



**ASIC**

Australian Securities & Investments Commission

## REPORT 168

# Market assessment report

ASX Limited, ACN 008 624 691

Australian Clearing House Pty Limited, ACN 001 314 503

ASX Settlement and Transfer Corporation Pty Limited,  
ACN 008 504 532

Sydney Futures Exchange Limited, ACN 000 943 377

SFE Clearing Corporation Pty Limited, ACN 050 615 864

Austraclear Limited, ACN 002 060 773

28 August 2009

### About this report

This report summarises ASIC's:

- seventh assessment of ASX and SFE under s794C(2) of the *Corporations Act 2001* (Corporations Act).
- seventh assessment of ACH, ASTC and SFECC and fifth assessment of Austraclear under s823C(2) of the Corporations Act.

This report relates to the period 1 January 2008 to 31 December 2008. Accordingly, it does not address the Government announcement of 24 August 2009 on proposed structural changes to the supervision of Australia's financial markets.

ASX group will continue to have its current supervisory responsibilities for its markets and clearing and settlement facilities until at least the end of the next period for assessment purposes.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Previous reports on licensees within the ASX group

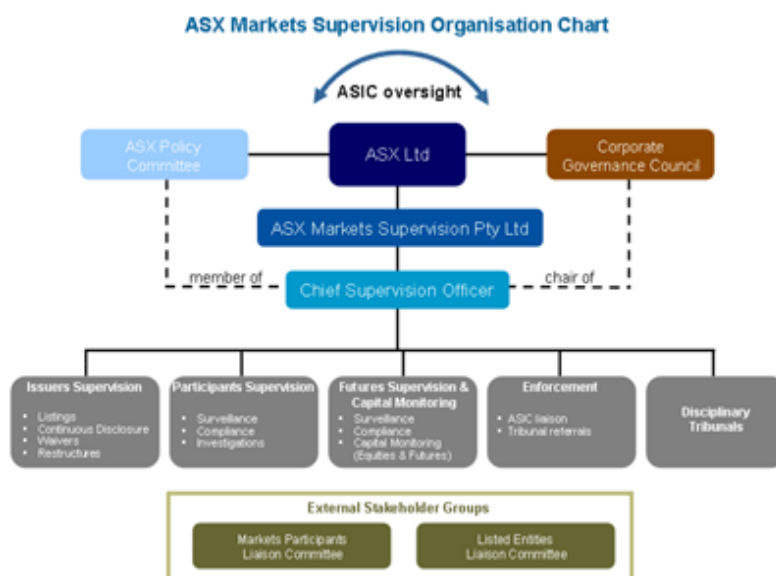
Our last reports about ASX Limited (ASX), Australian Clearing House Pty Limited (ACH), ASX Settlement and Transfer Corporation Pty Limited (ASTC), Sydney Futures Exchange Limited (SFE), SFE Clearing Corporation Pty Limited (SFECC) and Austraclear Limited (Austraclear) were publicly released in August 2008.

### Summary of recent assessment reports for ASX group licensees

Entity	Report number	Date released
ASX	REP 135	August 2008
	REP 94	May 2007
ACH	REP 135	August 2008
	REP 94	May 2007
ASTC	REP 135	August 2008
	REP 94	May 2007
SFE	REP 135	August 2008
	REP 99	November 2007
SFECC	REP 135	August 2008
	REP 99	November 2007
Austraclear	REP 135	August 2008
	REP 99	November 2007

## About ASX

- 1 During the period of the assessment, ASX and SFE each held an Australian market licence that permits it to operate a market in the financial products described on its licence. ACH, ASTC, SFECC and Austraclear each held a licence to operate clearing and settlement facilities. Copies of all licences are available on ASIC's website at [www.asic.gov.au](http://www.asic.gov.au).
- 2 The merger between ASX and SFE Corporation Limited was completed on 25 July 2006. ASX Market Supervision Pty Ltd (ASXMS) commenced operation as the supervisory arm of the ASX group on 1 July 2006. Other exchanges around the world, such as the New York Stock Exchange (and New York Stock Exchange Reg, Inc) have also employed a separate entity as part of the supervisory structure of their market. Below is the structure of ASXMS and the relevant current business units within the company.



- 3 Under a Supervisory Services Agreement between the ASX group licensees and ASXMS, ASXMS provides specified supervisory services to the licensees for the purposes of ensuring that the licensees meet their licence obligations to:
  - Have adequate conflict handling arrangements; and
  - Monitor conduct and enforce the rules.
- 4 Following a review last year by ASXMS of its conflict handling arrangements, only three types of minor supervisory decisions are made by areas of the ASX group outside ASXMS, namely:
  - The procedural process to admit Austraclear participants;

- The waiver of fail fees that would otherwise apply to failure to perform security delivery obligations; and
  - The automatic imposition of fines on an SFE Participant, whose actions have led to the invoking of the SFE Error Resolution Policy and a trade being cancelled.
- 5 The ASXMS board is informed of supervisory activity within non ASXMS business units through monitoring activity conducted by ASX Licence Compliance and also through quarterly reports from ASX Operations division to ASXMS. ASX Licence Compliance is an internal assurance function focusing on ASX group licence obligations.

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## A About this report

### Scope of these assessments

- 6 Under the Corporations Act, ASIC is required to annually assess the extent to which ASX group licensees have complied with their obligations under s792A(c) and s821A(c). These obligations are to have adequate supervisory arrangements, including arrangements to manage conflicts of interest. A corollary of these obligations is the extent to which ASX group licensees have adequately resourced these supervisory arrangements. The obligation to do so is found in s792A(d) and s821A(d), and compliance with these obligations has also been assessed.
- 7 In light of the volatile market conditions experienced in 2008 and as foreshadowed in ASIC's last assessment report, ASIC has assessed the ASX group licensees' compliance against a broader range of statutory obligations than were covered in prior assessments.
- 8 This broader assessment was conducted for the purpose of determining the extent to which the relevant ASX group licensee is complying with its obligations under s792A(a) and s821A(a). These are the obligations to, to the extent that it is reasonably practicable to do so, do all things necessary to ensure that the markets operated by the ASX group are fair, orderly and transparent and the services of the ASX group's clearing & settlement facilities are provided in a fair and effective way.
- 9 This report is focussed on the period 1 January 2008 to 31 December 2008. However, the assessment process did extend into the first half of 2009 and accordingly significant events which have taken place since 31 December 2008 have also been considered in preparing this report.
- 10 There are overlaps in assessment periods from year to year and this is managed by ASIC and ASX. ASIC's most recent previous assessment covered the period from 1 July 2006 to 30 March 2008—with the focus of the review between January to March 2008, being the major market developments that arose during those months.

### Our methodology

- 11 In conducting our assessment:
  - ASIC undertook extensive discussions with senior ASX group personnel including all the directors of ASXMS on targeted and topical

subject areas—with a particular emphasis on real-time surveillance and participant monitoring.

- ASIC also undertook a detailed review of ASX group practices and procedures by way of an extensive review of internal ASX group documentation obtained under notices issued pursuant to section 30 of the ASIC Act.
- ASIC also reviewed:
  - the annual regulatory report given to ASIC covering all ASX group licensees dated 30 September 2008 as required under s792F and 821E of the Act;
  - information received from and about ASX group licensees in the ordinary course of ASIC’s dealings with them as market or clearing and settlement facility licensees, including interaction with the licensees on a range of operational issues, referrals of serious contraventions and information obtained from the register of rule waivers;
  - information from external sources, including media and industry commentary;
  - the operation of the market throughout the period, in particular in relation to real-time surveillance; and
  - internal licensee material, including disciplinary and investigation files, internal reports and information collected by the ASX group during the assessment period; and
- ASIC has also had various discussions with representatives of the Reserve Bank of Australia.

## Structure of the report

- 12 This report is divided into the following sections:
- Section B contains the executive summary;
  - Section C contains ASX group's agreed actions, ASIC’s recommendations and observations;
  - Section D discusses market conditions and ASX group’s activities during 2008; and
  - Section E outlines the ways in which ASX group has complied with the agreed actions from the last assessment.

## B Executive summary

### Key findings, agreed actions and ASIC recommendations

#### Compliance with statutory obligations

- 13 ASIC is satisfied that (in terms of the standards set out in the Corporations Act) during the period to which this assessment report relates:
- ASX and SFE are, to the extent that it was reasonably practicable to do so, doing all things necessary to ensure that they operate markets that are fair, orderly and transparent under s792A(a);
  - ASX and SFE have adequate arrangements to supervise their respective markets under s792A(c) and that the provision of supervisory services is adequately resourced under s792A(d);
  - ACH, ASTC, SFECC and Austraclear are, to the extent that it was reasonably practicable to do so, doing all things necessary to ensure the services of the clearing and settlement facilities are provided in a fair and effective way under s821A(a); and
  - ACH, ASTC, SFECC and Austraclear have adequate arrangements to supervise their respective clearing and settlement facilities under s821A(c) and that the provision of supervisory services is adequately resourced under s821A(d).
- 14 While ASIC's view is that ASX group licensees complied with their obligations under the Corporations Act and that ASX group does continuously monitor and improve the performance of its supervisory activities, there are 13 areas for improvement or attention (covered by 9 agreed actions and 4 recommendations) that ASX group has agreed to, or should, address.

#### Factors ASIC has had regard to

- 15 These agreed actions and recommendations, while important, do not cause us to qualify our conclusion that ASX group licensees meet the statutory standards. In reaching these views, ASIC has also had regard to:
- ASX group's supervisory performance in 2008 when compared with previous assessment periods;
  - The existing arrangements of the ASX group and ASXMS board for ongoing review of market events and conditions and their implications for the current and future operation and supervision of ASX group's markets and clearing and settlement facilities;



- Changes in ASX group's supervisory resources and practices during 2008 and since;
- The demonstrated efficiency and soundness of ASX group's clearing and settlement facilities during 2008;
- ASIC's general understanding of supervisory approaches taken in a range of major overseas markets; and
- ASX group's implementation of previous assessment findings and recommendations, including ASX group's implementation of agreed actions from last year's assessment.

### Agreed actions

- 16 This report identifies areas where ASIC and ASX have concluded that changes and improvements were needed. ASX and ASIC have agreed in seven cases that ASX should report to ASIC on the effectiveness of changes and improvements that have been made by ASX in those areas, before and during the assessment process. ASX and ASIC have also agreed in two cases that ASX should undertake actions. The agreed actions are set out below (and discussed in detail in Section C).

### Participant monitoring

- 17 **Agreed action 1:** ASIC had concerns about the resourcing levels within the ASX Capital Monitoring function. During 2008, ASX increased the resourcing of this function and also initiated or proposed a number of changed practices that ASIC considers are necessary to obtain a more robust assessment of the capital position of participants (such as the introduction of spot checks of participants).
- 18 ASX group has agreed to submit a report to ASIC by 31 March 2010 reviewing the effectiveness of these changes (both in terms of resources and practices). This report should include discussion and explanation of any further changes in resourcing or practices that have occurred since 1 July 2009.
- 19 **Agreed action 2:** The ASX Compliance function has improved its practices and resources during 2008, to support an enhanced focus on the overall internal supervision culture of participants. ASIC agrees that these changes were necessary. ASX group has agreed to provide a progress report to ASIC by 31 March 2010, reviewing the effectiveness of these changes (both in terms of resources and practices) and whether any further changes are warranted. ASX has also agreed to provide a more complete report on the effectiveness of these changes as part of the ASX group's Annual Regulatory Report for 2009/10.

- 20 **Agreed action 3:** During 2008, ASX group has implemented a number of resourcing initiatives relating to its Enforcement and Tribunal functions in anticipation of pressures arising from organisational and market changes.
- 21 ASX group has agreed to report to ASIC by 31 March 2010 reviewing the effectiveness of these changes and ongoing adequacy of the resourcing in the Enforcement and Tribunal functions—giving particular attention to the consequences for resourcing of the organisational and market changes as they take effect. This report should include discussion and explanation of any further changes in resourcing or any new practices that have occurred since 1 July 2009.

### **Real time surveillance**

- 22 ASX was active during 2008 in its real-time supervision of its markets including making 96 market integrity referrals to ASIC. Notwithstanding this, ASIC identified a number of ASX's real-time surveillance practices that could be improved, such as additional practices to ensure consistent decision making by surveillance analysts and the wider use of listed entities' insider lists for potential insider trading matters.
- 23 **Agreed action 4:** ASX has agreed to report by 31 March 2010, on the effectiveness of changes it has made to practices for handling complaints in relation to trading activities and the effectiveness of changes it has made to implement more structured oversight of analysts' reviews of the need for price queries.
- 24 **Agreed action 5:** ASX has agreed, in consultation with ASIC, to give consideration to requesting on a more regular basis, insider lists from listed entities, to assist in insider trading investigations.
- 25 **Agreed action 6:** ASX has agreed to report by 31 March 2010, on the effectiveness of recent changes to the resourcing and procedures of ASX's real-time surveillance function. The report will include consideration of improvements in the consistency of performance of this function, particularly across different classes of issuers.

### **Issuers**

- 26 **Agreed action 7:** During 2008, three entities were admitted to the list without meeting the spread requirements. ASX has responded by changing its admission certification requirements. These changes were intended to minimise the scope for applicants for listing to mislead ASX about their satisfaction of the minimum spread requirements. ASX has agreed to report to ASIC by 31 March 2010 reviewing the effectiveness of these new procedures and identifying whether any further changes are warranted.

