



ASIC

Australian Securities & Investments Commission

REPORT 118

**Market assessment report:
National Stock Exchange of
Australia Limited
ACN 000 902 063**

January 2008

About this report

This report summarises ASIC's fifth assessment of National Stock Exchange of Australia Limited (NSEAL) under s794C of the *Corporations Act 2001* (Corporations Act).

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 NSEAL

The Stock Exchange of Newcastle Ltd was granted an Australian market licence (AML) commencing 11 March 2002. The AML was varied with effect 31 March 2004 and again from 20 December 2006 (including noting the change of name of the licensee to NSEAL).

Report number	Date released
N/A	November 2003
REP 36	December 2004
REP 42	June 2005
REP 82	September 2006

Contents

Key findings and recommendations	4
Key findings	4
Recommendations.....	4
A The assessment.....	5
Purpose and scope.....	5
Background.....	5
Our methodology	6
B Our observations and recommendations for NSEAL	8
NSEAL's general obligations	8
Other observations and recommendations.....	8
Conflict handling arrangements.....	11
Key terms	18

Key findings and recommendations

Key findings

- 1 We are satisfied that National Stock Exchange of Australia Limited (NSEAL) has adequate arrangements for supervising its market under s792A(c) of the Corporations Act.
- 2 To assist NSEAL to adequately arrange the handling of its conflicts of interest under s792A(c)(i), we have made some recommendations.

Recommendations

- 3 We recommend that:
 - Supervisory activities should be reported to the compliance committee given their significant oversight responsibility. We recommend that the compliance committee meet on a more frequent basis and take formal minutes.
 - NSEAL supervision should pay closer scrutiny to the role of nominated advisers (NOMADs). NSEAL should consider issuing an additional guidance note to NOMADs stating NSEAL expectations of NOMAD frequency of consultation and anticipatory interventions with their client issuer(s).
 - NSEAL should require that all NSEAL-approved NOMADs are independent on a continuing basis of the companies that contract them to be their adviser in relation to market obligations. A NOMAD should be required to demonstrate to NSEAL that both it and its executives are independent from the NSEAL companies for which it acts such that there is no reasonable basis for impugning the NOMAD's independence.

A The assessment

Key points

ASIC conducts annual assessments of market licensees, because it is required to do so under s794C of the Corporations Act. We also conduct annual assessments of clearing and settlement facility licensees under s823C.

The scope of our assessment must include the obligations found in s792A(c), but we can include other Chapter 7 obligations too.

ASIC uses the licensee's self-assessment reports, information from its previous assessments, ASIC's observation of the licensee's performance, market intelligence and other things to form a view of how well the licensee has operated its market.

Purpose and scope

- 4 ASIC is required to assess how well a market licensee complies with its obligations in s792A(c) at least once a year (s792C(2)).
- 5 A market licensee is required to have adequate arrangements for supervising the market (under s792A) including for:
 - handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market is fair, orderly and transparent;
 - monitoring the conduct of participants on or in relation to the market; and
 - enforcing compliance with the market's operating rules.
- 6 In addition, we are permitted to extend the scope of our assessment to review how well NSEAL complies with any or all of its obligations under Chapter 7 (s794C(1)).

Background

- 7 The NSEAL market licence permits NSEAL to operate a market in the financial products described on its licence. A copy of NSEAL's market licence is available on ASIC's website at www.asic.gov.au.
- 8 With effect from 20 December 2006, NSEAL varied its licence to permit the licensee's name to be changed from Stock Exchange of Newcastle Limited to National Stock Exchange of Australia Limited.

- 9 NSEAL is a wholly owned subsidiary of NSX Limited (NSXL), a company listed on the Australian Securities Exchange. NSXL also controls another company holding an Australian Market Licence (AML), Bendigo Stock Exchange Limited (BSXL). NSEAL shares supervisory structures and staff with BSXL.

Our methodology

Our assessment process

- 10 A market licensee's obligations are ongoing. Whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance.
- 11 We therefore use the assessment process to:
- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market in accordance with its obligations under the Corporations Act at the time of the assessment; and
 - identify issues, which in our view need, or may need, to be addressed to ensure ongoing compliance.

