



**ASIC**

Australian Securities & Investments Commission

## REPORT 135

# 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**

31 July 2008

### **About this report**

This report summarises ASIC's sixth assessment of ASX and SFE under s794C(2) of the *Corporations Act 2001* (Corporations Act).

This report summarises ASIC's sixth assessment of ACH and ASTC under s823C(2) of the Corporations Act.

This report summarises ASIC's sixth assessment of SFECC and its fourth assessment of Austraclear under s823C(2) of the 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 licensees within the ASX group

Our last reports about ASX Limited (ASX), Australian Clearing House Pty Limited (ACH) and ASX Settlement and Transfer Corporation Pty Limited (ASTC) were publicly released in May 2007. Our last reports about Sydney Futures Exchange Limited (SFE), SFE Clearing Corporation Pty Limited (SFECC) and Austraclear Limited (Austraclear) were publicly released in November 2007.

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

Entity	Report number	Date released
ASX	REP 94	May 2007
	REP 68	March 2006
ACH	REP 94	May 2007
	REP 79	August 2006
ASTC	REP 94	May 2007
	REP 79	August 2006
SFE	REP 99	November 2007
	REP 75	June 2006
SFECC	REP 99	November 2007
	REP 76	June 2006
Austraclear	REP 99	November 2007
	REP 76	June 2006

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# About this report

## Scope of these assessments

- 1 The assessments relate to:
  - how well the relevant ASX group licensee is complying with its obligations under s792A(c) and (d) or 821A(c) and (d) (as appropriate). These are the obligations to have adequate supervisory arrangements (including conflicts handling arrangements) and to adequately resource those supervisory arrangements.
  - the arrangements that ASX group licensees have in place to supervise their markets and clearing and settlement facilities under s792A(c) and 821A(c) respectively; and
  - the resources that are devoted to supervision activities under s792A(d) and 821A(d) respectively.
- 2 The scope of the assessment has not been extended to include the other statutory obligations of the ASX group licensees, beyond the obligations found in s792A(c) & 821A(c) to have adequate supervisory arrangements (including conflict handling arrangements) and to adequately resource those supervisory arrangements (s792A(d) and 821A(d)). These will be the subject of future assessments.

### Market events in 2008

- 3 The securities markets have experienced significant turnaround in performance and sentiment since December 2007. These events and how they may have impacted on ASX have been included in this report (see Part B paras 107–121. For example, this report includes actions to change procedures for handling settlement delays that have been agreed between ASIC and ASX in response to the Tricom delayed settlements. ASIC delayed this report until it had completed its review of ASX arising out of these more recent market events.
- 4 This report, therefore, covers the period 1 July 2006 to 30 March 2008.

## Key findings

- 5 ASIC is satisfied that:
- Both ASX and SFE have adequate arrangements to supervise their respective markets under s792A(c), comprising arrangements to handle conflicts between commercial interests and the need for the licensees to ensure that the market is fair, orderly and transparent, to monitor the conduct of participants on the market and to enforce compliance with the markets rules, and that the provision of supervisory services is adequately resourced under s792A(d).
  - Each of ACH, ASTC, SFECC and Austraclear have adequate arrangements to supervise their respective clearing and settlement facilities under s821A(c), comprising arrangements to handle conflicts between commercial interests and the need for the licensees to ensure that facility services are provided in a fair and effective way, and enforcing compliance with the facility's operating rules, and that the provision of supervisory services is adequately resourced under s821A(d).

## Agreed actions

- 6 While we consider that ASX's arrangements to supervise the markets under s792A(c) in relation to conflicts are adequate, developments in the ASX group of companies' structure in the period under review and recent market events that have occurred in the market reinforce the need for ASX to take additional steps to ensure that their arrangements remain adequate into the future. In particular this report identifies areas where we have recommended (and ASX has agreed) that ASX should make changes and improvements in order to further strengthen the way ASX manages conflicts.
- 7 These Agreed Actions are detailed below (see Parts A and Part B) and fall under these headings (with 10 specific Agreed Actions):
- Role of ASX Markets Supervision Pty Limited (ASXMS) board and Licence Compliance – agreement to formally clarify roles of Licence Compliance and ASXMS in certain respects.
  - Role of the Policy Committee – agreement to clarify role and constitution of the Policy Committee.
  - Human, financial and technological resources – agreement to continue to monitor supervision resources, particularly for special projects.
  - Reporting of staffing for non ASXMS supervisory activities – agreement to revise the quarterly report of the Group Executive Operations to cover the division's supervisory resources.

- Assurance about total cost of supervision – agreement to provide additional certification of supervisory expenditure.
- ASXMS funding levels – agreement to provide additional certification of sufficiency of budget to meet supervision obligations.
- SYCOM upgrade process – agreement to review SYCOM upgrade process.
- Benchmark measures – ASIC and ASX to cooperate on developing benchmarks for market supervision.
- Error resolution – agreement of SFE to revise certain procedures for Error Resolution Policy applications.
- ASTC settlement process – agreement to revise certain ASTC settlement processes in light of Tricom related delays experienced in February.

- 8 While there are matters for improvement, ASIC's view is that nevertheless, ASX had adequate arrangements in place for the review period and with these Agreed Actions should continue to have adequate arrangements.
- 9 In prior years, ASIC provided recommendations to ASX. In this report, as ASX agrees to the changes, they are presented as 'Agreed Actions'.
- 10 ASIC notes that on 21 July 2008 (after the date to which this report relates) ASX announced that the composition of the board of ASXMS is to change from 1 August, with only one common director of ASX and ASXMS.

## Conflicts of interest

- 11 Under s792A(c)(i) and 821A(c)(i) of the Corporations Act, ASX 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 the market is fair, orderly and transparent or that clearing and settlement services are provided in a fair and effective way.
- 12 ASIC makes 2 points by way of clarification of the existing legislative framework because there have been concerns in the market during recent volatility over ASX's role as a market operator and supervisor of its markets:
- First, the regulatory regime under which ASX operates does not preclude the existence of conflicts of interest for ASX. There is no per se prohibition on ASX having conflicts of interest but ASX must manage its conflicts so as not to allow its commercial interests to prevail over its supervisory role. Whether or not (e.g. through separation of ASX'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 (for an earlier period and not in real time) within the existing legislative framework.