## Technology and operations

- 27 **Agreed action 8:** Two technology outages during 2008 were caused by software error. In one instance, this resulted in a number of participants on the SFE market not being aware that their orders had been executed.
- 28 ASX group has agreed to report to ASIC by 31 March 2010, on a review of the effectiveness of ASX group's measures to monitor and deal with software capacity issues on an ongoing basis. This report will also outline what arrangements ASX group has put in place to improve the means and nature of communications to participants in the event of a systems related incident of this type.
- 29 **Agreed action 9:** SFE invoked its Error Resolution Policy in December 2008. As part of this process, SFE determines a Fair Price Value (FPV) which is used to identify which trades are to be cancelled.
- 30 ASX group has agreed that on invocation of the Error Resolution Policy by ASX group, ASX group will ensure the basis for determination of the FPV is fully documented and that ASX group will report to ASIC as soon as possible after the Error Resolution Policy is invoked (and prior to the submission to ASIC of the ASX Market Operations Incident Report), on the basis of the rationale for the FPV determination.

## Recommendations

- 31 This report also makes recommendations that are intended to respond to specific areas which emerged in 2008 regarding ASX group's approach to the operation and supervision of its markets and which need to be addressed in the near term. The recommendations are set out below (and discussed in detail in Section C).
- 32 **Recommendation 1:** Algorithmic trading and direct market access are growing as methods for dealing on ASX group's financial markets. Typically algorithmic trading is implemented by direct market access. During the assessment period, ASIC identified incidents which highlighted the potential for these activities to threaten the orderliness of ASX's markets.
- 33 ASIC notes ASX group has commenced a review of the implications of these methods of trading for the orderly operation and supervision of its markets. ASIC recommends that ASX group's review of algorithmic trading and direct market access should include consideration of the following matters:
- The adequacy and consistency of ASX group's operating rules and procedures, in setting minimum risk and operational requirements for participants in enabling direct market access to clients;

- Whether the operating rules set suitable standards of accountability by participants for the trading activities of its direct market access clients;
  - Whether retail investors are adequately informed about the nature of the direct market access services and the characterisation of the securities and investments that they acquire via this service; and
  - Developments in international best practice standards for the provision of direct market access services and the supervision of algorithmic trading.
- 34 ASX group should report to ASIC on its review of algorithmic trading and direct market access by 31 March 2010. The preparation and delivery of this report will assist in any joint work that ASIC and ASX group may appropriately undertake in this area.
- 35 **Recommendation 2:** The front line real time surveillance activities of ASX Surveillance play a critical part in identifying matters warranting further investigation and ultimately, disciplinary or enforcement action by ASX and/or ASIC. ASIC notes that ASXMS (including the ASXMS Board and senior management) conducts ongoing reviews of the performance of its real-time surveillance function. As part of ASX's ongoing review of this function, ASIC recommends that ASX includes in its report for the purposes of agreed action 6, analysis of the following matters:
- The impact of a bear market on this function;
  - Market commentary on the effectiveness of this function; and
  - The effectiveness of this function in monitoring trading in different classes of listed entities (e.g. liquid and relatively illiquid stocks of listed entities).
- 36 The report should outline what additional improvements might or should be undertaken by ASX, recognising that the Government announcement of 24 August 2009 will impact on what ASX might reasonably be expected to undertake in respect of the surveillance function.
- 37 **Recommendation 3:** ASIC considers there is value in ASX undertaking further consideration of the way in which it approaches decisions to administer trading halts and suspensions and the related operating rule framework, to ensure they continue to promote the delivery of fair, orderly and transparent markets in the context of the recent changed market conditions.
- 38 In undertaking this review, ASIC recommends ASX considers a range of issues including the appropriateness of tools used in other jurisdictions such as 'circuit breakers' and the appropriateness of rules that deal with the management of listed stock once their market price hits a certain minimum. ASX should report on this review by 31 March 2010.

- 39        **Recommendation 4:** ASX has admitted to listing and quotation, a number of issuers with partly paid securities. The following entities are not no-liability companies and have partly paid products with an attaching liability:
- BrisConnections Investments Trust and BrisConnections Holding Trust
  - Multiplex Prime Property Fund;
  - Westpac Office Trust;
  - Citadal Resource Group Limited; and
  - Solagran Limited.
- 40        BrisConnections Investments Trust and BrisConnections Holding Trust (together, BrisConnections) were admitted to ASX's official list and their partly paid stapled units, BCSCA, were quoted on 30 July 2008. Subsequently BCSCA traded down to the lowest price possible on ASX of \$0.001 and remained there from late 12 November to 15 April 2009, when trading was suspended because of a corporate action by BrisConnections.
- 41        During the assessment period, ASX did consider whether the market in BCSCA was operating in accordance with ASX's statutory obligations and concluded that it did so at all times. ASIC recommends that ASX group conducts a further review of the circumstances surrounding BrisConnections and any other partly paid securities issued by entities other than no-liability companies, having regard to its statutory obligation, to the extent it is reasonably practicable to do so, to ensure it does all things necessary to operate markets in a fair, orderly and transparent manner.
- 42        The results of this review should be reported to ASIC by 30 November 2009. This review should consider:
- Whether partly paid securities of this type should be quoted by ASX;
  - Its approach to trading halts and suspensions;
  - Its approach to market participants permitting direct market access to retail investors (including whether investors have sufficient information to trade on an informed basis);
  - The way in which the features of quoted products are displayed to online traders;
  - The way in which partly paid products on its website are identified to market users; and
  - When trading in low priced securities may cease to be fair, orderly and transparent and how ASX group should respond in these circumstances.

### Ongoing and future work

- 43        ASIC believes that the market events of 2008 were such that it is now a good opportunity for ASX group to review a range of broader issues having regard

to its statutory obligations including its obligation, to the extent it is reasonably practicable to do so, to do all things necessary to ensure that ASX group operates markets that are fair, orderly and transparent. ASIC suggests any review should be completed as early as possible in 2010 so its results can form part of ASX group's business planning and review of resourcing needs for the financial year 2010-2011. ASIC recognises that the Government announcement of 24 August 2009 will impact on what ASX group might reasonably be expected to undertake in respect of the surveillance function.

44 ASIC notes that ASX group, the ASXMS Board and senior management of ASXMS are engaged on an ongoing basis in strategic analysis of issues that arise in the operation and supervision of its financial markets and their implications for ASX group's compliance with its statutory obligations. Nevertheless, ASIC encourages ASX group to include a review of the following issues:

- Assessing the suitability of entities for listing and quotation;
- New product development and quotation;
- Retail investor protection;
- Identifying and responding to future potential 'at risk' aspects of the operation of its markets (including the need to impose additional requirements on ASX issuers in respect of the frequency and quality of asset valuations); and
- Exercise of ASX's discretions under its operating rules.

45 These areas are briefly discussed below and contain a number of issues on which ASIC and ASX will need to work together.

#### **Suitability for listing and quotation**

46 The volatile market conditions of the recent period have highlighted the question of whether entities with particular business models are suitable for listing on ASX's market.

47 ASIC suggests ASX examines the current framework for the listing of entities and quotation of securities (including ASX's listing and market rules and its approach to any relevant discretionary decisions). Such a review should take into account the experiences during the volatile market conditions of 2008 (including issues such as illiquidity in the products of particular entities) and future possible listing applications from entities in sectors that may be particularly affected by any ongoing economic downturn.

### **Product development and quotation**

- 48 During 2008, ASX group was short-listed for an international award for its project methodology. Whilst the project process around ASX group product development (such as the development of new financial products or new market initiatives e.g. AQUA or Contracts for Difference) is typically timely and efficient, it is imperative that appropriate profile and consideration is given to the associated supervisory and investor protection issues around bringing a particular product to market. This is particularly the case given the extent to which the nature of market conditions have recently changed.
- 49 In particular, the events of 2008 have re-emphasised the importance of appropriate supervisory considerations being undertaken by ASX group as part of its product development framework—particularly for the development and subsequent supervision and orderliness of trading in novel and complex products accessible to the retail sector.
- 50 During the course of the assessment process, ASX group introduced a ‘sign-off-by-supervision’, which attests to the satisfaction of the relevant supervisory considerations before any project is able to proceed to the next phase. ASIC notes this initiative but still suggests there is value in a review of the entire product development process (whether or not that product development is considered an ASX group ‘project’), including the effectiveness of the more recent change of ASX practices.

### **Retail investor protection**

- 51 In addition to a number of separate agreed actions and recommendations in this report which have consequences for retail investors (e.g. direct market access—Recommendation 1), ASIC encourages ASX group to review the way in which it interacts with this segment of its market and gives particular consideration to the possible changes in retail investor behaviour that may eventuate as a result of the recent losses to Australian household wealth.
- 52 For example, ASIC suggests ASX group reviews the way its popular website provides important market related information to retail investors, with a view to maximising its usefulness, completeness and currency and also reviews the coding it applies to different categories of financial products.

### **Approach to potential ‘at risk’ sectors**

- 53 As the economic cycle progresses, it is likely that certain sectors or types of issuers may be increasingly affected. ASIC encourages ASX to review potential ‘at risk’ areas of the market. ASIC believes this will aid ASX’s capacity to pre-emptively address market, operational and supervisory concerns (in a number of ways, including the quality of disclosure and market conduct standards). This should include a review of:

- Asset related disclosures and the need to impose additional requirements on ASX issuers in respect of the frequency and effectiveness of asset related disclosures and valuations (such as a review of the Valmin and JORC Codes);
- Complex corporate structures and related disclosure issues; and
- Leverage ratios of particular sectors and the aptness of particular disclosure models for certain types of issuers.

### Exercising discretion

- 54 In December 2006, ASX issued Guidance Note 25 to assist entities understand how ASX exercises some of the discretions it has in the Listing Rules. In light of the market events of 2008, ASIC encourages ASX to again review the considerations by which it exercises its discretion under the ASX Listing Rules. This review should have a particular focus on corporate governance, including the exercise of ASX's discretion on matters such as who can vote at general meetings to approve particular transactions.

### Market conditions and events

- 55 A discussion of the market conditions and major market events for 2008 and the early part of 2009 are contained in section D of this report. Some key aspects of the market conditions of 2008 are as follows:
- There was a fall in the ASX/S&P 200 index of 41% (in local currency terms) (Source: *Bloomberg*);
  - There was a doubling in the volatility of the ASX equity market from 2007 to 2008 (Source: *Bloomberg*);
  - Household wealth fell 42.6% and the value of superannuation fell 22% between 30 September 2007 and 31 December 2008 (Source: *ABS*); and
  - There was an estimated loss in value arising from corporate and investment product collapses of about \$73 billion for the period 1 January 2008 to end May 2009 (Source: *ASIC*).
- 56 The table below outlines a number of the major market events during 2008 and how they are dealt with in this report.

The market event	How it is dealt with in this report
The application of the short selling regime	<ul style="list-style-type: none"> <li>• Discussed in Section D at paragraph 208, including the delay in the opening of the market on 22 September 2008;</li> </ul>



The market event	How it is dealt with in this report
Corporate and investment product collapses (e.g. Allco Finance Group Limited, Babcock & Brown Limited, ABC Learning Limited)	<ul style="list-style-type: none"> <li>• Discussed in Section D at paragraph 179;</li> <li>• ASX's approach to real time market and continuous disclosure surveillance discussed at paragraph 93 and at paragraph 123; and</li> <li>• Agreed actions 4-6 and Recommendation 2 include consideration of ASX's real time surveillance function and Recommendation 3 requests review of its approach to trading halts and suspensions.</li> </ul>
Tricom	<ul style="list-style-type: none"> <li>• Tricom was considered as part of ASIC's 2008 ASX assessment report (see ASIC Report 135 at paragraphs 107-114 and Agreed action 10 to revise certain ASTC settlement processes. ASTC has since made these changes—see Section E);</li> <li>• Discussed in paragraph 205 (including ASX and ASIC regulatory outcomes);</li> <li>• In Agreed action 1, ASX has agreed to provide a report on the effectiveness of ASX's changes in 2008 and early 2009 to its participant Capital Monitoring function (see paragraph 72); and</li> <li>• In Agreed action 2, ASX has agreed to report on the effectiveness of ASX's changes in 2008 and early 2009 to its ASX Compliance function (see paragraph 80).</li> </ul>
Other failed or near failed market participants (e.g. Opes Prime, Chimaera, Hogans)	<ul style="list-style-type: none"> <li>• Discussed in Section D at paragraphs 177 and 206;</li> <li>• In Agreed action 1, ASX has agreed to provide a report on the effectiveness of ASX's changes in 2008 and early 2009 to its participant Capital Monitoring function (see paragraph 72); and</li> <li>• In Agreed action 2, ASX has agreed to report on the effectiveness of ASX's changes in 2008 and early 2009 to its ASX Compliance function (see paragraph 80).</li> </ul>
The market in listed partly paid stocks	<ul style="list-style-type: none"> <li>• Recommendation 4 asks for a review by ASX of its approach to quotation and supervision of trading in partly paid stocks (see paragraph 137).</li> </ul>
Fall in market confidence by retail investors	<ul style="list-style-type: none"> <li>• Discussed in Section D at paragraph 170;</li> <li>• All the agreed actions and recommendations in this report in part go to promoting investor confidence in the markets; and</li> <li>• At paragraph 51 ASIC encourages ASX to undertake a review which takes into account ASX's approach to retail investor protection and in particular, the nature of market related information made available by ASX to retail investors.</li> </ul>

57 Section D also includes a discussion of ASX group's activities in 2008 and its responses to the market conditions and events.