What we considered

- 12 In conducting our assessment we:
- analysed information we received from and about NSEAL in the ordinary course of our dealings with the licensee, including NSEAL's annual regulatory report required under s792F;
 - reviewed information from the media, NSEAL's website, ASIC's complaints management records and other sources;
 - considered the operation of the market throughout the period, in particular in relation to issues of disclosure and trading;
 - interviewed NSEAL personnel; and
 - reviewed policies and procedures for the conduct of NSEAL markets in general and their supervisory responsibilities in particular.
- 13 From 5 March 2007 to 8 March 2007 we attended the offices of NSEAL and its holding company, NSXL, in Newcastle. During this on-site phase of the assessment we reviewed NSEAL operational records and spoke to NSEAL personnel and management.

Consultation

- 14 NSEAL has had the opportunity to view and comment on the findings and recommendations contained in a draft version of this report. Where appropriate, this final report reflects NSEAL's responses.

What we focused on for this assessment

- 15 One focus of this assessment was to review how NSEAL responded to the issues we identified with its supervisory arrangements as a result of our previous assessment. In our last assessment we made recommendations about putting in place procedures to discipline participants and entities that breached the licensees' operating rules.
- 16 We also examined structures to ensure the licensee's board remained accountable for supervisory outcomes. This examination involved checking that the two committees charged with making key supervisory decisions were formally accountable to the NSEAL board for supervisory outcomes; were fully informed by NSEAL staff of all information relevant to the decisions they were charged to make; and discharged their duties objectively and without interference from the commercial side of NSEAL's business.

B Our observations and recommendations for NSEAL

Key points

We consider NSEAL's arrangements for supervising its market are adequate, including arrangements for:

- handling conflicts between the commercial interests of the market licensee and the need for the market licensee to ensure that the market is fair, orderly and transparent;
- monitoring the conduct of participants on or in relation to the market; and
- enforcing compliance with the market's operating rules.

We have made a number of observations and recommendations based on our assessment. These are detailed in this section.

NSEAL's general obligations

- 17 We are satisfied that NSEAL had adequate practices and procedures to monitor and supervise participants, listed disclosing entities and arrangements for handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner in accordance with its obligations under s792A(a) of the Corporations Act. No failures to adequately manage conflicts of interest were identified.

Other observations and recommendations

Committee structure

- 18 On 30 June 2006, NSXL introduced a committee structure common to both the NSXL group AML holders: NSEAL and BSXL. The committee structure consists of two separate bodies that serve both the NSEAL and BSXL markets: the listing and admissions committee and the compliance committee.

Listing and admissions committee

- 19 The listing and admissions committee is responsible for assessing and approving applications for applications by entities for admission to the

NSEAL official list and where appropriate, approve applications to be recognised as a NSEAL broker or NOMAD. To list on NSEAL an issuer must appoint an advisor from a list of NSEAL-approved stockbrokers, bankers, lawyers or other organisation. The advisor's role is to guide the issuer's directors on their responsibilities and obligations under the market's operating rules. NSEAL has provision to discipline NOMADs that fail to perform their obligations to NSEAL.