- Secondly, the statutory standard on ASX is that it adequately manages its conflicts (i.e. that its management processes are adequate to ensure that ASX's commercial interests do not prevail over its supervisory function). ASIC's role is to assess if ASX has adequate arrangements in place. In the last 5 reports, and in this report, ASIC has concluded that ASX's arrangements for managing conflicts are adequate (i.e. meet the statutory standard).

## Separate roles of ASX and ASIC – ASIC's cooperation with ASX

- 13 Under the existing legislative framework, both ASX and ASIC have separate roles in the supervision of the markets and of market participants. In addition, ASIC supervises ASX. ASX and ASIC co-operate extensively with each other, under the umbrella of a Memorandum of Understanding between the two organisations, that notes their complementary roles.
- 14 ASIC and ASX meet formally each month to discuss supervisory issues, relating to both listed entities and market participants. In recent months there have been joint supervisory reviews of market participants. The surveillance of short selling and possibly illegal trading activity that started in March 2008 was also a joint activity.
- 15 ASIC is in the process of refocussing its MarketWatch and markets enforcement teams that deal with referrals from ASX on insider trading and market manipulation, to enhance its capabilities. In addition, ASIC recently announced that it will add more resources to the oversight of brokers and market participants. They will add to the total resources of both organisations available for market surveillance. These additional resources should also assist in reducing potential risks inherent from the fact that ASX and ASIC are separate organisations (particularly for areas such as insider trading where speed from possible detection to investigation is imperative).

## 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) and 821A(c) for market licensees and clearing and settlement facility licensees respectively, but we can include other Chapter 7 obligations too.

This assessment is of ASX group's obligations under s792A(c) and 821(c) and s792A(d) and 821A(d). We have not extended the scope of the assessment beyond these obligations and in respect of s792A(d) and 821A(d), our review only took into account the adequacy of resources dedicated to supervision.

ASIC has undertaken an integrated assessment of each of the licensees of the ASX group.

ASIC uses the licensees' self-assessment reports<sup>3</sup>, information from its previous assessments, ASIC's observation of the licensee's performance, market intelligence and other things we consider appropriate to form a view of how well the licensee(s) have operated its market and clearing and settlement facilities respectively.

This assessment covers the period 1 July 2006 to 30 March 2008.

## Purpose and scope

### ASX and SFE annual assessments

- 16 ASIC is required to assess how well a market licensee complies with its obligations in s792A(c) at least once a year (s794C(2)).
- 17 A market licensee is required to have adequate arrangements for supervising the market (under s792A) comprising arrangements 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.
- 18 In addition, we can extend the scope of our assessment to review how well ASX

<sup>3</sup> Pursuant to s792F and 821E of the Corporations Act a licensee must give ASIC an annual report on the extent to which the licensee has complied with its obligations under ch.7.



and SFE comply with any or all of their obligations under Chapter 7 (s794C(1)). The scope of the assessment has not been extended to include the other statutory obligations of the ASX group licensees, beyond the obligations found in s792A(c) to have adequate supervisory arrangements (including conflict handling arrangements) and to adequately resource those supervisory arrangements (s792A(d)).

### **ACH, ASTC, SFECC and Austraclear annual assessments**

- 19 Section 823C(2) requires ASIC to assess how well a licensed clearing and settlement facility operator complies with its obligations in s821A(c) at least once a year.
- 20 Section 821A(c) requires a clearing and settlement facility licensee to have adequate arrangements for supervising the facility, comprising arrangements for:
- handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the facility's services are provided in a fair and effective way; and
  - enforcing compliance with the facility's operating rules.
- 21 In addition, s823C(1) permits ASIC to extend the scope of its assessment to review how well ACH, ASTC, SFECC and Austraclear comply with any of their obligations apart from s821A(aa) under Chapter 7. We have also assessed ACH's, ASTC's, SFECC's and Austraclear's compliance with their obligations to have sufficient resources for the required supervisory arrangements to be provided (s821A(d)). We have not assessed ACH, ASTC, SFECC and Austraclear in respect of their other obligations, such as their obligation to do all things necessary to ensure that the facilities' services are provided in a fair and effective way.

### **Assessment period – 1 July 2006 to 30 March 2008**

- 22 ASIC must undertake an assessment of ASX group at least once in each year commencing 11 March. This is the date that the Financial Services Reform Act 2001 commenced. The assessment period for this report is 1 July 2006 to 30 March 2008. This assessment period includes the financial year of ASX group licensees. In practice, we review information covering the financial year and through to the time of our onsite review, which is typically conducted on or about November of each calendar year. The annual regulatory reports that ASX group licensees must provide under s792F and 821E are due 3 months after the end of each financial year, and are generally received by ASIC at the end of September. There are overlaps in periods between assessments from year to year, and this is managed between ASIC and ASX. This report covers each licensee in the ASX group. ASIC's last report on ASX, ACH and ASTC was published on 10

May 2007. ASIC's last report on SFE, SFECC and Austraclear was published on 20 November 2007.

- 23 We have also reviewed ASX group's performance in the period after our November onsite through to the end of March 2008, which saw heightened market volatility. Several events that are discussed in more detail later in this report occurred during this period.

## Background

### The ASX group

- 24 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 hold a licence to operate clearing and settlement facilities. Copies of all licences are available on ASIC website at [www.asic.gov.au](http://www.asic.gov.au).
- 25 The merger between ASX and SFE Corporation Limited was completed on 25 July 2006. ASXMS commenced operation as the supervisory arm of the ASX group on 1 July 2006. ASX Supervisory Review Pty Limited ceased to operate in October 2006. ASX Supervisory Review was a subsidiary of ASX, but with independent directors, that had oversight of ASX's conflict handling arrangements as they stood at the time, and reported to the ASX board about the operation and effectiveness of the arrangements. These transactions were dealt with in detail in our previous report on ASX group dated May 2007.
- 26 With effect from 5 December 2006, ASX varied its licence to permit the licensee's name to be changed from Australian Stock Exchange Limited to ASX Limited. The ASX group then began to operate under the brand 'Australian Securities Exchange'.
- 27 This assessment covers the first full year of operation of ASXMS, and is our first review of the operation of ASX's conflict handling arrangements in the absence of the oversight structure formerly provided by ASX Supervisory Review. This report describes improvements that should be made to ASX group's conflict handling arrangements, but ASIC has not identified any issue that causes us to conclude that conflicts have not been adequately dealt with during the period under review.
- 28 Under a Supervisory Services Agreement between the 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.

ASXMS has been delegated powers by the licensee's to perform its supervisory functions via delegation instruments.

