April 2005, Bendigo Bank's control of BSX has been diluted from a controlling interest in BSX to a substantial holding in NSXL. We examined closely the processes for BSX's consideration as to whether to admit Bendigo Bank franchisees to its official list. We identified some problems, unrelated to conflict management, that are discussed elsewhere in this report.

We conclude that the culture of BSX supervision is such that there is no present systemic failure to adequately manage the temptation for BSX managers to prefer the interests of a key stakeholder to their duty to ensure that BSX runs a fair, orderly and transparent market.

**Listed entity supervision*****Continuous disclosure***

Under BSX listing rule (LR) 3.1, if an entity becomes aware of any information concerning it that a reasonable person would expect would have a material effect on

the price or value of the entity's securities, it must immediately provide this information to BSX. According to BSX procedures, one of the ways BSX monitors compliance by listed entities with this obligation is through reviewing newspapers and other (including electronic) publications for articles about listed entities. Articles about listed entities are examined for information that suggests a listed entity should have disclosed information to BSX. If, after assessing the article and recent announcements by the listed entity, it appears information should be disclosed to BSX, a query to that effect will be made to the entity.

An area that a reasonable person may expect to have a material effect on the price or value of an entity's securities is actual performance against an entity's prospectus forecasts. We examined BSX's supervision in this area by reviewing the financial reports and prospectuses of 35 community banks listed on BSX as at 9 March 2006. We analysed their actual financial performance and compared that to forecast information. It is worth noting that forecasts used in our analysis were the low end forecasts or, as they are termed, the '80% Modified Forecasts'. Furthermore, a large proportion of the community banks that were analysed were not listed on BSX at the time their forecasts were released through their prospectuses and actual results reported and were therefore not subject to BSX's continuous disclosure rules.

Our review noted that community banks do not generally meet their prospectus profit/loss forecasts. We noted two instances where it appears that BSX listed entities' actual profit/loss results were materially different from prospectus forecasts and the entities failed to update the market, other than when the annual/half year reports were released. BSX did not identify these omissions in disclosure. As there have been a substantial number of new community bank listings on BSX since 2005, a large number of which have listed using a prospectus that has included financial forecasts, BSX must substantially improve its supervision of forecast versus actual earnings disclosure.

Our review also noted two instances where entities disclosed payments in their annual financial reports that materially affected their financial position. Given the magnitude of the payments and their subsequent effect on the entities' financial performance for the relevant financial year, in our view they should have been disclosed at the time of the payment in accordance with the entity's continuous disclosure obligations. We saw no evidence of these material payments being queried by BSX. Again, BSX did not identify these omissions in disclosure.

#### **Recommendation 4**

We recommend that BSX must be more vigilant in monitoring continuous disclosure obligations, in particular where entities have released prospectus forecasts and where entities have made material payments during the financial year.

BSX has responded to this recommendation by, amongst other things, advising that it will review its surveillance practices and develop a guidance note on continuous disclosure obligations. Whilst this action goes part of the way to responding to our concerns, we remain unsatisfied with BSX's explanations for the failings that we identified.

**Trading**

BSX procedures state that unusual movements in the prices or volumes of listed securities are monitored under the BSX Market Surveillance Plan. Unexplained material movements are referred to the companies' office so a query can be made of the relevant entity. A range of initial checks are then carried out to determine whether the change is explainable or should be examined further. These initial inquiries include checking announcements by the relevant entity to the market, speaking with the relevant market participants and making initial inquiries of the relevant entity.

During our assessment we noted some deficiencies in BSX's monitoring of trading activity on its market, specifically in relation to price queries relating to community bank entities.

We examined a case where BSX reviewed the trading of a community bank entity that traded at \$1.09 in October 2005 and traded next in January 2006 at \$1.90. The BSX Markets Manager queried the entity and in a filenote dated 30 January 2006 noted that the price of \$1.90 was close to the price that the company secretary had reported that the shares had transacted at prior to listing and in that context that the price movement was not unusual. We were further advised that the entity's company secretary had advised BSX that they considered the \$1.09 price to be undervalued and were disappointed with that price.