- 20 During our assessment, we observed that the listing and admissions committee was undertaking its functions in an appropriate manner and in accordance with its stated charter. Below we make some observations about the processes used to judge whether an applicant is 'suitable' for admission to the official list, as required by NSEAL's listing rule (LR)-based admission standards.
- 21 NSEAL LR set out the requirements that an entity must satisfy before it can be listed on NSEAL. Under LR 3.5, an issuer and its business must be 'suitable for listing'. Distinct from the general suitability requirement, under LR 3.6 a new applicant must have a two year track record of trading adequately under substantially the same management or, if not previously a company, under a similar structure, with adequate trading to be established by a least one year's audited accounts. On listing, the entity must have a spread of at least 50 shareholders with 25% of shares held other than by directors.
- 22 Although LR 3.10 requires a new applicant to have an expected initial market capitalisation (IMC) for all the securities to be listed of at least A\$500,000, NSEAL permits 'suitable' entities to list with a lower IMC if the fund-raising has been used for listing-related expenses. If the new applicant's IMC has fallen below the \$500,000 threshold at listing, NSEAL will put the entity on a watch list, then look at cash burn rates regularly, and issue 'please explain' letters to establish how they intend to raise fresh capital. Half-yearly and annual financial reports are then examined to ensure cash on hand is sufficient to finance operations. Cash on hand could be zero for instance if the listed entity has bank bill backing. NSEAL's companies manager is responsible for assessing listing applications and for making recommendations to the listing and admissions committee, which has the delegated power from the NSXL/NSEAL board to determine listing applications.
- 23 We reviewed the listing process for entities that listed on NSEAL after March 2006, to ensure that they satisfied the 'suitability' and shareholder spread tests under the LR, and considered whether NSEAL followed its listing procedures for determining suitability. We paid special attention to listing applications promoted by former NSEAL chairmen, directors and other related parties.

- 24 We concluded that the listings and admissions committee was making supervisory decisions that were not adversely affected by commercial or other non-supervisory considerations.

Compliance committee

- 25 According to its charter, the compliance committee's primary objective is to undertake compliance and surveillance functions as delegated by the NSXL board. In relation to the NSEAL market, it also assesses and where appropriate, grants requests for waivers from the NSEAL operating rules.
- 26 During the review period the compliance committee held three formal meetings where formal minutes were taken. On the other occasions that it met the compliance committee convened on an ad hoc circular resolution basis to consider waiver applications. We did not see any evidence of the committee considering any compliance and surveillance related matters, nor did the committee have the results of these matters formally reported to them from NSEAL compliance personnel.
- 27 The compliance committee charter states that the compliance officer, who is the chair of the committee,
'Has primary responsibility to deal with day to day compliance issues referred by the General Manager and as appropriate will seek advice from all other members of the committee as required.'
- 28 During the review period, at least three investigations of supervisory significance were conducted by the NSEAL general manager. We were advised that the compliance committee chairman, in his role as NSEAL's compliance officer, was kept informed of developments, and in turn briefed the other members of the compliance committee.
- 29 Despite its charter requiring the preparation of minutes for meetings, recording of the substance of the chairman's briefings to committee members, and subsequent discussion, was cursory. Given the importance of this committee and its significant oversight responsibility, and given the seriousness of some of the day-to-day compliance issues that arose during the review period, we believe that supervisory activities that required NSEAL's general manager to make significant supervisory decisions still need to be reported to the committee on a more systematic and formal basis. We are also of the view that in the absence of Chinese walls more comprehensive minutes of meetings of the dedicated supervisory committee are required to ensure transparency of the decision-making process and to fix accountability for effective management of conflicts.

- 30 The compliance committee is also responsible for overseeing participant compliance with NSEAL operating rules and attended to this role adequately.

Recommendation 1

We recommend that significant supervisory investigations and decisions conducted by delegates of the compliance committee be formally reported to the compliance committee to ensure the committee's accountability and attendance to its significant oversight responsibility. Also, the compliance committee should formally minute its review of significant investigations conducted by NSEAL staff that make supervisory decisions.

Independence of committee decisions

- 31 Due to necessarily limited resources available to NSEAL it is still not possible for it to create Chinese walls to ensure that NSEAL employees are not subject to undue pressures to make decisions in their capacity as committee members based on considerations other than promotion of a fair, orderly and transparent market. NSEAL continues to operate alternative structures to ensure that committees separate and distinct from NSEAL management are accountable to NSEAL's board for supervisory decisions. As NSEAL's market grows it will need to consider other means to implement effective separation of functions in the future.