- 29 ASXMS comprises the following business units:
- Participants – encompassing Compliance Services, Surveillance and Investigations;
  - Issuers;
  - Enforcement;
  - Futures Supervision;
  - Prudential Risk Management; and
  - Tribunals.
- 30 Not all supervisory activity is undertaken by ASXMS. Parts of ASX Operations division, including Companies Announcements Office (CAO) and Market Support, have supervisory functions. CAO disseminates company announcements and has a role in determining whether announcements are price sensitive. Market Support exercises functions in relation to the trading platforms and clearing and settlement facilities, which by their nature are supervisory because they involve compliance with the operating rules. The ASXMS board become apprised of supervisory activity within non ASXMS business units through monitoring activity conducted by ASX Licence Compliance, which is an internal assurance function focusing on ASX group licence obligations, and also through quarterly reports from ASX Operations division to ASXMS.
- 31 ASX group gave its annual regulatory report to ASIC and the Minister under s792F and 821E of the Act as one licensee group. Our annual assessments of the six ASX group licensees have been carried out in one integrated review.

## Equity market performance

- 32 The period covered by this assessment has seen a significant turnaround in market performance and sentiment.
- At the start of July 2006, the All Ordinaries Index (AOI) stood at 5,000 and continued its bull run of the previous years for the remainder of 2006, finishing at 5,644. The AOI closed above 6,000 for the first time in February 2007 and climbed to a then high of 6,455 on 24 July, before subsiding below 6,000 during August as a result of initial fears stemming from the US subprime crisis. These fears were short-lived, however, as

the market continued its climb to eventually reach its highest level ever on 1 November 2007, closing at 6,853 and then finishing the year at 6,421.

- In January 2008, the market continued falling as concerns about the US subprime crisis intensified and global equity market confidence weakened. By mid January, the AOI fell below 6,000 for the first time since August 2007. On 22 January, \$110 billion was wiped off the ASX as the market fell by 408.9 points (7.26%) – its biggest 1-day decline since the crash of October 1987. The AOI eventually finished the month at 5,697, 1,156.6, or 16.88%, below the peak reached in November 2007. On 31 March, the AOI finished at 5,409.7. The market has declined since that time.

## Our methodology

### Our assessment process

33 A market licensee's and a clearing and settlement 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.

34 We use the assessment process to:

- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market and a clearing and settlement facility licensee has in place for supervising its clearing and settlement facility 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

35 In conducting our assessment we considered:

- the annual regulatory report given to ASIC covering all ASX group licensees dated September 2007 as required under s792F and 821E of the Act;
- information we received from and about ASX group licensees in the ordinary course of our dealings with them as market or clearing and settlement facility licensees, including:
  - information received as part of the operating rule amendment process pursuant to s793D and 822D of the Act;
  - interaction with the licensees on a range of operational issues;

- referrals of serious contraventions;
- the register of rule waivers; and
- ASX group's most recent annual report;
- information from external sources, including media commentary and reports published by ASX group;
- the operation of the market throughout the period, in particular in relation to issues of disclosure and trading;
- internal licensee material, including disciplinary and investigation files, internal reports and information collected by ASX group on a continuous basis;
- discussions with senior ASX group management, including discussions in June 2008 regarding our recommendations for improvements;
- interviews and discussions with a range of ASX group personnel;
- Reserve Bank of Australia reports on its assessment of ASX group clearing and settlement facility (C&S facility) licensees under s823CA(1) of the Act.
- changes to its compliance capabilities and processes described by ASMXS at the 11<sup>th</sup> Annual SDIA Conference on 22 May 2008 in a joint presentation by the Chief Supervision Officer (CSO) and General Manager, Participants. These changes include:
  - an online participant compliance system called ASX Compliance Master;
  - a SMARTS upgrade;
  - new technology to support the identification of insider trading activity;
  - a renewed focus on settlement failures and participant governance and control issues in relation to their adequacy to prevent market manipulation from occurring; and
  - changes in the way that investigations are conducted, resulting in a significant reduction in the time taken to complete an investigation as well as a significant increase in the number of investigations completed.

36 We served notices on ASX group under s30 of the ASIC Act for material covering the period from 1 July 2006 to the time of the onsite review in November 2007 (the assessment period). For the purposes of the onsite review, ASIC staff attended ASX's Sydney offices between 30 October and 16 November 2007. During this time ASIC reviewed ASX group records and held interviews with ASXMS business unit and executive management, the independent board directors of ASXMS and ASX Operations management.

- 37 Prior to the onsite review we wrote to the CSO on 10 October 2007 with detailed questions covering human, financial and technological resources and conflict handling arrangements. A response was received on 24 October 2007.
- 38 Following the onsite review, ASIC received ASX correspondence dated 10 December 2007 in relation ASX group's conflict handling arrangements. After the onsite review various correspondence and discussions also occurred between ASX group and ASIC in relation to the upgrade of SYCOM.
- 39 ASIC sent ASX group a copy of ASIC's draft findings and recommendations on 26 May 2008. Meetings between ASIC and ASX group were held to discuss these findings and recommendations in June 2008. ASX was provided with a final draft of this report on 23 July 2008.

### **Consultation**

- 40 ASX group 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 ASX group's responses, and specifically its agreement to certain actions.

### **What we focused on for this assessment**

- 41 This assessment comprises two distinct parts. Part 1 of Section B of this report reflects the issues as they stood from our November 2007 assessment process. Significant market events occurred after November and the downturn in the market in January 2008. In particular, delays to the batch settlement process associated with Tricom highlighted particular problems associated with margin lending and related securities lending and borrowing practices (possibly connected with short selling) which gave rise to a delay in the settlement process. The actions ASIC has recommended to date that ASX should take in response to those events are dealt with in part 2 of Section B of this report.
- 42 The key focus of part 1 of the assessment was to review the obligations of ASX group licensees to have sufficient human, financial and technological resources, and to have adequate conflict handling arrangements.
- 43 In relation to resources, we sought to reconcile the human and financial resources applied to supervision compared with the previous period, identify any staffing shortages, and considered the effectiveness of ASXMS board oversight of resource adequacy. For technological resources we focussed on aspects of the capacity and reliability of the main market and clearing and settlement platforms, and in particular the extent to which these issues are being managed.