The query and the response were not released to the market and it appears that BSX did not query who the parties to the trade were. This would be particularly relevant in our view, given the comments by the entity's company secretary and potential for manipulation.

We also reviewed trading in 12 listed entities as at 24 February 2006. We noted five trades relating to two listed community bank entities where substantial price movements of greater than 20%, both up and down, were not analysed or questioned by BSX. Furthermore, there did not appear to be any explanatory announcements.

**Recommendation 5**

We recommended that BSX review its supervisory practices in relation to trading conducted on its markets. BSX should introduce rules, whereby it publishes price queries it issues, along with the entities' responses, similar to LR18.7A of the ASX listing rules. This would ensure a fully informed and transparent market.

In response to this issue, BSX has advised that it will conduct a review of its trading supervision practices, including its record-keeping for trading investigations. Since 1 October 2006, greater scrutiny of BSX trading has also occurred following the introduction of a 'Compliance Explorer' program, which is a program used by many exchanges around the world for trading surveillance. BSX also advised that due to the thin trading volumes and broad spreads on its market, mandatory disclosure of price queries is unwarranted. Whilst this action goes part of the way to responding to our concerns, we remain unsatisfied by BSX's explanations for the exceptions we noted.

***Periodic disclosure***

The BSX listing rules require that an entity must provide BSX with a completed copy of Annexure 3A detailing its financial results following the end of each half-year (LR 3.3) and full financial year (LR3.5). Under LR 3.17(a) to (n), an entity must also include certain additional information in its annual report including details about corporate governance, shareholder spread and substantial shareholders. According to BSX procedures, the BSX companies' office pays particular attention to both the timeliness and substance of the information provided to BSX under these rules.

In our previous assessment report, we noted some exceptions with LR3.17 compliance and recommended that BSX should review its supervisory practices in relation to periodic disclosure requirements. In response, BSX advised that existing checklist procedures for periodic reporting will be extended to include content matters.

During our discussions with the BSX Markets Manager on the timeliness of disclosure, we were advised that BSX had suspended 3 entities for failure to lodge a half yearly/annual report within the time required. One was noted in BSX's annual regulatory report and two occurred after 30 June 2005. He also advised that the entities are automatically suspended if they do not lodge their financial reports in a timely manner. We reviewed the files relating to these and were satisfied with BSX's action in this area.

In terms of the substance of disclosure, as a result of our recommendations last year, BSX increased its supervision in this area through a structured program to review the annual report additional disclosure required by LR3.1 (a) to (n), leading to 7 entities being identified as non-compliant. While BSX has made progress in relation to monitoring the periodic disclosure by entities listed on its market and in turn addressed our recommendation from last year, it is still not enforcing its rules in a timely manner.

During our assessment we noted that seven community banks were written to in early January 2006 in relation to disclosure in annual reports, and specifically the failure on the part of those community banks to comply with LR 3.17. Of the seven entities, two lodged following the initial letter from BSX. The remaining five entities were sent a reminder email on 1 February 2006. Subsequently, four of these lodged the required information over the ensuing weeks. At the time of our assessment visit, one entity was yet to lodge the requested information despite BSX's reminders. Subsequently, on 11 May 2006, BSX suspended this entity for failure to disclose. This entity was reinstated on 6 July 2006 following release of the required information.

Given that the time taken to obtain disclosure was in the vicinity of three to four months after the lodgement deadline, BSX should have taken stronger action to ensure compliance.

**Recommendation 6**

We recommend that BSX more vigorously enforce its periodic disclosure requirements and use its suspension powers if necessary to ensure timely disclosure of information required pursuant to its listing rules.

In response to this, BSX has advised that, in future, it will more vigorously enforce its periodic disclosure requirements and will consider suspending entities for serious and material breaches.