### Separate and complementary roles of ASX and ASIC

58 Under the existing legislative framework, ASX group is the 'front line' regulator of participants' conduct in relation to its market and both ASX group and ASIC have separate and complementary roles in the supervision of the markets and of market participants. ASIC also supervises ASX group.

59 For real-time surveillance, both ASX group and ASIC identify suspicious conduct that may impact on ASX group's markets and which may constitute

a breach of the Listing Rules, Market Rules and Corporations Act. ASX group and ASIC also investigate suspicious behaviour and pursue enforcement action.

### **Limits on ASX supervision and investigation**

- 60 In investigating suspicious conduct, it must be noted that ASX group's powers of enquiry are limited to those available under contract with its issuers and participants. By contrast, ASIC has broader powers to seek information under the law and may pursue a broader range of entities than those contracted to ASX group.
- 61 The entities ASX group may take action against are also limited to its issuers and participants (and their responsible executives) and the only direct action available is in respect of breaches of its operating rules.<sup>1</sup>
- 62 For example, if ASX group wants to investigate suspicious trading activity, it typically only has contractual powers to obtain information from the participant that placed the relevant orders. Ordinarily, it would not be able to obtain detailed information mandatorily from the client of the participant who may have given the instructions to place those orders. By contrast, ASIC has legal powers to obtain information from the client directly and may also take enforcement action against that person in circumstances where the ASX group would not be able to do so.

### **ASX and ASIC overlap**

- 63 In practice ASX group and ASIC cooperate extensively in the detection and investigation of potential breaches. These breaches might include market manipulation matters which are prohibited under both the market rules and the Corporations Act or insider trading breaches, which are prohibited under the Corporations Act but which ASX group may be best placed to initially detect. Under the Corporations Act, ASX group is required to notify ASIC of any actual or suspected significant breach of its operating rules or the Corporations Act.
- 64 To support these co-operative arrangements, ASIC and ASX have a Memorandum of Understanding that notes their complementary roles. An important part of these cooperative arrangements are the meetings that are scheduled regularly between ASIC and ASX group, to discuss supervisory issues relating to both listed entities and market participants.
- 65 Below is a table that details the resources that ASIC and ASX (including SFE) devote to performing their respective supervision of the markets and market participants as of 30 June 2009.

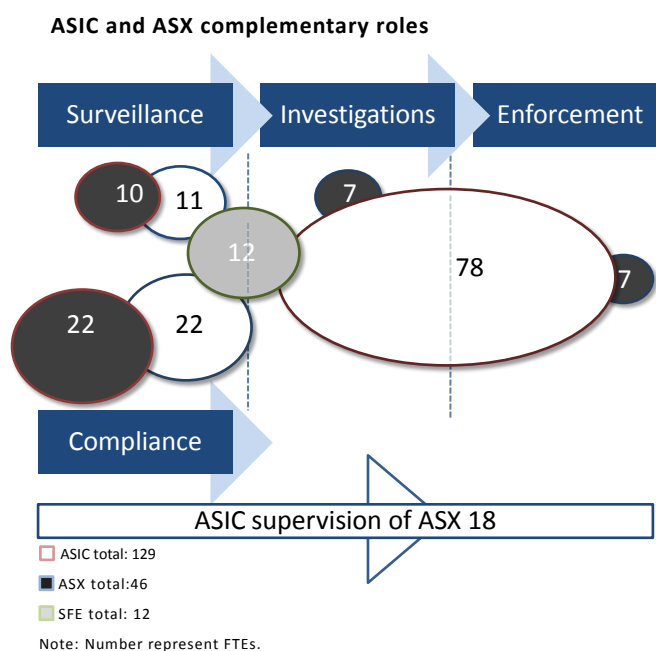
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<sup>1</sup> For further information see ASX publication 'ASX's role in Australia's Financial Regulatory framework', June 2008.

Function	ASIC	ASX	SFE	ASX & SFE <sup>2</sup>
Real-time surveillance/ MarketWatch	11	10	2	
Participants supervision	22	22 <sup>3</sup>	6 <sup>4</sup>	
Investigations/Enforcement	78	7	4	7
ASIC supervision of ASX	18 <sup>5</sup>	n/a	n/a	n/a
Subtotal	129	39	12	7
<b>Total ASIC: 129</b>		<b>Total ASX &amp; SFE: 58</b>		

Note: Both ASIC and ASX have additional teams that support the supervision of markets and market participants and which are not included in this table.<sup>6</sup>

66 The diagram below illustrates the joint and overlapping roles played by ASIC and ASX group in the detection and resolution of suspicious trading and behaviour on ASX group’s markets. It includes the overlapping roles that ASX group and ASIC play in real-time surveillance of the market and monitoring participant compliance. It also includes the complementary roles of ASX and ASIC in investigations and enforcement and the separate ASX group supervisory role of ASIC.



<sup>2</sup> ASX and SFE share 5 FTEs in the Enforcement function and 2 in the Tribunals function.

<sup>3</sup> This figure includes 6 from the Capital Monitoring function.

<sup>4</sup> This figure includes 2 FTEs dedicated to the capital monitoring of SFE participants.

<sup>5</sup> ASIC’s Exchange Market Operators team of 24 FTEs (as at 30 June 2009) supervises all market licensees and exempt market operators. ASIC estimates at least 75% of these resources undertake the supervisory role over ASX.

<sup>6</sup> These include resources from ASIC’s Corporations, Investment Managers, and Emerging Mining and Resources teams and resources from ASX’s Issuers team.

67 The comments in this report about the adequacy of ASX group's real time surveillance and areas for improvement take into account the context in which ASX group carries out those functions, and the relevant parameters of ASX's role.

### **Conflicts of interest**

68 Under s792A(c)(i) and 821A(c)(i) of the Corporations Act, ASX group must have adequate arrangements to handle its conflicts of interests. This is in effect an obligation to ensure that its commercial interests do not prevail over the requirement to ensure that, to the extent that it is practicable to do so, the market is fair, orderly and transparent or that clearing and settlement services are provided in a fair and effective way.

69 ASIC notes the following points about the legislative framework:

- First, the regulatory regime under which ASX group operates does not preclude the existence of conflicts of interest. There is no per se prohibition on ASX group having conflicts of interest but ASX group must manage any conflicts it does have so as not to allow its commercial interests to prevail over its supervisory role. Whether or not (e.g. through separation of ASX group's supervisory function from its commercial role or otherwise) there should be such a per se prohibition is a policy matter for Government. ASIC's role is to conduct the assessment within the existing legislative framework; and
- The statutory standard on ASX group is that it adequately manages its conflicts (i.e. that its management processes are adequate to ensure that ASX group's commercial interests do not prevail over its supervisory function). ASIC's role is to assess if ASX group has adequate arrangements in place. In the last 6 reports, and in this report, ASIC has concluded that ASX's arrangements for managing conflicts are adequate (i.e. meet the statutory standard). Paragraph 190 contains further commentary with respect to ASX group's compliance with the obligation to manage its conflicts of interest during this assessment period.

### **Compliance with agreed actions from last year's assessment**

70 In August 2008, ASIC published its most recent previous assessment report of the ASX group, which included ten agreed actions. Those agreed actions and their status are set out in Section E.

## Topics for next assessment

71 As part of its next assessment of the ASX group, in addition to a review of ASX group's supervisory arrangements, ASIC intends to include a review of the following matters:

- ASX group's compliance with ASX's agreed actions and ASIC's recommendations in this report;
- ASX group's approach to considering the appropriateness of issuer listing or product quotation;
- ASX group practices in relation to product development;
- ASX group's approach to pre-emptively addressing potential 'at risk' areas of the market;
- The need to impose additional requirements on ASX issuers in respect of the frequency and effectiveness of asset related disclosures and valuations (such as a review of the Valmin and JORC Codes);
- The development and supervisory experience of ASX group's CFD and AQUA market;
- The effectiveness of ASX group's changed practices for supervision of market participants;
- ASX group's approach to secondary capital raisings;
- ASX group's approach to the review of financial reports by listed or quoted entities; and
- The adequacy of resourcing of ASX group's Enforcement and Tribunal functions.

## C Agreed actions, ASIC recommendations and observations

### Participant monitoring

#### Capital monitoring

- 72 One of ASX's important functions is to supervise participants' ongoing compliance with the operating rules of the relevant market and clearing & settlement facilities. One of the most important areas in this respect, is the supervision of ongoing compliance by participants with the capital standards that ASX group has set for those entities that it permits to trade, clear and settle transactions through its facilities.
- 73 Capital monitoring of participants across ASX is undertaken by the Capital Monitoring team, and the Futures Supervision team performs this function with respect to the rules of the SFE markets and clearing & settlement facilities.
- 74 ASIC had concerns that during the assessment period, there were significant resourcing constraints within the Capital Monitoring function. Whilst FTEs in Capital Monitoring were 4.4 at 31 December 2008 and increased to 6 FTEs by 30 June 2009 (with an additional FTE budgeted for FY 2010), they were as low as 1.8 for the month of February 2008 (with assistance during this period being provided by 2 staff who perform capital monitoring in Futures Supervision).
- 75 Given the technical nature of the calculations required under the ASX's risk based capital requirements, appropriate resourcing in this area is imperative and should be closely monitored—particularly in light of the additional activities proposed below.
- 76 In addition to increasing resources ASX has made or proposed the following changes:
- Commencement of a project in March 2008 to replace the existing automated capital reporting system (known as ASX Returns) and the CARS system used to review and analyse returns. The new system is scheduled to be introduced later this calendar year;
  - A proposal to require participants to obtain a re-authorisation (by way of self-assessment) with respect to their use of the risk based capital requirements. Capital Monitoring grants an authorisation to participants at the time of their admission and re-authorisation after they commence new relevant business activities. The proposal is that participants will be

required to provide Capital Monitoring with a self-assessed re-  
authorisation to ensure their ongoing suitability for the risk based  
regime;

- Changes to the admission process so that applicants provide a sign-off from an external accountant or auditor that the participant has facilities, procedures, personnel and financial resources that are adequate for the performance of its obligations as a participant;
- A review of the risk based capital requirements to determine whether (particularly in light of international developments) amendments should be made to certain aspects of these requirements. These may include the treatment of securities lending and borrowing transactions, margin lending and margined OTC derivatives (such as CFDs) and whether some form of liquidity requirements should be imposed;
- A review of the pro forma auditor's reports which are required in support of the participant's annual returns—to determine whether any enhancements to these pro forma reports can be made. The checklist used by Capital Monitoring to review annual returns will also be revised to include (amongst other things) explicit noting of Capital Monitoring having undertaken a more detailed review of participants' statutory accounts;
- A review of risks in relation to the accuracy of returns to provide better means for detecting inaccuracy; and
- The introduction of spot checks of participants by Capital Monitoring.

- 77 ASIC acknowledges ASX's initiatives in this area and agrees they are necessary.
- 78 ASX has agreed to submit a report to ASIC by 31 March 2010, reviewing the effectiveness of the changes (both in terms of resources and practices) implemented by ASX. This report will analyse the outcomes of these changes against the regulatory objectives that these changes are intended to achieve and whether any further changes in the revised supervisory approach are warranted.
- 79 ASIC has invited ASX group to consider whether the capital monitoring function for both ASX and SFE is currently best positioned within the ASX group structure. ASIC notes that ASX group has given previous consideration to this issue and in weighing up alternatives, believes the function to be appropriately located. ASIC also notes that every month senior officers from ASXMS, Clearing & Policy, Clearing Risk Operations and Trading Operations and Markets meet to share information about market participants for the purposes of managing systematic risk and enabling productivity and preventative action as regards participants which may show signs of weakness.

### Agreed action 1: Report for Capital Monitoring

ASX has agreed that by 31 March 2010, it will provide ASIC with a report reviewing the effectiveness of the changes made or proposed for Capital Monitoring (both in terms of resources and practices) as implemented by ASX. This report should analyse the outcomes of these changes against the regulatory objectives that these changes are intended to achieve and whether any further changes in the revised supervisory approach are warranted.

### Participant compliance

- 80 Ongoing participant compliance with operating rules other than those relating to capital, is supervised by practices that include periodic onsite reviews of participants, non-routine ‘spot’ onsite reviews, participant self-assessment and a review of participants on an ad hoc basis.
- 81 Total FTEs dedicated to this function across ASX and SFE increased by around 7% as of 31 December 2008, when compared with 1 January 2008. More specifically, FTEs in ASX Compliance grew from 12.6 to 14.4 during the assessment period, increased to 15.8 by June 2009 and to 16.8 in July 2009. At the same time, FTEs in Futures Supervision (which in part performs a similar function with respect to SFE market and clearing participants) remained at 11.8 at 30 June 2009 and remains budgeted at 11.8 for the 2010 financial year.
- 82 Importantly, during the assessment period, ASX Compliance undertook a review of the way in which it conducts its business with a number of initiatives being proposed. These include a strategic drive to effect cultural change within participants. ASIC agrees with ASX that these changes were necessary. In particular, ASX wishes to promote the internal supervision culture within participants that puts in place ‘preventative’ compliance measures, with a focus on:
- Enhancing participants’ understanding of risks inherent in their business models and increasing cultural awareness of strategic compliance requirements to best position participants to cope with emerging risks;
  - Participants building appropriate internal supervisory, risk and compliance frameworks to mitigate the risks;
  - Enhancing participant understanding of relevant operating rules; and
  - Shifting the onus of proof from ASX to participants—by requiring participants to demonstrate to ASX that they are in compliance and have appropriate risk frameworks in place.
- 83 To assist in the delivery of these strategic initiatives, ASX Compliance has restructured its business and divided its operations into two distinct functions—a dedicated participant review team and a team focussed on



business as usual. It has also implemented a participant monitoring system called ‘Compliance Monitor’, which has the potential to better enable tracking of participant’ conduct and facilitate more accurate ‘targeting’ of participant risk. In addition to obtaining approximately 2 additional FTEs to support this revised strategy and approach, ASX Compliance has also broadened its skill set to include those with particular technological expertise. At the same time, Futures Supervision maintained a number of its longstanding practices and procedures.