44 In relation to ASX group's conflict handling arrangements we reviewed the integrity, and independence of, ASXMS from ASX and the role of ASX Licence Compliance. In particular we considered:

- the operations of a Policy Committee which was set up post SFE merger, comprising ASX group executives, ASX general counsel, and the CSO, and whether its functions and activities were consistent with the principle of insulating supervisory decision making from inappropriate commercial influence;
- the effectiveness of ASXMS board oversight of the adequacy of conflict handling arrangements; and
- the work of ASX Licence Compliance in monitoring the adequacy of conflict handling arrangements.

45 We also reviewed other specific matters including:

- the application of SFE's ERP (Error Resolution Policy) following its invocation on 25 July 2007;
- administration of the inspection processes in particular cases of SFE participant misconduct; and
- performance of the clearing and settlement functions in general.

## B Our observations and recommendations

### Key points

ASIC consider ASX's and SFE's arrangements for supervising their respective markets are adequate, comprising 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 operating rules.

ASIC considers that ACH's, ASTC's, SFECC's and Austraclear's arrangements for supervising their respective facilities are adequate, including arrangements for:

- handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the facilities services are provided in a fair and effective way; and
- enforcing compliance with the operating rules.

We have made a number of observations and recommendations (that ASX has agreed to) based on our assessment. These are detailed in this section.

While we consider that ASX's arrangements are adequate, developments in the ASX group of companies' structure in the period under review and recent events that have occurred in the market reinforce the need for ASX to take further steps to ensure that the arrangements remain adequate into the future. In particular this report identifies areas where we have recommended, and ASX has agreed to make refinements and improvements to its supervisory and conflict handling arrangements.

ASX has not in all instances agreed with ASIC's conclusions on the need for improvements but it has nevertheless agreed to make the changes as Agreed Actions.

### Part 1 – November assessment issues

#### Conflict handling arrangements

- 46 ASX group licensees must have adequate arrangements for handling conflicts between their commercial interests and as applicable – their obligations to ensure that the market operates in a fair, orderly and transparent manner; or their obligation to ensure that the clearing and settlement facilities services are provided in a fair and effective manner.
- 47 The main sources of conflict which could arise for ASX are that:



- (a) ASX group may reduce supervisory and compliance obligations on participants and listed entities where:
  - (i) it could result in an increase in business, via trading volumes or listings; or
  - (ii) ASX group is in a commercial relationship with a participant and/or a listed entity; or
  - (iii) a participant is a related entity of ASX group;
- (b) ASX group may increase supervisory or compliance obligations where it is in competition with a participant and/or a listed entity;
- (c) ASX group may not allocate enough resources to supervision in pursuit of commercial objectives, including profits; or
- (d) the overall rule or policy framework may be changed at the expense of ASX group's supervisory capacity or the appropriate regulation of the market.

48 ASX group's conflict handling arrangements comprise organisational separation of supervisory activity, intercompany agreements, internal policies, protocols and internal assurance activities. The key arrangement in this respect is the location of core supervisory activity, in the specific purpose subsidiary ASXMS. ASXMS staff report to the CSO and the CSO reports to the board of ASXMS and not the CEO of ASX group or the ASX Limited board. Protocols exist regarding the interaction between ASXMS and other parts of ASX group. Licence Compliance monitors this interaction.

49 Licence Compliance also directly oversees ASXMS' decisions involving certain listed entities or participants (including ASX group subsidiaries) that ASX group may otherwise have a conflict in supervising.

50 The ASXMS board assumes responsibility for the adequacy of the arrangements for each of the licensees and oversees, reviews and monitors the activities carried out by Licence Compliance.

51 The allocation of responsibilities pursuant to these arrangements is principally set out in instruments of delegation between each licensee and ASXMS, the ASXMS Supervisory Services Agreement, the ASXMS Constitution, the ASXMS Board Charter and the ASX/ASXMS Board Protocol. There is also a Commercial & Supervisory Conflict of Interest Policy for all ASX group Employees, which is supported by a Conflict of Interest Protocol for ASX Staff.

52 ASIC reviewed the ongoing efficacy of conflict handling arrangements – in particular, the engagement of and performance of the ASXMS board in overseeing the adequacy of conflict handling arrangements, and ASX Licence Compliance's performance in supporting the ASXMS board's oversight.

### Improvements in arrangements

53 ASIC has not in the course of its review identified any event during the review period where we believe a conflict of interest has not been adequately dealt with. However ASIC believes that there is a need for greater clarity in some of ASX's conflict handling arrangements. Elimination of some ambiguities further reduces the risk that decisions might be made which rank commercial interests ahead of the requirement to ensure the market is fair, orderly and transparent or that clearing and settlement services are provided in a fair and effective way.

#### *Roles of ASXMS board and Licence Compliance*

54 While the licensees are accountable for the obligation to have adequate arrangements to manage conflicts of interest, responsibility for monitoring of the arrangements is delegated. As stated above, responsibility for the provision of services to ensure that licensees have adequate arrangements in place has been delegated to Licence Compliance and to ASXMS and the ASXMS board assumes responsibility for the adequacy of the arrangements for each of the licensees. In ASIC's opinion these arrangements, as expressed in certain agreements, policies and procedures are not sufficiently clear and the clarity of these documents could be improved as to how they describe the roles of the ASXMS board and Licence Compliance.

55 ASIC believes that the documents can be clearer, so that they are not capable of misinterpretation, either internally or externally.

56 We also consider that the ASXMS board, as the body responsible for determining whether conflict handling arrangements are adequate, should also be required to sanction any proposed change in formal conflict handling arrangements and that this requirement should be reflected in all of the appropriate documents setting out and underlying all of the arrangements.

57 While ASX did not agree with our conclusions in paras 54–56, it has agreed to the following:

#### **Agreed Action 1**

Changes will be made to supporting legal instruments (including delegation documents and intercompany agreements), policies (including board charters and protocols) and procedures as might be necessary to clarify the respective roles and responsibilities of Licence Compliance and the ASXMS board within ASX group's conflict handling arrangements. Changes are specifically required to the ASX/ASXMS Board Protocol and the Supervisory Conflict of Interest Policy. Changes will need to address monitoring of the arrangements and ongoing assessment of adequacy of the arrangements.

The ASXMS board will be required to sanction any proposed changes in formal conflict handling arrangements and this responsibility should also be appropriately documented.

ASX group has agreed to give ASIC a plan of how it will implement this action by 31 October 2008.