Conflict handling arrangements

- 32 We examined decisions made, and the processes followed, by the supervisory committees on admission and on-going continuous and periodic disclosure supervision. Our view was that if independence and adherence to proper procedure by the two supervisory committees could be demonstrated, this would give us assurance that NSEAL was meeting its obligation to have adequate arrangements to manage its conflicts of interest.
- 33 The usual practice adopted by exchanges to deal with conflicts of interest is to prevent commercial staff having any communication with supervisory staff that is designed to affect a pending supervisory decision. This is generally achieved using Chinese walls that permit contact to be managed, improper interventions to be identified and wrongdoers disciplined.
- 34 Due to the small number of staff and justifiable cost constraints, it is not practicable for the NSXL group to impose physical and managerial separation of supervisory from commercial functions. In previous annual assessments of NSEAL, we have agreed that, provided the NSXL group board (which is coextensive with the NSEAL board) and the CEO have no role in supervisory decision making, and accountability for the decision to

admit an entity to the NSEAL official list and to issue waivers from NSEAL's operating rules rests with independent committees, this will be sufficient to manage adequately conflicts of interest.

- 35 Relevant to NSEAL, for example, a former chairman of the NSXL group is a participant in the market, a promoter of new listings, associated with an exchange-approved NOMAD and a director of NSEAL-listed entities. He is also a member of the NSEAL compliance committee.
- 36 We examined decisions made by, and processes followed by the supervisory committees on admission and on-going continuous and periodic disclosure supervision of entities linked to present and former NSEAL directors. The decisions examined were justifiable by reference to NSEAL policies and precedent.

Monitoring of continuous disclosure

- 37 NSEAL LR 6.4 and 6.5 require a listed disclosing entity to immediately provide information to NSEAL when it becomes aware of any information concerning it that a reasonable person would expect would have a material effect on the price or value of the entity's securities.
- 38 Disorderly or unexplained movement in prices can be an indicator that price sensitive information has not been disclosed to the market. On the NSEAL official list most entities are thinly traded. This makes it difficult to identify whether a significant price movement—that is, a trade executed a long way from the previous market price, has resulted due to an unfair, and potentially illegally exploited knowledge asymmetry between the buyer and seller.
- 39 We concluded after examining a few cases of anomalous price movements that some key supervisory decisions, including decisions to take no action, were being made by NSEAL supervisory staff without the formal involvement of the compliance committee. We recognise that many supervisory decisions need to be made expeditiously and involve exercise of delegated individual judgment. Nevertheless, our view is that when NSEAL supervisory staff identify possible LR breaches they should formally advise all members of the compliance committee of the facts once these are determined so that the compliance committee is in a position to form a view about whether NSEAL should discipline a participant, a listed entity, a listed entity's directors and/or a NOMAD.
- 40 Recommendation 1 above addresses this.

Market surveillance

- 41 NSEAL listed securities were monitored manually until May 2005. The sporadic trading of most stocks meant that this was feasible, since individual

trades could be analysed at the time of execution. However, this manual monitoring was open to the possibility of human error, and was probably not going to be adequate in the event of increased trading volumes.

- 42 In May 2005, NSEAL upgraded its surveillance capabilities by implementing 'Compliance Explorer', a software product of Capital Markets CRC Limited, as its main tool for market trading surveillance. Major benefits delivered to NSEAL were more frequent updates for price data, full market depth by price for each stock, growth of capital tables for each security, dividend records for each security, trade data by security available as display and as a spreadsheet for download, placement of the quote ticker on the home page, public company research data available to the public via the website, and capacity to send really simple syndication (RSS) announcements as email. RSS is a family of web feed formats used to publish frequently updated content such as blog entries, news headlines or podcasts.
- 43 Compliance Explorer monitors trading behaviour in real-time, and generates automatic alerts where trading falls outside certain pre-determined parameters. NSEAL specifies these parameters in its internal written surveillance procedures, with responsibility for monitoring alerts resting with NSEAL's general manager.
- 44 Whenever an alert is triggered, this is investigated by surveillance staff who subsequently inform the general manager when necessary. If it is deemed necessary to query an entity regarding unusual trading behaviour, NSEAL writes to the company, which then has three days to respond. This correspondence is released to the market through NSEAL's website.
- 45 We noted that NSEAL had been vigilant in following up such alerts with companies, enforcing the response window for companies, and releasing relevant correspondence to the market.