- 84 ASX has agreed that by 31 March 2010, it will provide ASIC with a progress report reviewing the effectiveness of these changes (both in terms of resources and practices). The report will provide analysis of the progress as to how the intended regulatory outcomes have been met by these initiatives and whether any further changes in the revised supervisory approach are warranted. A more complete report on the effectiveness of the changes will be provided to ASIC as part of ASX group’s Annual Regulatory Report for 2009/10.

#### Agreed action 2: Report by ASX Compliance

ASX has agreed that by 31 March 2010, it will provide ASIC with a progress report reviewing the effectiveness of the changes to ASX Compliance (both in terms of resources and practices). The report should provide analysis of the progress as to how the intended regulatory outcomes have been met by these initiatives and whether any further changes in the revised supervisory approach are warranted. ASX agrees that a more complete report on the effectiveness of the changes will be provided to ASIC as part of ASX group’s Annual Regulatory Report for 2009/10.

### Review of DMA and algorithmic trading

- 85 Algorithmic trading and direct market access (DMA) are becoming increasingly popular methods of dealing on ASX group’s financial markets—with current estimates that 26% of buy side traders now using algorithmic trading for more than 40% of their order flow.
- 86 The potential supervisory consequences of these trading methods are being considered in an international context within organisations such as the International Surveillance Group (of which ASX is a member) and IOSCO. ASIC acknowledges that ASX group has commenced a project to review the supervisory consequences of the growth in DMA. The importance of ASX undertaking a review of this type was underscored during our 2008 assessment, in which ASIC identified examples where activities associated with DMA and algorithmic trading had the potential to threaten the orderly operation of ASX group’s markets. These included:

- Two significant increases in the SFE S&P/ASX200 futures contract in the final days of 2008, as a result of particular algorithmic trading strategies undertaken by a client of an SFE broker through the DMA system that had been made available to it; and
- Direct market access by retail clients to units in BrisConnections (and possibly other products), in circumstances where it is alleged that some of those clients did not fully understand the structure and liabilities attaching to the products they were acquiring.<sup>7</sup>

87 ASIC considers that the review commenced by ASX may assist in any joint work that ASIC and ASX group may appropriately undertake in this area. As part of its review, ASX group should include particular consideration of the following matters:

- The adequacy and consistency of ASX group's operating rules and procedures, in setting minimum risk and operational requirements for participants in enabling DMA to clients;
- Whether the operating rules set suitable standards of accountability by participants for the trading activities of its DMA clients;
- Whether retail investors are adequately informed about the nature of the DMA services and the characterisation of the securities and investments that they acquire via this service; and
- Developments in international best practice standards for the provision of DMA services and the supervision of algorithmic trading.

88 In considering these issues, ASX group should have regard to:

- Observations made by the SFE Market Practice Committee (MPC) in two matters before it in 2008, in which it did not find against a particular participant for activity undertaken by a client that had been provided with direct market access, but did note that the relevant actions were not in the spirit of a fair, orderly and transparent market. The MPC requested that in future, the exchange more closely reviews the relationship between the client and the participant to determine whether the participant should be responsible for the client's actions under the market operating rules; and
- The regulatory basis for any differences between ASX and SFE in the certification requirements for relevant risk management systems and processes.

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<sup>7</sup> In this regard ASIC acknowledges the important step ASX took in May 2009 to amend its market rules to require market participants to obtain a written acknowledgement from retail investors before they acquire partly paid securities.

### Recommendation 1: Report on DMA and algorithmic trading

ASIC recommends that by 31 March 2010, ASX group provides a report to ASIC of its review of DMA and algorithmic trading on its markets and whether any improvements in its operating framework or supervisory approach are necessary or not.

### Enforcement and Tribunals

- 89 As of April 2008, the enforcement of breaches or potential breaches against participants across ASX and SFE were consolidated into one business unit. Enforcement of a breach of an operating rule is now undertaken by ASX's Enforcement function. That business unit now has carriage of all enforcement matters and the previous tribunals that separately considered breaches of ASX and SFE rules have also been consolidated.
- 90 In last year's assessment, both ASIC and ASX identified potential resourcing concerns within the Enforcement business unit. ASX and ASIC have also identified a number of reasons to anticipate that resourcing pressures on both the Enforcement function and the Tribunal could be maintained in the foreseeable term. These reasons include:
- Integration of disciplinary tribunals—the integration is likely to contribute to ongoing increases in work of the Enforcement function because breaches of the SFE operating rules will now also be reviewed by this business unit prior to lodgement with the Tribunal—and the single Tribunal will now be required to deal with both ASX and SFE matters;
  - Increased number of referrals to ASIC—the changed market conditions are likely to result in an increasing number of referrals to ASIC, which the Enforcement function will vet prior to being sent;
  - Complexity of matters—both the Enforcement function and the Tribunal will be required to deal with more complex market manipulation matters which are an inevitable corollary of a market downturn; and
  - Increase in contested matters—given the inevitable increase in market manipulation matters, there is also greater likelihood that more of these types of matters will be contested by participants who fear the greater reputational risks that these matters bring. The increase in the maximum fine for matters of this type (from \$250k to \$1m) is also likely to result in more contested matters—with additional resource implications for the Enforcement unit and Tribunal.
- 91 In anticipation of these potential resourcing pressures, ASX increased the resourcing in Enforcement as of the beginning of 2009 and did the same for the Tribunal function. As an additional step designed to deal with resourcing pressures, during this period ASX recruited an experienced staff member

from the Financial Services Authority (United Kingdom) and retains ongoing access to resources to brief external legal counsel if needed. Funds to brief external counsel are available from fines imposed by the Tribunal.

- 92 Notwithstanding these initiatives and existing resources, there was material staff turnover in the Enforcement function during 2008 and the full impact of the resourcing pressures which were anticipated, may be difficult to completely gauge at this stage. ASX has agreed that by 31 March 2010, it will provide a report reviewing the adequacy of the Enforcement and Tribunal functions' resources for the period 1 July 2009 to 28 February 2010. This report will include consideration of the factors outlined in paragraph 90.

### Agreed action 3: Report on resourcing in Enforcement and Tribunal

ASX group has agreed that by 31 March 2010, it will provide a report to ASIC reviewing the adequacy of the Enforcement and Tribunal functions' resources for the period 1 July 2009 to 28 February 2010. This review should include particular further consideration of:

- The recent integration of ASX and SFE disciplinary tribunals and enforcement functions
- The potential for increased referrals to ASIC
- The increasing complexity of enforcement matters
- The increased number of contested matters.

## ASX real-time surveillance

- 93 ASX Surveillance has two primary functions:
- Real time monitoring of unusual trading activity which could result in a need for a listed entity to publish an announcement or a security to be placed in trading halt; and
  - Identification of trading incidents which may require further investigation for potential breaches of market rules, market manipulation or insider trading provisions of the Corporations Act, and subsequent investigation of those matters.
- 94 A number of futures contracts are also traded on the ASX market, and surveillance of trading in these products is briefly discussed at paragraph 120.

## Human resources

- 95 In this year's assessment, ASIC closely reviewed the appropriate level of human resources devoted to both aspects of ASX Surveillance's functions (referred to in paragraph 93 above), but in particular the resources devoted to real time monitoring, particularly in light of market conditions during 2008.
- 96 ASX Surveillance had 8 FTEs for much of the assessment period and increased the number to 9 during 2008, partly in response to expectations that greater resources may be needed to adequately monitor the AQUA market. This increased to 10 FTEs by 30 June 2009 (which included appointment of a senior analyst in June 2009).
- 97 While ASX Surveillance did consistently trigger one of its resource metrics (in relation to the number of SMARTS 'alerts' reviewed each month), this was explicable by reference to the highly directional market.

## Technology

- 98 ASX Surveillance utilises a range of technology to perform its functions, with particular reliance on SMARTS (which provides real time trading 'alerts', primarily directed to identifying potential unusual price or volume movements) and IRESS (which provides real time trading data, including order book information). During the assessment period ASX Surveillance commissioned an upgrade of SMARTS.
- 99 The primary purpose of this upgrade was to improve SMARTS' capacity. This upgrade was completed in May 2009. ASX Surveillance is also developing technology that will assist in its insider trading investigations by enabling more efficient, automated matching of information from disparate sources. ASIC supports ASX Surveillance in developing this technology for use as soon as practicable.
- 100 During this assessment ASIC reviewed a number of instances for which the patterns of trading prior to significant corporate announcements appeared unusual and for which ASIC did not receive a referral from ASX. ASIC also reviewed ASX Market Analysts' responses to 'alerts' generated over a sample of randomly chosen trading days. Although ASIC did not find any instances where a referral should have been made but was not, ASIC identified certain areas in which ASX could improve the arrangements it has in place. Agreed actions and recommendations on these improvements are set out below.
- 101 ASIC considers implementation of the Agreed actions and Recommendations will improve the supervisory arrangements currently in place and promote ASX's continued compliance with its statutory obligations to have adequate arrangements to monitor the conduct of participants.

## Ensuring timely identification of price query need

- 102 There was one incident involving trading in particular securities in August 2008 involving a significant price movement (on high trading volumes) which was not identified by ASX Surveillance. Whilst this incident gave rise to important considerations, it is also relevant to note that over 100,000 SMARTS alerts were generated during 2008 and that this matter was also subsequently referred to ASIC by ASX prior to this assessment process.
- 103 On this occasion, an ASX Surveillance analyst had received a SMARTS alert in relation to the shares early in the day, but dismissed it due to the low volume of shares that had been traded. However, the analyst did place the share on 'Watch', which was a step intended to be a prompt for the analyst if any further information came to light relating to the share.
- 104 SMARTS did not provide a follow up alert, and the analyst did not conduct any other follow up. As a consequence, ASX Issuers (which is responsible for liaising with listed entities in this situation and issuing price queries and ultimately placing securities in trading halt if required to prevent a disorderly market developing), took no action on the day of the significant price movement.
- 105 The other issue arising out of this incident is that ASX received a complaint from the public on the day of the significant price movement which was not passed on to ASX Surveillance or ASX Issuers in a timely manner, and which with hindsight, ASX acknowledges should have been.
- 106 This incident was the subject of reports to the ASXMS board. As a result of this incident, ASX reviewed its complaints procedures and protocols for dealing with public complaints in relation to trading activities with the aim of ensuring any urgent complaints are passed on to the appropriate staff within ASX as soon as possible. It has also recently introduced structured oversight of analysts' reviews.

### Agreed action 4: Report on changes to complaints handling and oversight of analyst reviews

ASX has agreed that by 31 March 2010, it will provide a report to ASIC on the effectiveness of changes:

- To practices for handling complaints in relation to trading activities; and
- To the structured oversight of analysts' reviews,

including how effective these changes have been in complementing ASX's surveillance technology, particularly in identifying situations where a price query may be required.

## Investigations into potential insider trading incidents

- 107 ASIC reviewed a number of investigation files maintained by ASX Surveillance on potential incidents of insider trading.
- 108 In conducting these investigations, ASX Surveillance accesses a variety of information, including information maintained on ASIC registers and trading data provided by ASX market participants, to establish whether there is a need to make a referral to ASIC. In some instances ASX will request ‘insider’ lists from listed entities and any of their advisors who are ASX participants, to assist in these investigations.<sup>8</sup>
- 109 Based on our review of ASX Surveillance’s approach to a number of insider trading investigations, ASIC believes ASX Surveillance could improve its considerations of possible insider trading referrals if it requested information from listed entities and their advisors more regularly. ASIC notes there are limitations on ASX’s ability to obtain ‘insider’ lists. ASIC would like to work with ASX to develop options for maximising ASX’s capacity to obtain these lists.

### Agreed action 5: Insider lists

ASX has agreed, in consultation with ASIC, to give consideration to requesting on a more regular basis, insider lists from listed entities, to assist in insider trading investigations.

## Ensuring consistency and quality of ASX Surveillance

- 110 The performance of ASX Market Analysts in conducting real time monitoring of market activity (including review of potentially unusual trading activity prior to significant corporate announcements) is reviewed and assessed by the ASX Surveillance managers. During the assessment period, this review and assessment by ASX Surveillance managers was largely conducted on an ad hoc basis.
- 111 As a result, there was little initial structured management oversight of this work—creating the risk that the consistency and quality of the work undertaken by ASX Market Analysts was not uniform across team members.
- 112 In the case of incidents that may require further review and possible investigation, ASX Surveillance maintains a ‘List’. Once a matter is placed on the ‘List’, ASX Surveillance managers are involved in either progressing or dismissing the matter—and it was at this stage based on our assessment, that ASIC is confident that a consistency of approach and judgement in

<sup>8</sup> ‘Insider’ lists are lists of individuals who are aware of a price sensitive item of information prior to it being publicly announced.

decision making was typically brought to bear. More transparent monitoring of the number of matters on the 'List' at any time (and over a period of time) is one way in which the transparency of ASX Surveillance's operations could be improved to allow ASXMS better visibility.