#### *Role of Policy Committee*

- 58 The Policy Committee was established as an executive decision-making body within ASX group and deals with a broad range of issues, including determining or clarifying the policy underlying the ASX operating rules. Under its charter the Policy Committee has the power to develop new policy to be applied in making supervisory decisions and in this respect decisions of the Policy Committee may intersect with pending supervisory decisions. For instance, the Policy Committee may make a decision concerning the policy of a particular rule against which a live waiver application will then be considered within ASXMS.
- 59 The Policy Committee comprises the CSO, ASX group executives and general counsel, and within its charter is permitted to take into account the interests of ASX as a whole, including ensuring that any proposed policy change is consistent with ASX's legal obligations and reputation (including performance of its supervisory obligations). Decisions of the committee must be unanimous, giving any committee member, including the CSO, an effective veto. Licence Compliance also attends committee meetings to observe that the committee's deliberations are in keeping with ASX conflicts of interest policies.
- 60 The Policy Committee developed from the separation in 2005 of regulatory policy decision making from supervisory decision making, after the establishment of the Regulatory Policy Unit that reports to the ASX Chief Executive Officer (CEO). Following the SFE merger in July 2006, the Policy Committee was established to act as a decision-making body, and Regulatory Policy Unit was renamed the Regulatory and Public Policy Unit.
- 61 Before the establishment of the Policy Committee, decisions on policy were taken by the CEO in consultation with the General Manager Regulatory Policy Unit and the Group Executive Market Supervision (now the CSO).
- 62 Although we believe the Policy Committee is an appropriate structure for policy based decision making and the separation of policy-making from supervisory decision-making, ASIC considers that there is room for improvement in the arrangements. Our concern is that although there are some safeguards already in place to avoid the potential for commercial interests to hold sway over supervisory interests, there may still be a risk of this in the present arrangements and additional controls would provide further assurance.

- 63 In particular the Policy Committee's operation should be more transparent and capable of further oversight by the ASXMS board. The chair of the committee should change from a representative of ASX business development as it is at present.
- 64 There needs to be a clearer delineation between matters that may be properly determined by the Policy Committee, and matters that must be determined by dedicated, unconflicted supervisory staff. To address this, the terms 'Supervisory Decision' and 'Supervisory Policy' need to be clearly defined so that the ambit for decision making between the Policy Committee and ASXMS (and parts of ASX Operations which also make supervisory decisions, for instance in relation to clearing and settlement matters) is distinct.
- 65 The current formulation for avoiding or managing conflicts also places reliance on individuals (the ASXMS CSO in particular via his power of veto) to ensure the Policy Committee, when it decides to change policy, does not unduly influence pending supervisory decisions. We think that an appropriate control on this veto power, would be for the CSO to regularly account his use of it to the ASXMS board.
- 66 ASX has agreed to put additional safeguards in place as follows:

#### Agreed Action 2

ASX group has agreed to make the following improvements to its current arrangements for the Policy Committee.

- ASX is to revise the definition of 'Supervisory Decision' and clarify the meaning of 'Supervisory Policy' so that decisions within the appropriate remit of the Policy Committee are clear. Specifically supervisory decisions (which address the circumstances of a particular listed entity, product issues or participant) should always be made by dedicated supervisory staff.
- The Policy Committee Charter is to be changed so that it is explicit that the Policy Committee is not able to make or seek to influence 'Supervisory Decisions'.
- The CSO will give regular written reports to the ASXMS board on matters discussed at the Policy Committee, attaching meeting agendas and minutes. The ASXMS board will have access to Policy Committee papers on request for their review.
- Papers to the Policy Committee should identify whether any Policy Committee decision on a matter for decision in the paper may effect a 'Supervisory Decision'. Where no such comment is made, the CSO must give his comment to this effect on the paper at the Committee Meeting, which comment will be minuted.
- The CSO is to give a briefing to the ASXMS board about each meeting of the Policy Committee and attest in respect of pending supervisory decisions whether or not he has exercised his power of veto on any

Policy committee decision and the reasons for exercising or not exercising such veto.

- While the constitution of the Policy Committee includes a chair, the chair will not be a business development executive.
- A quorum is to be defined (in the Policy Committee Charter) as including the CSO or the CSO's delegate.
- Amendments to supporting legal instruments (including intercompany agreements), policies (including board charters and protocols) and procedures as might be necessary should be made to reflect these changes.

ASX group has agreed to give ASIC a plan by 31 October 2008 about how it will implement these changes.

## Human, financial and technological resources

- 67 Licensees must have sufficient human, financial and technological resources to supervise the market or clearing and settlement facility, and to ensure that the market or clearing and settlement facility operates in the way required by the Act.

### Human resources

#### *ASXMS staffing*

- 68 Under the Supervisory Services Agreement, ASX group must provide sufficient funding and resources (staff, equipment and software) to ASXMS to enable it to meet its obligations.
- 69 Pursuant to the Supervisory Services Agreement, and reiterated by the ASXMS Board Charter and the ASX/ASXMS Board Protocol, the ASXMS board is directly charged with biannually reporting to the licensee boards on whether funding and resources for supervision are adequate.
- 70 We reviewed whether ASXMS was adequately resourced by following up the recommendation in our last assessment report that the ASXMS board should closely monitor the continuing efficacy of the strategies it had in place to ensure there are sufficient human resources. The assessment focused on whether ASX group's new arrangements were effective, whether the performance of the ASXMS board in its oversight of resource adequacy was effective, and whether any staffing shortages were apparent.
- 71 A management reporting tool for measuring the adequacy of staffing called the 'resource metrics tool' has been implemented. The resource metrics tool comprises a range of pre-agreed workload drivers impacting core supervisory functions and are specific to each ASXMS unit. Each unit also has pre-agreed indicators of possible resource shortages. ASXMS business unit general managers are required to track these drivers at an individual

staff level and report exceptions to the CSO monthly. Commentary is also provided to explain the rationale for exceptions, as well as measures and plans in place to better manage workloads. A summary of this information is also included in a monthly report to the ASXMS board. This measurement and reporting regime has meant greatly improved transparency about ASXMS staffing.