Periodic disclosure

- 46 Under the NSEAL LR, an entity must advise NSEAL of its financial results for each half-year and full financial year. Its procedures state that NSEAL pays particular attention to both the timeliness and substance of the information provided to it.
- 47 We sampled entities' compliance with the financial reporting lodgement deadlines imposed by NSEAL's rules. We noted that NSEAL proactively contacts listed entities when reporting deadlines are imminent and that the vast majority of entities met those deadlines. NSEAL appropriately suspended trading immediately in the securities of any that did not.

- 48 NSEAL undertakes reviews of all periodic annual financial reports to ensure they comply with the additional information requirements of its LR. NSEAL sent letters to entities where additional disclosure was required. These requisition letters were sent in mid December 2006. During an interview, NSEAL's companies manager said NSEAL recognised that periodic disclosure required that follow-up requisitions take place as soon as possible after receipt of financial reports. NSEAL advises that it is improving its timeliness for sending out these letters.
- 49 With regard to monitoring of listed disclosing entity corporate governance disclosure, NSEAL issued draft Practice Note No. 14, which was sent to all NSEAL listed entities under cover of a standard letter on 26 September 2006. Listed disclosing entities were asked to provide comment and feedback by 4 December 2006. NSEAL Section IIA rule 6.9 (11) requires NSEAL listed disclosing entities to disclose in the issuer's annual report their 'main corporate governance practices'. The practice note says that they can choose to use the ASX corporate governance guidelines or the NSEAL practice note guidance that is not based on 'if not, why not?'
- 50 NSEAL interprets its Section IIA rule 6.9 as having three aspects:
- First, the listed entity must consider what good corporate governance means to the listed entity in its own specific circumstances.
 - Secondly, the listed entity must formulate policies and procedures relevant to the individual entity, which support adherence with the principles.
 - Thirdly, the entity must regularly revise its policies and procedures to ensure ongoing compliance with the principles.
- 51 NSEAL's Practice Note No.14 states NSEAL's expectation that listed entities seek their NOMAD's assistance to prepare the required policies and procedures. We conclude from this that the NSEAL corporate governance disclosure expectations place active obligations on NSEAL-listed entities to address effective board control of management, and other key corporate governance principles necessary to protect investor interests and to promote a fair market.
- 52 NSEAL's view is that by promoting a principled rather than a more prescriptive approach it is not advocating less disclosure than would be required by other stock exchanges.
- 53 We accept that the NSEAL model, although different to other markets, may be effective provided NSEAL monitors NOMAD provision of appropriate advice to listed entities.

Nominated advisers

General oversight

- 54 NOMADs are required to be available at all times to advise and guide the directors of an issuer as to their responsibilities and obligations to ensure compliance by the issuer on an ongoing basis with the LR. We saw no evidence that NOMADs had been contacted by NSEAL to gauge whether directors of the listed entities had been provided with advice, for instance in relation to market disclosure matters. NSEAL does not copy correspondence to NOMADs when there are price queries sent to listed companies, so it falls to the NOMAD to maintain communication with its listed entity clients. During the review period NSEAL concluded that no issues arose that required it to investigate a NOMAD's performance.

Independence

- 55 While a NOMAD is the contracted agent of a listed disclosing entity, NSEAL has a role in vetting applications from prospective NOMADs to be admitted to the list of advisers that may be contracted by a listed entity to serve as its NOMAD.
- 56 NSEAL's eligibility criteria for NOMADs requires that the NOMAD show a degree of independence from the listed entity that they are advising. NSEAL requires each NOMAD to certify annually that it continues to:
- meet the eligibility criteria; and
 - act independently, responsibly and in a professional manner in ensuring compliance with NSEAL's applicable rules and practice notes.
- 57 It must also certify that, as at the date of the annual certification, it was not aware of any breach of NSEAL's applicable rules or the Corporations Act in relation to the relevant entity, which has not previously been advised to NSEAL by the entity and its directors.
- 58 We found no evidence that NOMADs are not independent of NSEAL, or its listed entities or its participants, or that as a consequence of any lack of independence NOMADs were not performing their obligations. However, we believe NSEAL should reconsider whether parties with conflicts of interest should be permitted to act as a NOMAD. It is our view that NSEAL should consider further the question of whether a NOMAD with conflicts of interest is able to properly perform its role.