113 In this context, ASIC notes that ASX appointed a senior analyst in June 2009 with a view to promoting increased structural oversight of the decision making in the ASX real time surveillance function (including what goes on and off the 'List'). ASIC also notes that the ASX Surveillance function has recently in 2009:

- Commenced end of day meetings (after market close) to review activity and issues which arose during the day; and
- Undertaken work to better define categorisation of alerts and to reduce scope for divergence of explanations for the actions taken by ASX Market Analysts.

114 ASX has agreed that by 31 March 2010, ASX will report to ASIC on the effectiveness of the recent changes to the resourcing and procedures of ASX's real-time surveillance function. The report will include consideration of improvements in the consistency of performance of this function.

#### Agreed action 6: Report on changes to surveillance function

ASX has agreed that by 31 March 2010, ASX will report to ASIC on the effectiveness of the recent changes to the resourcing and procedures of ASX's real-time surveillance function. The report will include consideration of improvements in the consistency of performance of this function

115 The front line real time surveillance activities of ASX Surveillance play a critical role in identifying matters warranting further investigation and ultimately, disciplinary or enforcement action by ASX and/or ASIC. ASIC notes that ASXMS (including the ASXMS Board and senior management) conducts ongoing reviews of the performance of its real-time surveillance function. As part of ASX's ongoing review of this function, ASIC recommends that ASX includes in its review for the purposes of Agreed action 6, analysis of the following matters:

- The impact of a bear market on this function;
- Market commentary on the effectiveness of this function; and
- The effectiveness of this function in monitoring trading in different classes of listed issuers (e.g. liquid and relatively illiquid stocks of listed entities).

116 The report should outline what additional improvements might or should be undertaken by ASX, recognising that the Government announcement of 24



August 2009 will impact on what ASX might reasonably be expected to undertake in respect of the surveillance function.

#### Recommendation 2: Report on forward looking review for real-time surveillance

ASIC recommends that ASX includes in its report for the purposes of Agreed action 6, analysis of the following matters:

- The impact of a bear market on this function
- Market commentary on the effectiveness of this function
- The effectiveness of this function in monitoring trading in different classes of listed issuers (e.g. large, medium and small listed entities).

The report should outline what additional improvements might or should be undertaken.

### SFE real-time supervision

- 117 One of the primary roles of Futures Supervision is to monitor conduct of SFE market participants trading in SFE quoted contracts. Each day, Futures Supervision performs a daily review of the beneficial ownership report which SFE market participants must lodge each day by 8am (these reports show the beneficial owner of the positions held); performs a daily review of the names in which the accounts are held; and undertakes a review of the market two weeks from expiry and daily in the week before expiry to ensure that positions are not unexpectedly large.
- 118 On a daily basis, ASX Trading and Market Operations perform real-time monitoring of price movements to detect unexpectedly large changes in the derivative prices. In this respect, the focus is on disorderly trading (being trading that departs significantly from the last undisputed trade). The market is also typically monitored and reviewed when a complaint is received by SFE or if other indications exist that the market may not be operating in a fair, orderly and transparent manner. Futures Supervision will also routinely review matters raised through third parties (such as the financial press) and will investigate referrals and complaints coming from participants, clients and others.
- 119 ASIC considers these arrangements (which have been in place for some time) to be adequate. However, ASIC notes that from time to time, new futures contracts are quoted (such as the recent coal futures contract) and it encourages ASX to monitor the ongoing adequacy of its arrangements for new contracts and to put in place timely adjustments to practices and resources as necessary.

- 120 ASIC also notes that the practices adopted by SFE real-time surveillance differ from those adopted for the real-time surveillance of futures products traded on the ASX market. ASIC acknowledges that there may be an appropriate basis for these differing practices, but as part of monitoring the ongoing adequacy of its arrangements, ASIC encourages ASX group to ensure that the different approaches adopted by ASX and SFE are consistent with best practice across both markets.

### **New product developments**

- 121 Contracts for difference (CFDs) started trading on SFE on 5 November 2007, making the SFE the first exchange in the world to quote these products. During the assessment period, trading in these products remained limited. Despite this, it is important that SFE remains vigilant to the possibility of market manipulation and investors (in particular retail investors) trading on an uninformed basis - particularly in circumstances where trading picks up. ASIC will again review the development and supervision of the CFD market as part of next year's assessment.
- 122 ASX's CFD Market Management Policy also sets out the process for ceasing trading in a CFD if the relevant underlying stock goes into trading halt or suspension. This process is currently manual. Whilst this may be appropriate in current circumstances in which trading is limited, ASIC encourages ASX group to ensure it remains vigilant to the need to automate this process.

## **Issuers**

- 123 ASX Issuers' primary role is to interact with listed entities and monitor their compliance with the Listing Rules. Key aspects of ASX Issuers responsibilities are to:
- Monitor listed entities' compliance with the periodic and continuous disclosure regime imposed by the Listing Rules;
  - Approve new listing applications;
  - Exercise discretions granted to ASX under the Listing Rules (including decisions to place a security into trading halt, suspend a security from quotation, delist an entity and to restrict certain persons from voting on proposals in general meetings); and
  - Consider requests for waivers from the operation of the Listing Rules in particular instances.

## Other activities

- 124 In addition to carrying out its core monitoring activities, ASX Issuers conducted a number of initiatives during the assessment period (and in some cases continuing into 2009), in part in response to market conditions and developments. These included publishing guidance to listed entities on:
- Disclosure of margin lending arrangements involving directors;
  - ASX's approach to trading halts and suspensions; and
  - The need for prompt disclosure of changes to profit expectations.
- 125 Special projects conducted by ASX Issuers during the assessment period and continuing into 2009 included:
- Ongoing reviews of director's trading activity during blackout periods;
  - A review and report on the compliance by listed entities with the Joint Ore Resources Committee (JORC) Code; and
  - Educational campaigns (including campaigns conducted in conjunction with ASIC and the JORC Committee) relating to matters including continuous disclosure compliance and JORC Code compliance.

## Effect of market conditions on activities of ASX Issuers

- 126 The emphasis of ASX Issuers' activities changed significantly during the assessment period. The number of new listing applications was significantly lower than in 2007 (93 in 2008 compared with 314 in 2007), as was the number of M&A and other corporate transactions involving listed entities. On the other hand, there were a significant number of listed entities in financial difficulty during the assessment period, which required ASX Issuers to closely monitor compliance with continuous disclosure obligations (and refer matters to ASIC where appropriate), consider using ASX's power (or consider discussing with listed entities) to place entities into trading halt and suspension, and deal with listed entities whose securities had been suspended for significant periods of time.
- 127 More recently, since November 2008 ASX Issuers has dealt with a significant volume of secondary capital raising activity. This type of activity has given rise to possible issues around continuous disclosure (and possible instances of insider trading) as well as a specific role for ASX Issuers in considering a range of applications for waivers from the Listing Rules. The supervisory arrangements adopted by ASX Issuers in relation to these capital raisings will be reviewed in detail in our next assessment.

## Resources

- 128 The total size of the ASX Issuers team was almost static from December 2007 to December 2008 (43.7 FTEs in 2008 as against 42.9 FTEs in 2007).

This headcount increased to 45 at 30 June 2009 and is budgeted for FY 2010 at 46.6. Across the state offices, there was also very little change in human resources, although there were some secondments within ASX for parts of the assessment period.

129 These figures are consistent with the lower levels of new listing activity and mergers and acquisitions activity during the period, being balanced in part by an increase in secondary capital raising activity during November and December 2008.

130 Resource metrics adopted by ASXMS to monitor the adequacy of ASX Issuers human resources were infrequently triggered during the assessment period.

### **Issuer's adequacy of supervisory arrangements**

131 Balanced against the lower resourcing demands placed on ASX Issuers by the need to review new listing applications was the need to deal with a number of listed entities in financial difficulty (as discussed above at paragraph 126). ASIC reviewed a number of files maintained by ASX Issuers in relation to a range of listed entities.

132 Our conclusion from this review is that the arrangements ASX Issuers have in place to monitor its listed entities are adequate. In reaching this conclusion ASIC did not form a view as to whether the action taken by ASX Issuers in all instances was appropriate—rather, it formed a view that the general implementation of the processes ASX Issuers has in place for monitoring listed entities, were adequate during the assessment period.

### **Review of approach to trading halts and suspensions**

133 While ASIC acknowledges that ASX issued guidance in 2008 on its administration of trading halts, ASIC believes there is value in ASX undertaking a review of the way in which it approaches decisions to administer trading halts and suspensions and the related operating rule framework to ensure they continue to promote the delivery of fair, orderly and transparent markets in the context of the recent changed market conditions.

134 In undertaking this review, ASIC recommends ASX considers:

- The appropriateness of 'circuit breakers' for responding to falls in individual stocks and individual sectors. ASIC notes that the World Federation of Exchanges is conducting a project considering this issue and that ASX is a member of the relevant working group;
- The appropriateness of rules that deal with the management of listed stock once their market price hits a certain minimum (e.g. New York

Stock Exchange Policy on Price Criteria in section 802.01C of its manual). Under this rule, the listed entity is either required to reorganise its share capital to maintain a minimum share price or undertake suspension or ultimately delisting; and

- The appropriateness of imposing a requirement that a listed entity immediately obtains (and releases to the market) a valuation of its assets if its traded securities fall below a prescribed minimum value.

### Recommendation 3: Review of approach to trading halts and suspensions

ASIC recommends that by 31 March 2010, ASX provides a report to ASIC which reviews its approaches to decisions to administer trading halts and suspensions and the related operating rule framework. This review should also consider the appropriateness of:

- Circuit breakers;
- A minimum pricing regime; and
- A valuation requirement arising if a minimum price is met.

### Satisfaction of minimum spread requirement

135 In light of three new listings during the assessment period when a new listed entity was subsequently found to have failed ASX's 'spread' requirements for admission, ASX changed the form of confirmation it requires from new listed entities in relation to satisfying the spread requirements and made related changes to its procedures. These changes were intended to minimise the scope for applicants for listing to mislead ASX about their satisfaction of the minimum spread requirements. ASIC notes that it received from ASX a referral in relation to each of these listings and is currently investigating one of them about possible misleading conduct by an applicant for listing.

136 ASX has agreed to submit a report to ASIC by 31 March 2010 that reviews the effectiveness of these new procedures and to determine whether any further changes are required to ensure entities that do not satisfy the minimum spread standard are not admitted to listing.

### Agreed action 7: Report regarding procedures for meeting spread requirements

ASX has agreed that by 31 March 2010, ASX will submit a report to ASIC that reviews the effectiveness of the new procedures with respect to the application of the 'spread' requirements and whether any further changes are warranted.

## BrisConnections and partly paid products

### Partly paid products

- 137 ASX has admitted to listing and quotation, a number of issuers with partly paid securities. The following entities are not no-liability companies and have partly paid products with an attaching liability:
- BrisConnections Investments Trust and BrisConnections Holding Trust;
  - Multiplex Prime Property Fund;
  - Westpac Office Trust;
  - Citadal Resource Group Limited; and
  - Solagran Limited.
- 138 BrisConnections was admitted to ASX's official list on 30 July 2008. BrisConnections issued partly paid stapled units (BCSCA) with \$1 paid up initially, with a \$2 unpaid liability attached. The BrisConnections float raised approximately \$390 million, and was the largest IPO on ASX by value during 2008.
- 139 In the months following quotation of BCSCA, the price at which trading took place in BCSCA on ASX fell, so that by late October the traded price was \$0.001. \$0.001 is the lowest price at which a buy or sell order can be placed on ASX's market.
- 140 There have been allegations by retail investors that they acquired BCSCA during October and November 2008, without understanding the nature of the liability attached.
- 141 The number of trades in BCSCA dropped significantly over the month of November 2008, such that after 19 November 2008 there were very few buy orders at the offered price of \$0.001, with substantial sell orders at that price.
- 142 From late November 2008 until 15 April 2009, there continued to be a large number of sell orders at \$0.001 (with approximately 24% of all BCSCA units being offered at \$0.001 by December 2008) and very few buy orders.

143 At the close of trading on 15 April 2009 BCSCA was suspended from trading as a result of a corporate action by BrisConnections, in advance of a call, and trading ultimately resumed in a newly issued stapled unit, BCSCB, on 6 May 2009 following expiry of the time for payment of the call.

### **Review of market framework**

144 In view of the circumstances surrounding BrisConnections and trading in BCSCA from listing, ASX should review the issues outlined below, having regard to its statutory obligations including its obligation to, to the extent it is reasonably practicable to do so, ensure it continues to do all things necessary to maintain a fair, orderly and transparent market in the future.

145 ASIC notes that during the assessment period, ASX did consider whether the market in BCSCA was operating in a fair, orderly and transparent manner. ASX concluded that its market operated on a fair, orderly and transparent basis.