- 72 There has been an increase in staff. From July 2006 to November 2007, which includes the point of merger with SFE supervisory staff, there was an increase of 28 full time equivalent positions (FTEs). After adjusting for the inclusion of SFE staff there was a real increase of about 15 FTEs. Staff turnover rates have also improved by comparison to the last assessment.
- 73 All levels of ASXMS management are monitoring resourcing on a continual basis. The ASXMS board is also active in its monitoring role.
- 74 At the time of our assessment visit we were concerned that there might be potential staffing shortages in the Surveillance and Enforcement units. In relation to Surveillance, planned changes to SMARTS parameters were likely to increase workload, and the unit's headcount was unchanged over the period in spite of a significant change in market activity. After our assessment visit, in May 2008, an additional unbudgeted resource (1 FTE) was added to the Surveillance Unit. Staffing in the Enforcement Unit also remained unchanged during the period, despite a potential increase in workload, arising in part from the merger of the SFE and ASX disciplinary arrangements. On 3 June 2008 ASIC was advised that the ASXMS Board approved an increase in budgeted staff resources by 8 FTEs in the 2008–09 financial year, which included the one FTE added in May 2008 for Surveillance and an additional FTE for Enforcement.
- 75 We also reiterate our comments made in previous reports that the adequacy of supervisory resources, and in particular staffing should be evaluated by ASX group from a longer-term perspective with provision existing for about turns in the market. ASXMS has implemented a series of additional resource metrics which recognise the condition of a bear market. The adequacy of resources should also be determined with reference to maintaining the capacity to undertake special projects as the needs arise, without detriment to business as usual demands. An example of such a project is the recent joint ASIC/ASX review of possible predatory trading by hedge funds.

### Agreed Action 3

ASIC identified potential staff shortages in the Enforcement and Surveillance Units at the time of our assessment visit. Additional resources have been added to ASXMS in May 2008 and for the 2008–09 financial year (8 FTEs in total) including staff for the Enforcement unit.

ASIC had also identified at the time of our assessment (and previously) a need for the ASXMS board to ensure that its oversight of staffing more broadly factors in changing market conditions and the requisite variation in demand for supervisory services. The resource metrics system has subsequently been updated to include metrics that recognise the condition of a bear market.

ASIC acknowledges that the resource metrics system is a good monitoring tool, but that it is not an absolute measure of adequacy and that the ASXMS board should still exercise its continuing judgement to take into account a range of factors. Importantly and furthermore the scope of the board's assessment will factor in the need for ASXMS to retain staff capacity to undertake special projects from time to time.

ASXMS has agreed to continue to monitor resourcing on this basis, particularly for special projects.

#### *Reporting of staffing for non-ASXMS supervisory activity*

- 76 While licensee supervisory responsibilities are delegated to ASXMS, certain supervisory services are conducted in business units outside ASXMS, predominately in ASX Operations division, and so beyond ASXMS management control. A recommendation of our previous report concerned the effectiveness of governance arrangements for the oversight of supervisory activity conducted by non-ASMXS business units, and in particular whether those arrangements would work to ensure that those functions were properly resourced.
- 77 In response to this recommendation, ASX group augmented reporting and protocols between ASXMS and Operations division with quarterly reports from the Group Executive, Operations (GE Operations) to the CSO and quarterly reporting from Licence Compliance to the ASXMS board.
- 78 At the time of our assessment visit we determined that the reports to the CSO did not contain enough analysis or evidence to justify the conclusion about the adequacy of resources to support supervisory functions in these units.

#### Agreed Action 4

The quarterly report from the GE Operations to the CSO will provide a proper basis for the assessment of the sufficiency of resources in business units performing supervisory function in Operations division. The report will be revised so that the resources applied to supervisory functions in these areas are identified and confirmation is then given as to their availability during the reporting period. The report will also confirm whether any operational incident with a supervisory consequence was a result of a lack of resources.

The reports to be issued for the quarter ended 30 September 2008 and following will include these additions.

#### Financial resources

##### *Assurance about total cost of market supervision*

- 79 Accompanying the increase in supervision staffing, there was an increase in funding to ASXMS during the assessment period. The total supervisory spend (not including SFE supervision) in 2006/07 was 19% higher than the total supervisory spend (including SFE supervision) in 2005/06. In 2007/08 ASXMS is expecting its direct costs of supervision to increase by a further 9%.
- 80 ASX group reports the total cost of market supervision by way of its annual regulatory report each year to ASIC and the Government. This total cost comprises direct costs associated with ASXMS and indirect costs arising from a proportion of the direct costs of non ASXMS business units conducting supervisory activity or providing services which support ASXMS activities. The activities or operations which are costed are those which directly generate or contribute to the operation of a fair, orderly and transparent market and a fair and effective clearing and settlement facility.
- 81 ASIC has asked ASX to provide further assurance as to the figure it reports annually as the total cost of market supervision, particularly having regard to the indirect costs component. This assurance is needed in the context of ASIC's requirement to report to the Minister on ASX's compliance with its statutory obligations, and does not arise from any concern on the part of ASIC with the reliability of the figures ASX has reported. ASX has agreed to provide ASIC with a certification from the Chief Financial Officer (CFO) and the CSO that all funds expended as reported were applied to meet costs associated with ASXMS' supervisory activity or providing services to support that activity. This certification will be made in the annual ASX group regulatory report.



### Agreed Action 5

ASX has agreed to provide an annual certification by the CFO and CSO that all funds expended as reported were applied to meet costs associated with ASXMS' supervisory activity or providing services to support that activity, and an ASXMS board resolution to that effect.

The certification is to be set out in the ASX group annual regulatory report.

The first certification is to be provided for the year to 30 June 2008.

#### *Greater certainty for ASXMS funding levels*

82 In relation to ASXMS funding arrangements more generally, under the Supervisory Services Agreement ASXMS must submit a proposed budget and business plan to ASX group before the end of each financial year, incorporating performance measures and proposals for efficiency and productivity gains over the period. At the same time an indicative budget must be provided for the following two financial years. In ASIC's view this process alone results in no assurance for ASXMS as to the availability of funding to enable planning for expenditure on technological and general business improvement. Alternative models would provide for a longer term agreed budget process, or setting of a budget by reference to market activity.

83 ASX group does not agree that this budgeting and business planning processes is inadequate in this regard. ASX has agreed to provide an annual certification by the CSO (and ASXMS board resolution) that:

- the budget for the forthcoming year and indicative budget for following 2 years is 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 Limited board.

### Agreed Action 6

ASX has agreed to provide an annual certification by the CSO that:

- the budget for the forthcoming year and indicative budget for following 2 years is 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 Limited board

and an ASXMS Board resolution to that effect.

Judgement of sufficiency will include reference to applicable benchmarks adopted by ASX pursuant to Agreed Action 8 below.

The certification is to be set out in the ASX group annual regulatory report.

The reporting is to commence for the 2009–10 financial year.