Recommendation 2

We recommend that NSEAL supervision should pay closer scrutiny to the role of NOMADs. NSEAL should consider issuing an additional guidance

note to NOMADs stating NSEAL expectations of NOMAD frequency of consultation and anticipatory interventions with their client issuer(s).

- 59 In relation to recommendation 2, NSEAL has advised that it is committed to producing more documentation for NOMADs either in the form of a handbook, a practice note or both. These documents will cover areas of all responsibilities of NOMADs, including a statement of NSEAL's expectation that a NOMAD will contact clients regularly to obtain notice of NSEAL correspondence.

Recommendation 3

NSEAL should require that all NSEAL approved NOMADs are independent on a continuing basis of the companies that contract them to be their adviser in relation to market obligations. A NOMAD should be required to demonstrate to NSEAL that both it and its executives are independent from the NSEAL companies for which it acts such that there is no reasonable basis for impugning the NOMAD's independence.

NSEAL should require its NOMADs to demonstrate clearly that neither their independence nor that of any of their executives has or will be compromised by any potential conflict of interest. The burden of proof should be placed upon the NOMAD.

- 60 NSEAL has advised that it agrees with recommendation 3.

Participant supervision

- 61 Participant supervision is the responsibility of the NSEAL compliance committee, with day-to-day monitoring a mix between NSEAL's general manager, NSEAL's companies manager and the compliance officer.
- 62 The compliance committee's charter indicates that it is responsible for reviewing and acting upon surveillance reports escalated by management and the compliance officer. The charter also notes that the compliance officer can act independently of the committee for day-to-day compliance, surveillance, and activities and report to ASIC and the board.
- 63 NSEAL have introduced an annual participant self-assessment, as one way of gauging the compliance of market participants with NSEAL's business rules. After receipt of these completed questionnaires, the NSEAL compliance officer also undertakes an annual assessment of each participant and reports back to the compliance committee.
- 64 NSEAL contracts with an external accounting firm—termed the exchange examining accountant (EEA), presently McCosker Partners (McCosker)—to monitor the periodic financial aspects of NSEAL participant compliance. The EEA provides a number of regular reports to NSEAL:
- a Monthly Report Table;

- a Period Ended June Summary Report; and
- a Period Ended December Summary Report and Reconciliation.

- 65 On a monthly basis the EEA provides NSEAL with a monthly report table summarising the surplus liquid funds (SLF) reports provided by participants. These monthly reports are reviewed by NSEAL staff and anomalies addressed with the EEA or the participant concerned. This report is circulated to the compliance committee.
- 66 For the period ended June each year the EEA provides to NSEAL a summary of the previous six months' reports. This serves as a mechanism to reveal any systemic issues that may have been detected. This report too is circulated to the compliance committee.
- 67 The third report, the Period Ended December Summary Report and Reconciliation, is provided to NSEAL by the EEA in the same form as that for the Period Ended June Report, but adds a summary of the results of site visits for selected participants. The site visits include revisiting with the participant calculation of their SLF returns, reconciliation of the SLF returns with the participant's annual report and sighting of various documents to confirm aspects of the returns. Again, this report is circulated to the compliance committee.
- 68 NSEAL business rules require that NSEAL participants prepare and lodge specified periodic information with NSEAL. Some current certificates of insurance were not copied to files that we examined but otherwise returns were in order.

Key terms

Term	Meaning in this document
AML	Australian Market Licence
ASIC	Australian Securities and Investments Commission
BSXL	Bendigo Stock Exchange Limited
Corporations Act	The Corporations Act 2001 (Cth)
IMC	initial market capitalisation
LR	listing rule
NOMAD	nominated adviser
NSEAL	National Stock Exchange of Australia Limited
NSXL	NSX Limited