We also reviewed the annual reports of 12 entities listed on BSX for compliance with the additional informational requirements of LR 3.17. We found insufficient disclosure regarding community banks' corporate governance practices under BSX LR 3.17(c). LR3.17(c) requires a statement of the main corporate governance practices in place during the reporting period.

We noted two instances where entities had simply stated that the 'board had adopted policies' without disclosing the nature of these policies, while in another two instances entities had stated 'the board was working toward these policies'. All instances related to community banks.

When questioned about this, the BSX Markets Manager advised that if an entity states that they have procedures or procedures are in the process of being prepared, his interpretation is that the entity has complied with the requirement in LR 3.17(c). He added that the rules did not actually require an entity to have such standards, as long as they said something about them.

In June 2004, Bendigo Bank obtained immunity from the ACCC against legal action under the third line forcing conduct provisions of the Trade Practices Act. In its submission, Bendigo Bank argued that there were benefits to be gained from listing community companies on BSX including making them more successful commercial enterprises within their communities. Some relevant arguments included that it provides a more transparent communication path to investors and potential investors as a result of continuous disclosure and the additional disclosure requirements may lead to improved efficiencies for community companies, as the requirement for companies to provide more rigorous disclosure can lend itself to better systems and controls, improved management of information and greater operating efficiency of the business as a whole.

A statement that an entity has corporate governance policies without detailing what they are does not in our view constitute compliance with this rule, nor does it help achieve the benefits outlined above for listing community enterprises, especially in relation to transparency of disclosure to shareholders.

**Recommendation 7**

We recommend that BSX consider drafting a guidance note to communicate BSX's expectations and to assist entities in complying with the corporate governance practice disclosures required by LR3.17(c).

BSX has accepted our recommendation.

**Admission to the BSX official list**

Chapter 1 of the BSX listing rules set out the requirements that must be satisfied before an entity can be listed on BSX. According to BSX's compliance manual and procedures, the BSX Markets Manager is responsible for assessing listing applications and for making recommendations to the Listing Committee, which has the delegated power from the BSX board to determine listing applications.

We reviewed the process followed by 15 out of the 22 entities that listed on BSX between 7 March 2005 and 24 February 2006 to ensure that they satisfied the profit or asset and shareholder spread tests under the listing rules and considered whether BSX followed its listing procedures.

During the assessment we observed that BSX admitted two community bank entities without taking into consideration equity raising costs, which is not in accordance with BSX listing rules and procedures which require that an entity have net tangible assets (NTA) of at least \$500,000, after deducting the costs of fundraising. We did not note any other instances of BSX not incorporating equity raising costs in their calculation of NTA so we are comfortable that it is not a systemic problem.

All but one of the 22 entities that listed during the assessment period were community bank entities. Of these, six were admitted with the asset requirement waived. However, this is in line with BSX policy and BSX is seeking listing rule amendments to facilitate a community board which is subject to ongoing discussion between BSX and ASIC.

**Recommendation 8**

We recommend that BSX be more vigilant when considering listing applications, in particular when considering the impact of equity raising costs on their assessment of the asset test admission criterion.

BSX has accepted our recommendation.

**Participant supervision****Arrangements for monitoring participant conduct**

BSX's arrangements for monitoring participant conduct and for enforcing compliance with rules changed during the review period as a result of NSXL's acquisition of BSX and the closure of BSX's Bendigo office in October 2005.

As set out in the *Periodic lodgements* and *File loss* sections on page 18 of this report, our review of participant files suggests that to December 2005, there was no ongoing active monitoring of participant compliance with the BSX business rules regarding lodgement of documents. Furthermore, notwithstanding the loss of participant files, BSX did not produce any documents or information to confirm that such monitoring occurred.

Upon the closure of the Bendigo office, it is ASIC's understanding that the supervisory functions were initially carried out by the BSX Markets Manager and later these duties were transferred to the Newcastle office. As advised previously in the *General obligations* section of this report on page 9, it was not clear based on contradictory statements and documents which BSX or NSXL staff were responsible for monitoring participant compliance.