## Technological resources

### *SYCOM upgrade*

- 84 We reviewed the ongoing adequacy of key technology platforms - ITS, SYCOM, CAP, DCS and CHESS – that are integral to the operation of the markets and C&S facilities.
- 85 At the time of the assessment visit ASIC had some concerns regarding the adequacy of the SFE futures trading platform SYCOM. At the time of the ASX / SFE merger, ASX group thought that it would be desirable to merge the two trading platforms. However after a detailed review of SYCOM ASX group decided to retain it as it considered SYCOM to be a good system with excellent vendor support. There was also no demand from participants for a merged trading platform.
- 86 For the 2006–07 financial period SYCOM uptime (i.e. availability of the platform for trading) was 99.987%. In comparison with the previous financial period, this represented a significant improvement:
- in unavailability (157mins in 2006/07 compared with 883mins in 2005/06); and
  - in the number of incidents (4 in 2006–07 and 12 in 2005–06).
- 87 However some events occurred during the assessment period that questioned the robustness of the system. In particular, an incident on 16 August 2007 clearly revealed single points of failure in the network as well as the risks and complexities involved in recovering a 24-hour trading system, which, in addition, has to maintain two trading days in an open state at the same time.
- 88 Also in January 2007, in the context of ASX group evaluating the ability of SYCOM to support its launch of contracts for difference, SYCOM's vendor, TMI, made a number of observations to ASX group in relation to the capacity of SYCOM at that time, when compared to the vendor's original development guidelines for the system. Subsequently, after further consultation with TMI, ASX group is addressing these issues by enhancing SYCOM's robustness and capability (including increasing capacity) over the next few years. ASX group is also taking active steps to manage system capacity constraints, through the establishment of a Capacity Management Steering Committee, comprising senior executives from across the ASX group. Additionally, the Audit and Risk Committee, whose function is, among others, to assist the ASX board in monitoring ASX group management's framework to identify and manage enterprise risk, and internal control for the ASX group, receives periodic updates on the risk status of key systems.
- 89 In respect of the technological enhancements to SYCOM, an initial upgrade of the platform's hardware and network is intended to improve its resilience

and will result in a 200% increase in transaction processing capacity. This upgrade is scheduled for October 2008 (originally scheduled in November 2007 for live implementation in March 2008). This delay in implementation is due to software release quality issues which ASX advises have been fixed by the vendor. A major release of SYCOM, designed to position the platform for the future by making strategic enhancements easier to develop, was planned to go live in the fourth quarter of 2008. This major release involves more than 70 changes to the system. It is now targeted for implementation in the fourth quarter 2009 a 12 month delay.

- 90 The SYCOM project has an estimated cost of \$10m over two years and has ASX board oversight. It involves a complete restructuring of the system that, according to TMI, will enable the platform to absorb the impact of future ASX group requirements.
- 91 In March 2008, ASX group gave ASIC staff an update of the technical plans of the SYCOM release, technical milestones reached since the assessment, project governance (including ASX board oversight, operation of project steering committee) and the resources allocated to the project.
- 92 In June 2008 and in response to a draft of this report, ASX contend that SYCOM performance has improved significantly since the ASX/SFE merger with 100% uptime in the calendar year to date. Delays in implementation of planned releases have been the result of a strict quality assurance approach by the ASX technology team and a need to fix software quality issues in the development stage.
- 93 ASIC has a level of comfort that ASX group appears to be making good progress, the project is apparently adequately resourced and has appropriate governance. However we also think that an independent external review of the ASX group's processes surrounding the upgrade of SYCOM is appropriate. ASX has agreed to ASIC's proposal.

#### Agreed Action 7

ASX group have agreed that an independent external expert will review ASX group's processes surrounding the upgrade of SYCOM. The matters that will be reviewed are the planning processes and governance arrangements for the upgrade project.

ASX has agreed to provide the report to ASIC by 31 December 2008.

#### *Ongoing assurance of adequacy of technological resources*

- 94 As an adjunct to the previous issue, ASX has agreed to discuss with ASIC in more detail how it plans for its technology needs and whether these arrangements are effective in ensuring that ASX's systems, particularly its supervisory systems, retain their currency in terms of best proven technology and developments amongst peer overseas markets.

- 95 ASIC already has some understanding of the processes ASX group has in place for assessing its ongoing technology needs. ASIC is also cognisant of upgrades to existing supervisory systems such as SMARTS and the planned implementation of new systems within ASXMS.
- 96 In particular ASIC's interest is to ensure that in practice ASX adopts reliable appropriate technology, notwithstanding this may represent a significant cost to ASX group.

*Benchmark measures for resourcing and performance of supervision*

- 97 The CSO has been working with a number of World Federation of Exchanges members on a preliminary basis to establish industry-based benchmarks with which to measure market operation, both in terms of inputs and outputs. This is an ASX group initiative. ASXMS already has in place its own system of resource metrics, referred to earlier in this report, which it uses to measure the adequacy of staffing.
- 98 A set of agreed input based standards such as resourcing measures and output based performance standards would assist ASX group and ASIC in future assessment processes. Development of benchmarks will add objectivity to the assessment process; transparency to the marketplace about what is important and add another indicator to the review of ASX group's capacities.
- 99 ASIC has developed a preliminary set of measures that could form the basis for agreed benchmarks. These measures include input based benchmarks for the resourcing of supervisory services and more qualitative output based benchmarks which attempt to benchmark outcomes for supervision and which could be used as a measure of performance. ASX and ASIC have agreed to work together to further develop and implement these benchmarks.

**Agreed Action 8**

ASX and ASIC will cooperate on the development and implementation of an agreed set of input and output based benchmarks for market supervision. These benchmarks will be in place for the 2009–10 assessment period.

**SFE Error Resolution Policy**

- 100 At 11.30am on 25 July 2007 the June Quarter CPI figure was published. SFE Business Operations (SBO) identified and investigated extreme and contradictory price action in its 3-year bond futures and bank bill futures. SBO invoked SFE's Error Resolution Policy (ERP), resulting in 337 trades totalling 26,673 lots being cancelled, as the trades in question breached the ERP's market integrity range.
- 101 The incident attracted a significant amount of attention from stakeholders.