### **Quotation of partly paid securities**

146 As ASX currently has no technical ability to permit trading at a price lower than \$0.001, it has limited alternatives to facilitate trading in securities where genuine demand and supply factors would be likely to result in a traded price of less than \$0.001.

147 Accordingly, ASX should review whether it is appropriate to list an entity with a capital structure similar to that adopted by BrisConnections, with partly paid securities bearing a ratio of paid to unpaid amounts of greater than 1:1, or at all. As part of its review, ASX should review its approach to enforcing Condition 1 of Listing Rule 1.1<sup>9</sup>, and consider amending its Listing Rules to ensure it has further flexibility to refuse to list an entity with such a capital structure in appropriate circumstances.

### **Trading halts and suspensions**

148 ASX should review whether it needs to change its approach to trading halts and suspensions, particularly in respect of partly paid securities. Where trading in a security takes place at a price which does not reflect genuine demand and supply ASX should promptly consider whether it is necessary to suspend trading in the security in order to comply with its statutory obligation to do all things necessary to ensure a fair, orderly and transparent market. ASIC notes that separately in this report, ASIC has recommended ASX review its approach more generally to trading halts and suspensions

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<sup>9</sup> Listing Rule 1.1 says that "For an entity....to be admitted to the official list, the following conditions must be met to ASX's satisfaction" - " Condition 1:- The entity's structure and operations must be appropriate for a listed entity".

and envisages these two related reviews could be implemented without duplicating work.

### **Direct Market Access**

- 149 There was trading by some retail investors in BCSCA through execution only online securities brokers who allegedly did not understand the nature of the liability attaching to BCSCA. In light of this trading activity ASX should consider whether its standards in place for market participants providing DMA for retail investors, should be changed. ASIC notes ASX's amendment of its Market Rules on 1 May 2009 to require market participants to obtain a written acknowledgement from retail investors before they acquire partly paid securities, but considers that ASX should assess whether further steps are required.

### **Clarification of trading codes and provision of information**

- 150 The partly paid stapled units were traded under the code 'BCSCA', and the suffix 'CA' is explained in ASX's Guidance Note 18 as a security in the 'Contributing' market that is a partly paid security. However, Guidance Note 18 does not clearly indicate that unpaid contributions on securities quoted with the suffix will become a debt due by the holder even if the securities are forfeited for non-payment contributions. In the past some partly paid securities which have allowed the holder to surrender the securities rather than pay the call (with the result being that the holder will have no further liability to the issuer) have been quoted under this code. The trading codes specified in Guidance Note 18 do not currently recognise this distinction and should do so.
- 151 ASX should also review whether any other changes are necessary to ensure trading in partly paid securities takes place on an informed basis about the nature of the liability attaching to such securities. In particular, it would be timely for ASX to review the information made available to investors through the ASX website (e.g the clarity with which the liability is identified).



#### Recommendation 4: BrisConnections and partly paid securities

ASIC recommends that in addition to any review already conducted, ASX conducts a review of the circumstances surrounding BrisConnections (and other similar partly paid securities) with the results to be reported to ASIC by 30 November 2009. The review should have regard to ASX's statutory obligations including its obligations, to the extent it is reasonably practicable to do so, to do all things necessary to maintain a fair, orderly and transparent market. The review should consider:

- Whether partly paid securities of this type should be quoted by ASX and whether changes to its Listing Rules, application of its Listing Rules or both, is appropriate;
- Whether there need to be changes to ASX's policy in requiring trading halts or suspensions in trading for certain listed entities or sectors, and in particular for entities with quoted partly paid securities;
- Whether investors acquiring securities on the secondary market through execution only brokers have access to sufficient information to trade on an informed basis (including about the valuation of the securities and the nature of the liability attaching to such securities);
- The nature of the way in which partly paid products on its website are identified to market users;
- The way in which the features of quoted products are displayed to online traders; and
- When trading in low priced securities may no longer be fair and orderly and how ASX should respond to these circumstances.

## Technology and operations

152 As part of the assessment, ASIC also reviewed a number of specific matters relating to the technology and operations side of ASX group's business. As a general observation and particularly in light of the difficult market conditions during 2008, these aspects of ASX group's business performed well. Specifically, the uptimes of all ASX technology systems was over 99.95% and is discussed further at paragraph 218.

153 However, there were a number of incidents that occurred during the assessment period which ASIC considers are deserving of review - and for which ASIC received a number of complaints. These included:

- SYCOM outage on 12 December 2008;
- CHESS incident of 15 August 2008; and
- ASX's application of its Error Resolution Policy to incidents arising on 29 December 2008.

## **SYCOM outage**

- 154 An outage of the SYCOM system occurred on the opening of the night session on Friday 12 December 2008. The outage was caused by a software error that gave rise to the failure of the SYCOM system to process the complete Three Year Futures Overnight Options strike range, for the trading date 15 December, during the end of day series generation process.
- 155 Interest rate moves at the time and market volatility generated a very high number of series, which triggered the software error and resulted in the system outage.
- 156 ASIC and ASX group received several complaints, the majority of which centred on the fact that in some instances participants and therefore their end clients were not immediately aware of having trades executed during the levelling period, thereby leaving them with unknown exposures.
- 157 ASX group has an Incident Communications Plan in place but acknowledges there is potential for some communication issues to arise between market participants and their clients, following an incident of this type.

## **CHESS incident**

- 158 On 15 August 2008, CHESS participants lost connection to CHESS for 13 minutes as a result of the CHESS Logserver aborting. The flow on effect of this disconnection was a 16 minute delay in settlement processing. Subsequent analysis showed the issue to have also arisen as a result of a software error and this was rectified in a CHESS software release in December 2008 following testing.

### **Agreed action 8: Future incidents and communication procedures**

ASX group has agreed that by 31 March 2010, ASX group will provide ASIC with a report reviewing the effectiveness of its measures to monitor and deal with capacity issues on an ongoing basis. This report should also outline what arrangements ASX group has put in place to improve the means and nature of communications to participants in the event of a systems related incident of this type.

## **Spikes in S & P Futures contract in December 2008**

- 159 On 23 December 2008 at approximately 4.29 pm, the SFE S&P/ASX200 Futures contract rallied 207 points in 30 seconds and then fell back 129 points in the remaining 31 seconds prior to the close of the futures market that day. There were no claims of an error from any SFE participant, and

because the price action did not enter the Market Integrity Range of SFE's Error Resolution Policy, all trades stood.

- 160 On 29 December 2008 during the opening minute of trading there was again volatile and fast moving activity in the SFE S&P/ASX200 Futures contract. From the first traded price at opening (3621) the contract rallied 381 points in 29 seconds to a level of 4002. In the next 36 seconds the contract fell by 352 points to a level of 3650.
- 161 No errors were claimed in relation to the price action of 29 December. However, unlike the 23 December 2009 incident, the price movement during the 29 December 2009 incident had breached the Market Integrity Range of SFE's Error Resolution Policy and therefore all trades above 3900 were cancelled.
- 162 Both incidents arose as a result of trading by the same client of the same participant—with trading having been effected through algorithmic methods via the direct market access that the participant had provided to their client.
- 163 The Futures Supervision report into the incident of 23 December 2008 concluded that 'the Participant took pro-active steps to ensure the Client would not enter similar orders without first checking market liquidity'.
- 164 In addition, as part of its assessment of the matters, ASX group reviewed the order limits imposed by the participant on its client, but did not consider the limit to be inappropriate. The limit orders in place were a volume per order limit of 9000 lots and a maximum price change of 300 points for the S&P/ASX. These limits may permit the client to initiate similarly disruptive orders in the future if it wished to do so. Considerations of this nature should be included in the review of the supervision of direct market access arrangements highlighted in Recommendation 1.
- 165 Following on from complaints received by ASIC about the application of the SFE Error Resolution Policy to the incident of 29 December 2009, ASIC also sought to understand the process adopted by ASX group in applying the policy in this incident. In this context, ASIC reviewed the relevant ASX Market Operations Incident Report which provided the actual Fair Price Value (FPV) and also the variables used to determine the FPV. Based on the information reviewed, ASIC has no reason to dispute the relevant FPV determined by ASX on this occasion.
- 166 ASIC recommends that on invocation of the Error Resolution Policy by ASX group, ASX group ensures the basis for determination of the FPV is fully documented and that ASX group reports to ASIC as soon as possible after the Error Resolution Policy is invoked (and prior to the submission to ASIC of the ASX Market Operations Incident Report) on the basis of the rationale for the FPV determination.

**Agreed action 9: FPV determination**

ASIC recommends that on invocation of the Error Resolution Policy by ASX group, ASX group ensures the basis for determination of the FPV is documented and that ASX group reports to ASIC as soon as possible after the Error Resolution Policy is invoked (and prior to the submission to ASIC of the ASX Market Operations Incident Report) on the basis of the rationale for the FPV determination.

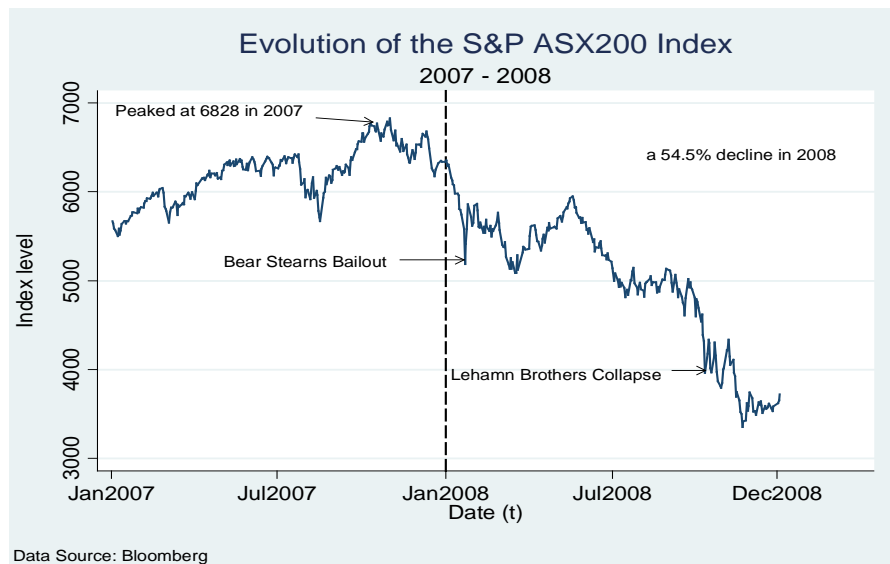
## D Market conditions and ASX activities in 2008

### Market conditions in 2008

167 During 2008, stock prices fell around the world and volatility on the world's leading exchanges was significantly higher than in 2007.

168 The rise in volatility in 2008 reflected greater uncertainty among market participants about the impact of the liquidity crisis on financial asset prices. There were widespread doubts among investors whether financial corporations would obtain the liquidity necessary to continue operations at a time when credit markets had frozen. In turn, this unavailability of credit was a response to the lack of information as to which companies were exposed to losses arising from the widespread use of credit and other derivatives

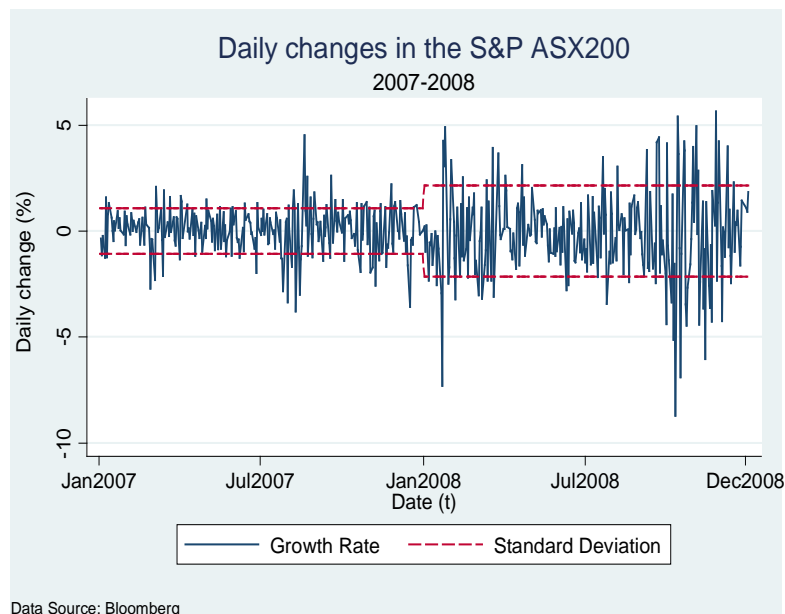
169 Whilst ASX group markets performed comparatively better than some other exchanges around the world, many ASX group market performance indicators also deteriorated during 2008. After reaching an historical high on 1 November 2007, the S&P/ASX 200 began its downward trend. By the end of 2008, its value had halved. As expected, similar changes were also observed in the SFE S&P/ASX200 Futures contract, being the major contract traded on the SFE.