The BSX board did not appear to receive any information relating to participants and their compliance with the BSX business rules, and it never sought such information.

In December 2005, the BSX Companies Manager presented as an agenda item to the BSX board a paper on why the collation of participant returns and their analysis be outsourced to McCosker Partners. The BSX board agreed and participants were advised of this change in arrangements in December 2005.

It appears, however, that the BSX board agreed to outsource a supervisory function without knowing how, when and if reports will be made on participant compliance with BSX business rules. Furthermore, it is of significant concern to ASIC that the BSX board has not requested such information to satisfy itself that it continues to meet its licence obligations. At the time of our assessment, the BSX Companies Manager who made the proposal to the board was not aware of the terms of the outsourcing. Further, the BSX board that approved the outsourcing did not query any aspect of the outsourcing. We were advised that NSXL's General Manager had made all the arrangements and that he would know the details.

ASIC Policy Statement 172 *Australian market licences: Australian operators* (PS 172) at PS 172.118 states that a market licensee remains responsible for compliance with each of its licensee obligations, even if it outsources performance of some aspects of the obligations. Therefore, a market licensee must have adequate processes for monitoring and assessing the performance of any outsourced activities.

ASIC considers that BSX does not have any processes for monitoring or assessing the performance of its outsourced functions with McCosker Partners, as required by PS 172.118.

During our assessment, we reviewed the reports prepared by McCosker Partners that are provided to NSXL's General Manager. We have the following concerns about the outsourcing of this function by BSX:

- the report shows that all three BSX participants lodged reports on 17 January 2006, which is later than the five business days required by the business rule; however, the report makes no mention that the participants are in breach of the BSX business rule; and
- the report only contains information on surplus funds.

As a result of our review, we question the purpose of outsourcing a function to a firm where the reporting provided to BSX on participant compliance appears to be limited to providing a table containing the amount of surplus funds of the participant and there is no reporting on other returns required by the BSX business rules.

**Recommendation 9**

We recommend that the BSX board should obtain updates on participant supervision and compliance with its business rules on a regular basis to satisfy itself that it is complying with its market licensee obligations at all times.

BSX has accepted our recommendation. Participant supervision is now the responsibility of a joint BSX and NSX Compliance Committee.

**Recommendation 10**

We recommend that BSX review the terms of its outsourcing of participant supervision to McCosker Partners, to satisfy itself it has adequate processes for monitoring or assessing the performance of McCosker Partners in accordance with PS 172.118.

BSX has accepted our recommendation.

***File loss***

During our assessment visit we were advised that BSX's participant files had been lost and that the files produced in response to an ASIC Act section 30 notice had been recreated from electronic lodgements, where possible. However, given only some of the participants lodgements were electronic, full recreation was not possible, so as a result participant files were incomplete. It was suggested that the loss was due to the closure of the Bendigo office and subsequent move of the participant files to Newcastle in October 2005.

**Recommendation 11**

We recommend that BSX require participants to re-lodge the documents for the period February 2005 to February 2006, and that BSX provide a detailed report to the BSX board on participant compliance with BSX requirements. A copy of this report is to be provided to ASIC.

BSX accepted our recommendation and a report was lodged with us.

***Periodic lodgements***

Under the BSX business rules (BR), a BSX broker must prepare and lodge various information with BSX including: accounts for each financial year, a schedule of investments as at the end of the financial year, surplus liquid capital returns and aged debtor returns, five business days after month's end; a certificate of currency for each of its insurance policies within 14 business days after the end of each financial year; and a trust account schedule on a quarterly basis, within 5 business days after the end of each quarter.

In our previous assessment report, we noted that BSX did not enforce certain business rules in relation to the submission of investment schedules by participants, compliance with capital rules was ad hoc and certificates of insurance were not being lodged as required. In response to recommendations concerning these matters, BSX advised that it would conduct a review of its business rules with a view to putting a submission to ASIC for deletion and or amendments of the relevant rules. BSX was made aware of our concerns in March 2005.