170 Between its peak in November 2007 and 6 March 2009, the S&P/ASX200 index lost 54% in local currency terms. Given the fact that over 40% of all adult Australians participate directly or indirectly in the Australian share market, this fall in value has had significant implications for Australian

household wealth.<sup>10</sup> Specifically, Australian Bureau of Statistics figures show the decline in the value of households' portfolio of shares and managed funds was \$189.5 billion between 30 September 2007 and 31 December 2008—a fall of 42.6%. Over the same period, the value of superannuation (including unfunded superannuation claims on government) declined by \$292 billion—a fall of 22%.<sup>11</sup>

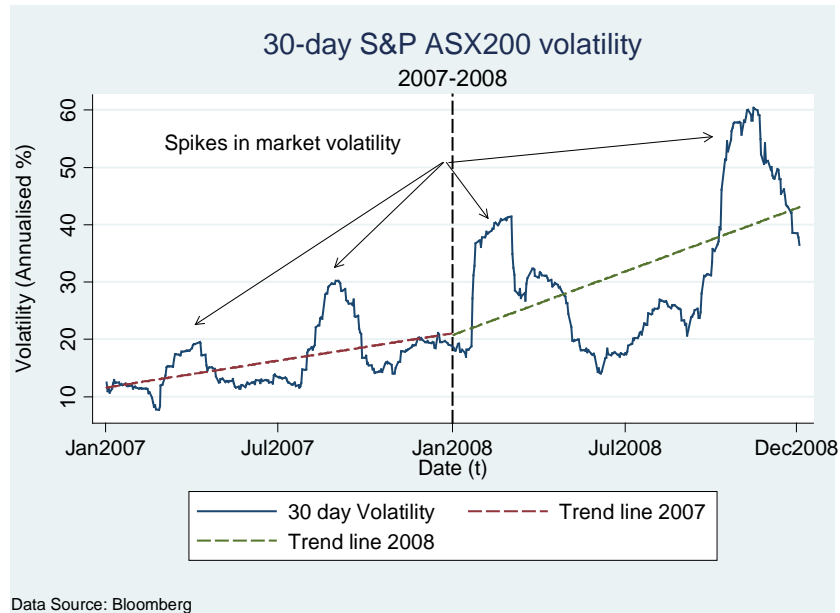
- 171 In 2008 the volatility of daily returns also increased significantly when compared with 2007. Daily changes in the value of S&P/ASX 200 index fluctuated within a narrow band of  $\pm 1\%$  in 2007 but doubled to  $\pm 2\%$  in 2008 and were still at that level at the end of last year. Again, similar changes in volatility were observed in the SFE S&P/ASX200 Futures contract.



- 172 Overall market volatility also increased significantly across the two years, and especially in 2008 when compared with 2007. These changes in volatility were highlighted by several incidents where volatility 'spiked' rapidly, followed by sustained periods of slow decline.

<sup>10</sup> Australian share ownership study (ASX) 2008: Approximately 6.7 million people or 41% of the Australian population aged 18 years plus, participated in the Australian share market either directly via listed investments namely shares or indirectly via a managed fund or self managed superannuation fund.

<sup>11</sup> Australian national accounts—financial accounts, Cat No 5232.0, December 2008.



- 173 From the perspective of ASX’s real-time surveillance of its market, this volatility gave rise to an estimated increase of around 45% more alerts generated by the ASX’s SMARTS surveillance system (although a significant number of these could be plausibly explained by general market movements)—which is a tool used by ASX to initially detect unusual price and volume movements. At the same time, there was an increasing perception by market commentators that the level of market manipulation was on the rise in 2008—which has historically been a corollary of a market downturn.
- 174 Finally, bid-ask spreads also rose rapidly in 2008. Market analysis has suggested that the widening of spreads was not a result of any substantial decline in liquidity. Indeed, other liquidity measures—such as turnover, number and size of trades—did not decline to unusually low historical levels in 2008. Rather, it is more likely that the widening of spreads was connected with the rise in price volatility. As volatility increases, so does the uncertainty about what the price of the next crossing would be. In such an environment, it is rational for potential buyers to place lower bids and potential sellers to attempt to obtain higher prices.

### Market events in 2008

- 175 These market conditions both heralded and reflected the difficulties faced by a number of high-profile market entities. Internationally, the nationalisation of several British financial institutions, over-exposure to sub-prime mortgages, freezing of credit markets, the bailout of Bear Stearns, and the collapse of Fannie Mae, Freddie Mac and Lehman Brothers are just some of the high profile international events that took place within this period.

- 176 Domestically, there were also a number of significant events in 2008 involving both ASX and SFE participants, entities listed on ASX and products quoted on ASX.
- 177 On the participant side, Tricom Equities Limited, Opes Prime Stockbroking Ltd, Hogan & Partners Stockbrokers Pty Ltd, and Chimaera Capital Limited are examples of entities that encountered severe financial difficulties. The failure of Lehman Brothers in September 2008 also resulted in the demise of its subsidiary, Lehman Brothers Australia Limited, which was a trading participant of ASX.
- 178 There were also a number of unusual trading incidents during the period on ASX and SFE's markets. For example, in July 2008, a 'fat finger' error by a participant resulted in QBE Insurance Group Limited shares trading down from around \$23 to around \$0.02, within minutes.
- 179 During 2008 and into 2009, there have been a significant number of corporate collapses or near collapses and significant declines in the value of investment products (e.g. ABC Learning Limited, Allco Finance Group Limited and Babcock & Brown Limited). ASIC estimates that near to \$73 billion has been lost in value as a result of corporate and investment product collapses from 1 January 2008 to end of May 2009 (calculated from the peak market capitalisation of the relevant entities).
- 180 Finally and shortly after the collapse of Lehman Brothers, ASIC imposed a ban on the covered short selling of shares quoted on ASX. This ban was to maintain confidence in our markets in the face of international turmoil and to complement moves made by other regulatory agencies overseas. Around the same time, ASX also effectively banned naked short-selling. The full effect of the short-selling ban per se remains difficult to gauge but the steps to permanently improve transparency should add to market efficiency. The ban was lifted for non-financial stocks (and financial stocks outside the S&P/ASX 200 Financials index including property funds) from 19 November 2008. Short selling large financial stocks remained banned until 25 May 2009.

### **Market conditions in 2009**

- 181 Whilst not strictly within the assessment period, it is also salient to consider the market conditions since the start of 2009. Whilst between the peak and its lowest point on 6 March 2009, the S&P/ASX 200 index lost 54% in local currency terms, since March it has recovered some 36% (as of 7 August 2009) of its value. Market volatility has also subsided in recent months when compared with 2008 levels, though it remains high in historical terms.
- 182 In the first half of 2009, the Australian stock market has also been important as a conduit for raising equity capital for listed entities. During this period,



ASX listed entities raised around \$47 billion in equity capital, equivalent to 4.5% of average market capitalisation over the period. By comparison, during the same period, entities listed on NYSE and LSE raised approximately 1.7% and 2% respectively, of their average market capitalisation.

## ASX activities in 2008

183 During 2008, ASX's supervisory arrangements and resources were stretched and existing practices were routinely tested. Notwithstanding this, ASX responded to the market conditions with a number of initiatives and by maintaining the standard of some ongoing practices.

### Resources

184 One way in which ASX responded was through the management of resources during this period to better supervise the changing nature of activity on the markets and C & S facilities it operates.

185 As discussed in paragraph 3, whilst the licensees within the ASX group retain responsibility for meeting their statutory obligations to supervise their respective markets and C & S facilities, under the Supervisory Services Agreement, ASXMS provides specified supervisory services to the licensees for the purposes of ensuring that the licensees meet relevant licence obligations.

186 Under the terms of the Supervisory Services Agreement, ASX group must provide sufficient funding and resources (such as staff, equipment and software) to ASXMS to enable it to perform its functions.

187 Between January and December 2008, ASX increased the number of FTEs in ASXMS by 6.5% - from 99.1 to 105.5. Taking a broader timeline, the number of FTEs within ASXMS has risen around 30% from 30 June 2007 to 30 June 2009. At the same time, the direct costs of supervision (of which staff costs constitute 92%) rose by 10% during FY08 and increased by another 17% by the end of FY09—a rise of 27% for the same period. The differences in percentage increases for FTEs and direct costs can be largely explained by the fact that staff commenced at different times during the relevant period.

188 An added measure dealing with resources was agreed by ASX in the course of last year's assessment—by which ASX undertook that the ASXMS Chief Supervision Officer will provide an annual certification to ASIC that:

- The budget for the forthcoming year and indicative budget for the following two years provides adequate funding for ASXMS to perform its supervisory services; and
- The budget submitted by the ASXMS board as its annual budget was approved by the ASX board.

189 The provision of this annual certification is to commence for the 2009-10 financial year, along with the implementation of the agreed performance benchmarks that ASX and ASIC have finalised following last year's assessment.

### Conflicts

190 As part of its statutory obligations, ASX group must also have adequate arrangements to handle its conflicts of interest. A broad description of the arrangements that ASX group has in place for this purpose was set out at paragraphs 3-5.

191 In addition, ASX group also has a number of other arrangements in place including its Licence Compliance function. Licence Compliance has specific responsibilities which include monitoring and advising on the adequacy of the ASX group's arrangements for handling conflicts of interest and how those arrangements are operating in practice. Licence Compliance reports directly to the Managing Director and CEO of ASX and indirectly to the ASXMS Chief Supervisory Officer.

192 During 2008, ASX group took a number of steps that will better assist it in managing its real or potential conflicts.

193 These steps included the implementation of the agreed actions from ASIC's most recent assessment, in so far as they related to the ASX group's conflict handling arrangements. These agreed actions included a range of changes to ASX group's internal documents and legal instruments to clarify the roles and functions of various bodies within ASX group, such as the ASX Policy Committee, which makes decisions in relation to novel policy issues confronting the ASX group. For example, ASX group implemented agreed changes to ensure that the chair of the Policy Committee will not be an executive from the business development side of the ASX group. ASX group also now ensures that a quorum of the Policy Committee must include the ASXMS Chief Supervision Officer (or their delegate).

194 The ASXMS board was also previously chaired by the then chairman of the ASX board, Mr Maurice Newman. In August 2008, Mr Newman resigned from the board of ASXMS and Mr Alan Cameron was appointed as his replacement.

195 ASIC notes that the appointment of a chairman of ASXMS who is not also on the board of ASX, is a measure that will add to the separate nature of the ASXMS board. Following the appointment of Mr Alan Cameron as chairman of ASXMS, of the five ASXMS directors, one also sits on the board of ASX.

196 During the course of 2008, ASIC acknowledges the ASXMS board has engaged ASXMS management and has exercised a willingness to review executive decision-making within the supervisory function. The foundation for this engagement is a reporting arrangement between ASXMS management and the board, which occurs via weekly e-mails, fortnightly reports and quarterly issues reports from the Chief Supervision Officer to the board. These reports typically focus on relevant resource metrics, which were introduced in 2007 and which have also been adjusted during 2008 to take account of market conditions. The ASXMS board also:

- Reviewed the supervisory implications of various new ASX product developments (e.g. the new tailored ASX AQUA market for quotation of certain structured products and managed funds);
- Reviewed the adequacy of existing and future resourcing; and
- Had significant involvement in testing and approval of business planning.

### **Supervisory activities**

197 Whilst ASIC considers that ASX group's levels of resourcing and conflict handling arrangements are adequate to meet its statutory obligations, as part of this assessment, ASIC has also reviewed the manner in which those resources and arrangements were deployed during 2008.

198 In this context, a particular focus of this assessment has been on the way in which ASX undertakes real-time surveillance of its market. ASIC notes this function was placed under pressure during 2008. For example (as discussed at paragraph 173), the number of alerts generated by the SMARTS system which ASX uses to help identify unusual trading patterns increased by around 45% in 2008, when compared with 2007 (although a large number of these could be plausibly explained by the general direction in which the market was moving).

199 In addition, and consistent with the conditions of a bear market, the number of suspicious instances of market manipulation (and rumours to this effect) increased markedly during 2008 and so too the stresses on resourcing required to detect and address the more complex nature of this market behaviour.

200 In this context, ASIC received 96 market integrity referrals from ASX in 2008 compared with 83 in 2007. These 96 referrals constituted 111 different

potential breaches. The following table details the nature of these matters in 2008, the action taken by ASIC to date and the results so far. Results so far include agreed undertakings and the imposition of licence conditions on AFSL holders.

	Total potential breaches	No further action	Ongoing investigation or enforcement action	Results so far
Market manipulation	21	11	9	1
Insider trading	36	18	16	2
Continuous disclosure	27	18	7	2
Other	27	10	8	9
<b>Total</b>	<b>111</b>	<b>57</b>	<b>40</b>	<b>14</b>

- 201 The number of investigations commenced and finalised by ASX Investigations during FY08 when compared with FY07 also increased (120 commenced and 97 finalised in FY 08 compared to 84 commenced and 73 finalised in FY07). Enforcement also finalised more matters in FY08 than FY07 (31 compared with 29) and following a review of fines imposed for disciplinary breaches by other international markets, ASX increased the upper limit of its fines from \$250k to \$1m on and from 31 March 2008. In addition, the aggregate fines imposed by the ASX tribunal in FY08 was more than double that in FY07 (\$451k to \$1.06m).

### Issuer related activities

- 202 ASX was active during 2008 in supervising a range of listed entities suffering financial difficulty, by seeking to promote compliance with continuous and periodic disclosure obligations, and where appropriate referring potential breaches of those obligations to ASIC.
- 203 Key ways in which ASX sought to promote a fair, orderly and transparent market in a range of listed entities who suffered financial difficulty during the period, were:
- Timely price queries and follow up (including in appropriate instances referrals to ASIC for further investigation);
  - Active discussion with listed entities of the need for (and the use of) trading halts and suspensions from trading; and
  - The release of guidance to listed entities on factors to focus on to ensure compliance with continuous disclosure obligations (including in respect

of margin lending arrangements of directors and timely announcement of potential asset revaluations).

204 Specifically ASX was also required to deal with a number of entities whose securities were suspended for significant periods of time. ASIC was satisfied with the approach ASX took to monitoring entities in this situation to ensure compliance with the listing rules and maintaining a close dialogue with listed entities to actively encourage resumption of trading as soon as possible.

## Participant related activities

### Tricom

205 On the participants side, ASIC's last assessment report discussed the circumstances relating to the Tricom settlement failures and agreed a number of actions with ASX to minimise the likelihood of similar circumstances arising in the future (see pages 30-32 of ASIC assessment report 135 dated 31 July 2008). These agreed actions included amending ASTC operating rules and this has occurred. In addition:

- The RBA has recently changed its Financial Stability Standards for Securities Settlement Facilities to encourage disclosure of securities lending arrangements. These changes arose following the experience of Tricom and the relevant ASTC rule changes have been recently informally lodged with ASIC;
- In February 2009, ASIC announced the imposition of certain licence conditions on Tricom and Tricom continues to be the subject of an ongoing ASIC investigation. ASX also imposed similar conditions on Tricom's status as a market participant of ASX. Those conditions itemised policies that were to be implemented over a three month timeframe and also required a whole-of-business disaster recovery plan to be implemented within six months. Other measures to be undertaken by the Tricom entities cover issues such as:
  - The prevention and detection of market misconduct, including insider trading and market manipulation;
  - Day-to-day supervision of Tricom representatives, including the prevention and detection of unauthorised trading in financial products;
  - The management of conflicts of interest;
  - Breach reporting; and
  - Minimum levels of compliance training; and
- In July 2009, ASX announced it had fined Tricom a total of \$1.35 million for 10 breaches of its operating rules. In doing so, the ASX Tribunal found that some of the contraventions were so significant and

serious that they deserved the imposition of the highest financial penalty available at the time the contraventions occurred. The breaches ranged from Tricom's inability to meet its payment obligations within the time required through to 'blatant and unmistakable' market manipulation.

### **Other participants**

- 206 In 2008, Opes Prime Stockbroking Ltd and some other participants also encountered severe financial difficulty which raised a number of regulatory issues, some of which are still under investigation.
- 207 More broadly, ASIC notes improvements to ASX's practices for participant monitoring (discussed at paragraph 72-84) take into account relevant ASX experiences with the supervision of participants that encountered difficulty during the recent period.

### **Short selling**

- 208 Shortly after the collapse of Lehman Brothers in September 2008, financial markets in Australia and internationally experienced unprecedented turmoil. ASIC's response was to temporarily ban covered short selling of listed securities and to require reporting and disclosure of permitted forms of covered short sales. Limited exceptions from the ban were provided in some circumstances where short selling was necessary for the markets to function effectively. Around the same time, ASX effectively banned naked short-selling by removing all securities from its Approved Short Sale Products List.
- 209 The decision to ban covered short selling of ASX quoted shares was made by ASIC over the weekend of 20-21 September 2008 and was in response to concerns about global market conditions. Over that weekend, ASIC and ASX had worked to minimise the prospect of the ban disrupting trading on ASX's markets. ASX received a significant amount of feedback regarding the level of confusion as to what trading was and was not permitted under the ban. As ASX had some concerns in relation to this, on the morning of 22 September 2008 it took the decision to delay the opening of the market by an hour to allow the market to comprehend the nature and extent of the ban.
- 210 The Government has subsequently introduced legislation that permanently bans naked short selling. ASIC lifted the ban on covered short selling on 25 May 2009.
- 211 ASIC's temporary regime to require reporting and disclosure of permitted forms of covered short sales was introduced in order to address the ambiguity of the then disclosure framework in the Corporations Act and ASX Market Rules as they applied to covered short sales.

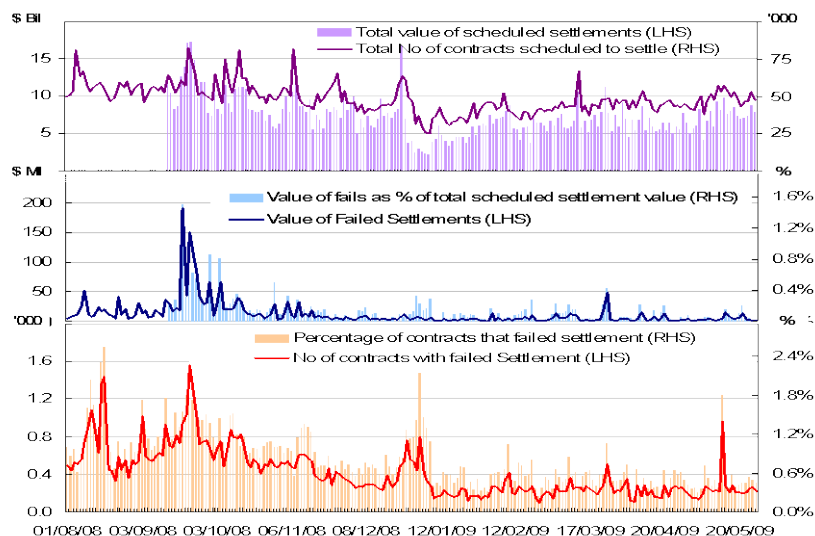
- 212 The Government intended to address the ambiguity through legislative change. To assist, ASIC worked with Treasury, ASX and the Reserve Bank of Australia (RBA) in identifying ways to amend the Corporations Act. As part of this process, in March 2008, ASX released a consultation paper seeking feedback on short-term measures it could put in place pending legislative change, including increasing transparency as to the level of stock lending/borrowing or amending ASX Market Rules by amending the short sale definition.
- 213 ASIC's interim short selling disclosure regime continues to apply. It is intended to remain until the Government's legislated disclosure regime comes into effect.

### **BrisConnections**

- 214 A significant subject of concern was the market in partly paid securities of BrisConnections in late 2008. A discussion of this event and ASIC's recommendations is set out at paragraph 138.

### **Settlement failure rates**

- 215 During the assessment period, the RBA released its 'Review of settlement practices for Australian Equities'. In its review the RBA publicly stated that: 'notwithstanding difficulties in obtaining comparable data on settlement fails internationally, the headline fails rate in the Australian equity market seems to compare favourably'.
- 216 Less than 1 per cent of transactions in Australia reportedly fail to settle on T+3 due to a participant's failure to deliver securities. Failed trades are rescheduled for settlement the following day, with around 75 to 80% of these then settling on T+4. The majority of settlement fails are for low-value trades, with ASX estimating that 98 % of the number of trades account for around a third of the total value of failing trades.
- 217 As shown in the diagram below, these failure rates increased slightly during the heightened volatility in the second half of 2008, but still remained relatively low before falling towards the end of the year.



## Technology and system uptimes

218 In addition, all ASX group IT systems operated with ‘uptimes’ of over 99.95%. Whilst ASX did experience some outages, these outages were relatively brief—particularly when compared with those experienced by some other major exchanges such as the London Stock Exchange (which had an outage of around 7 hours in September 2008) and the Toronto Stock Exchange (which had an outage for an entire trading day in December 2008).

## Other supervisory initiatives

219 During the assessment period, ASX group also undertook a range of other initiatives intended to pre-empt disorderly and ill-informed market behaviour. For example:

- In January 2008, ASX wrote to all participants seeking written assurance that participants had assessed the impact of the US subprime mortgage crisis on their business;
- In February 2008, ASX issued a companies’ update clarifying the information it expected listed entities to supply when requesting a trading halt and the circumstances ASX will consider in responding to a request;
- In February 2008, ASIC and ASX issued a joint statement reminding entities and directors of their disclosure obligations with respect to financing arrangements and margin loans;
- In March 2008, ASX and ASIC issued a joint press release in relation to short selling with ASX reminding participants of their obligations to report ‘covered’ short sales daily to ASX; and



- At various points during the year and in response to the volatile market conditions, ASX requested participants to lodge ad hoc capital returns to determine their ongoing compliance with their capital requirements.

- 220 In 2008, ASX also undertook a range of projects designed to deliver more transparent market outcomes. Domestically, this included a review of directors' trading—with a focus on director's interest notices and the prevalence of directors' trading during the 'black-out' period.
- 221 More recently, ASX has reviewed the compliance of entities with the JORC Code, and subsequently conducted joint education sessions (along with ASIC and the JORC Committee), to promote further understanding among listed entities and their advisers of their obligations under the JORC Code. As stated at paragraph 53 ASIC believes further work is needed on reviewing the need to impose additional requirements on ASX issuers in respect of the frequency and effectiveness of asset related disclosures and valuations (such as a review of the Valmin and JORC Codes).
- 222 Internationally, ASX is involved in a number of peak industry bodies and working groups including the World Federation of Exchanges, the International Surveillance Group, and CCP 12 (the global association of central counterparties). With respect to the World Federation of Exchanges, ASX is involved in the development of international benchmarking of stock exchange performance.

## E Agreed actions from last assessment

223 There were a number of agreed actions arising from last year's assessment. ASX has complied with those agreed actions in the following ways.

Agreed action	ASX response
<p><b>1. Role of ASX Markets Supervision Pty Limited (ASXMS) board and Licence Compliance</b>—agreement to formally clarify roles of Licence Compliance and ASXMS in certain respects by making necessary amendments to internal supporting legal documents, policies and procedures.</p>	<p>Amendments made to internal documents</p>
<p><b>2. Role of the Policy Committee</b>—agreement to clarify role and constitution of the Policy Committee including amendments to Policy Committee Charter. Other agreed actions include Policy Committee must not be chaired by a business development executive and a quorum of the Policy Committee must include the ASXMS Chief Supervision Officer. The ASXMS Chief Supervision Officer (CSO) must also give regular updates to ASXMS board on matters discussed at Policy Committee meetings and indicate whether his right of veto has been exercised.</p>	<p>Amendments made to internal documents. Practices with respect to chairing and quorum of Policy Committee have been addressed. Standing agenda item in CSO's quarterly report to the ASXMS board contains briefing of Policy Committee meetings and whether veto was used.</p>
<p><b>3. Human, financial and technological resources</b>—agreement to continue to monitor supervision resources, particularly for special projects and for the ASXMS board to ensure that its oversight of staffing more broadly, factors in changing market conditions and the requisite demand for supervisory services.</p>	<p>Resource metrics were updated to include metrics that reflect bear market conditions. Additional recruitment undertaken during 2008.</p>
<p><b>4. Reporting of staffing for non ASXMS supervisory activities</b>—agreement that as of quarter ending 30 September 2008, the quarterly report of the Group Executive Operations is to cover the division's supervisory resources in business units providing supervisory functions in the Operations division.</p>	<p>These changes were included in the reporting template used by the Group Executive Operations as of the quarter ending 30 September 2008.</p>
<p><b>5. Assurance about total cost of supervision</b>—agreement that ASX Chief Financial Officer and ASXMS Chief Supervision Officer to provide additional certification of supervisory expenditure.</p>	<p>Annual certification provided for 2007/08 year.</p>

Agreed action	ASX response
<p><b>6. ASXMS funding levels</b>—agreement that CSO will provide additional certification of sufficiency of budget to meet supervision obligations.</p>	<p>Certification will begin for 2009/10 year and will include reference to applicable performance indicators in item 8.</p>
<p><b>7. SYCOM upgrade process</b>—agreement to review SYCOM upgrade process.</p>	<p>KPMG engaged to prepare independent report. KPMG report delivered to ASIC confirming appropriateness of planning and governance arrangements for the upgrade project.</p>
<p><b>8. Benchmark measures</b>—ASIC and ASX to cooperate on developing benchmarks for market supervision.</p>	<p>Performance indicators agreed and are scheduled to be used in 2009/10 year.</p>
<p><b>9. Error resolution</b>—agreement of SFE to revise certain procedures for Error Resolution Policy applications.</p>	<p>Procedures were revised. See paragraph 159.</p>
<p><b>10. ASTC settlement process</b>—agreement to revise certain ASTC settlement processes in light of Tricom related delays experienced in February 2008.</p>	<p>Increased fines and ASTC operating rule changes (for automatic close out after T + 5 settlement failure) put in place as well as practice of referring T+10 settlement failures to ASX investigations for disciplinary action if appropriate.</p>

## Key terms

Term	Meaning in this document
ACH	Australian Clearing House Pty Limited
AFMA	Australian Financial Markets Association
AML	Australian Market Licence
ASIC	Australian Securities and Investments Commission
ASTC	ASX Settlement and Transfer Corporation Pty Limited
ASX	ASX Limited
ASX group	ASX, ACH, ASTC, SFE, SFECC and Austraclear
ASXMS	ASX Markets Supervision Pty Limited
Austraclear	Austraclear Limited
C & S facilities licensees	ACH, ASTC, SFECC and Austraclear
CEO	ASX Chief Executive Officer
CFO	ASX Chief Financial Officer
C & S facility	Clearing and settlement facility
Corporations Act	The Corporations Act 2001 (Cth)
CSO	Chief Supervision Officer
GE Operations	Group Executive - Operations
SFE	Sydney Futures Exchange Limited
SFECC	SFE Clearing Corporation Pty Limited
SSA	Supervisory Services Agreement
SYCOM	Sydney Computerised Overnight Market