Proposed rule amendments were not given to ASIC until June 2006. We are concerned that BSX took 15 months to address this recommendation, particularly given the new issues we have identified in this report and the need for them to be properly addressed on a timely basis.

During our current assessment we reviewed the files of the three BSX brokers and interviewed the BSX Markets Manager about BSX's processes. As noted previously, because the original files were lost, for the purposes of compliance with our notice BSX compiled the three participant files from electronic lodgements where possible. However, given only some of the participants lodgements were electronic, full recreation was not possible, so as a result participant files were incomplete.

In BSX's annual regulatory report, BSX states that participants complied with the BSX business rules and all documents required under the rules were received. In our discussions with the BSX Companies Manager, he advised that at the time the BSX annual regulatory report was lodged with ASIC (28 September 2005) the statement was correct and participant lodgements were complete, but it could not now be proved.

None of the files reviewed contained all of the information required pursuant to the BSX business rules.

We are concerned that BSX was unable to provide us with any alternative confirmation that the required documents were lodged, demonstrating how BSX monitored participant compliance with these rules during the review period. The process regarding collation and review of participant returns was changed in December 2005 when BSX agreed to outsource this function to accounting firm McCosker Partners.

Due to the file loss and inadequate monitoring processes, BSX is unable to satisfy ASIC that participants have complied with the requirements to lodge information and documents under the BSX business rules.

## **Adequacy of resources**

### ***Financial resources***

In this assessment, we considered whether BSX continues to meet its obligation to have sufficient resources for the operation of the market in a fair, orderly and transparent manner, including sufficient financial resources for the operation and supervision of the market. In our previous assessment report we noted that as a result of NSXL's acquisition of BSX, it was now being funded by NSXL, which had cash resources of over \$11 million.

Our review of BSX and BSX Group's annual financial reports and quarterly cash flow statements during the assessment period revealed a declining cash position for the BSX Group. As a result of our review, we sent two letters to the directors of BSX,

copied to the directors of NSXL, advising of our analysis and stating that we required comfort that there were appropriate arrangements in place to enable BSX to continue to satisfy its obligation under s792A(d).

In both instances we received a response from NSXL advising that it would provide any necessary financial, technological and human resources to BSX in order for BSX to comply with its requirements as a holder of a market licence.

We have thus far relied on NSXL statements to us that it will continue to support BSX. Given NSXL has control over 2 Australian market licensees, we would prefer to see more formal support arrangements in place.

We reviewed board minutes and noted that NSXL appeared to be making decisions affecting the adequacy of resources available to supervise the BSX market without consulting the BSX board. It also appeared that the BSX board were uninformed of the entity's ongoing financial position. While BSX Group's financial position was reviewed at each monthly NSXL board meeting, which is a joint meeting of both the NSXL and BSX Group board, none of the members of the BSX board sat on either the BSX Group or NSXL boards.

At its 20 October 2005 board meeting, the BSX board did review its financial statements for the year and noted that NSXL has confirmed that it would continue to fund the operations of BSX. However, other than this, no other consideration or reporting back had been provided by NSXL to the BSX board on its financial resources.

The BSX board charter states that the BSX Group Managing Director would also sit on the BSX board, which would assist in the informational flow between the NSXL/BSX Group boards and the BSX board; however, this was not occurring in practice.

We were concerned at this because while the BSX board has responsibility for BSX's market licence, it appeared to be uninformed about the financial resources available for supervision of its market.

**Recommendation 12**

We recommend that NSXL and BSX make a formalised written agreement detailing how NSXL will resource BSX and the supervisory services it will provide to BSX.

BSX has accepted our recommendation and NSXL maintains that it will continue to provide sufficient financial resources to BSX. As advised previously in this report, NSXL's recomposition of the NSXL, BSX and NSX boards aims to address the communication issues identified as a result of our assessment.