- Participant concern focused on the circumstances that gave rise to SFE's exercise of the ERP, the determination of the Fair Price Valuation (FPV) (which is used to determine whether a trade is within the market integrity range or not), and the cancellation of trades comprising one leg only of a spread order. Legal action against SFE has been initiated by three SFE participants in respect of losses they claim to have sustained.
- 102 An incident management team chaired by the GE Operations met daily to manage ASX group's response. ASXMS and License Compliance also investigated the incident. SFE held meetings with the Australian Financial Markets Association (AFMA), ASIC, institutional investors and SFE participants.
- 103 An ASX/AFMA/ASIC group was established (the AFMA working group) to consider the views of all market stakeholders in relation to any enhancements that could be made to the ERP. The working group made a number of suggestions to this effect to ASX group.
- 104 ASX group's Fair, Orderly & Transparent Committee (a committee of senior managers, with a mandate to review and develop appropriate responses to significant market or clearing events) considered the matter, including the internal reports, results of stakeholder meetings and the application of the operating rules.
- 105 The committee concluded that the ERP had been invoked and applied in accordance with the operating rules. ASX group published details of this conclusion on 14 September 2007. The committee also noted that there were potential lessons and areas for further review and potential enhancement of the ERP procedures and operational execution.
- 106 ASIC reviewed material in relation to the incident and found that there was insufficient documentation recording the calculation of the FPV. The AFMA working group determined, amongst other things that the understanding of the ERP by the participants and their clients was generally not comprehensive, and ASIC also agrees with this conclusion. Based on its own further review ASIC also saw evidence to suggest that participants thought that ASX group's communication during the incident was suboptimal. ASX group argues that there was in fact timely communication, and that ASIC should take into account the logistical challenges this incident presented.

#### Agreed Action 9

ASX group has revised SFE's ERP procedures for the calculation of the FPV so that on invocation of the ERP the calculation of the FPV is documented, including all workings performed to arrive at the FPV, the facts relied upon and any assumptions made and relied upon.

ASX group has agreed to ensure that it has a program to comprehensively explain SFE's ERP process to participants. ASX recognises the benefits of

further participant education, and agrees to continue to address ERP awareness on an ongoing basis through its individual participant compliance programs.

ASX group agrees to identify, develop and implement tools, templates and processes to assist in the operational management of an incident of this nature to ensure that communication with participants is conducted in a timely and efficient manner. ASIC notes ASX has already developed a process to refine communication with the market by way of notice when a market wide event occurs.

ASX group agrees to give ASIC a plan of how it will implement this action by 31 October 2008.

## Part 2 – Issues arising subsequent to the November assessment

### Market issue related to Tricom settlement delays

- 107 Settlement of the CHESSE batch normally occurs daily by 12:30pm, however on 29 January 2008 ASX group decided to delay settlement, which then did not occur until 4.42pm. The delay was due to problems with Tricom's scheduled settlements.
- 108 On the following day, 30 January, ASX group had to delay settlement again due to Tricom's participation in the batch settlement process and settlement occurred around 3.00pm.

### ASTC settlement processes

- 109 Based on our review of the Tricom related settlement delays on 29 and 30 January we are satisfied that ASX group's actions were reasonable and that its supervision of Tricom at the time the delays were occurring and afterwards has been appropriate and effective. However the incidents themselves and the resulting confusion in the market place suggested improvements in settlement processes should be considered. As indicated below, improvements have been implemented and ASX has agreed to review the way that such incidents are handled in terms of communication.
- 110 ASIC initially wrote to ASX Operations division in March 2008 about issues in relation to the settlement process and how it might be improved to avoid the disruption to the market including upon the confidence of market users caused by the position of one participant in the settlement batch.
- 111 On 26 May, the RBA issued a report called *Review of Settlement Practices in Australian Equities*, which concluded that although the current settlement practices had served the market well, some short term improvements were possible that 'might improve the robustness of the settlement process and improve market functioning'. Other more medium term changes were also

canvassed and are the subject of discussion with ASX group and RBA.

- 112 To date ASX has announced the following changes aimed at deterring delayed settlement:
- an increase to settlement fail fees levied on ASTC settlement participants for settlement shortfalls (from September 1, 2008);
  - introduction (from January 2009) of an automatic close out requirement after T + 5 wherein ASTC settlement participants will be required to close out a clients settlement shortfall at T + 5 by purchasing or borrowing shares; and
  - changes to the referral process for possible disciplinary action wherein ASX will enforce the new close-out requirement by referring any outstanding settlement positions that has not been resolved by T + 10 to ASXMS for investigation and for disciplinary action, if appropriate.
- 113 Other possible changes are being considered by ASX group in consultation with RBA and also ASIC.
- 114 Specifically ASX is considering a ‘normal’ settlement completion window of 2 hours.

#### Agreed Action 10

ASX group has announced and has or will implement all of the abovementioned proposals to amend ASTC settlement processes, including provision for appropriate amendments to the settlement rules, apart from the proposal in para 114. ASX has advised that its position with this proposal will be finalised by 31 October 2008.

ASX also has agreed to establish a market communication strategy which emphasises timely and appropriate disclosure of the circumstances and course of action following clearing and settlement incidents, by 31 October 2008.

#### Impact of non ASX and ASIC regulated or supervised activity on participants’ market obligations

- 115 ASIC initially wrote to ASXMS in March 2008 in relation to participant supervision and participant activities, which while not directly regulated by the rules, may impact upon participants capacity to comply with market based obligations. For example Tricom’s stock lending activities contributed to its inability to meet settlement obligations on 29 and 30 January 2008 because it was not able to deliver securities scheduled for settlement.
- 116 ASIC and ASX have agreed to work together in relation to the scope of both organisations to monitor or undertake qualitative reviews of the activities of participants not currently supervised or regulated, where that activity may have an impact upon the markets operated by ASX and SFE.
- 117 In May 2008 ASX added some pages to its website that set out ASX’s role in

supervision of the markets. ASX notes that it does establish and monitor market participant capital liquidity requirements. It says its role is directed to the issue of stability of the Australian clearing system and its own financial exposure as central clearing counterparty to market participants in ASX's clearing house. ASX does not oversee all aspects of a participant's business.

- 118 In May 2008 the Chairman of ASIC advised the market that ASIC will add resources in the area of supervision of market participants and market operators. This was a response to the market turbulence and also to ASX's abovementioned statement of its position.

### **Short selling**

- 119 ASIC has previously made recommendations concerning the ASX approved short sale list which designates those ASX securities which may be short sold without cover (under s1020B(e)).
- 120 The market volatility including the effects of alleged short selling activity by hedge funds highlighted a divergence of practice from the letter of chapter 19 of the ASX market rules requiring that participants report net short sale positions, either the result of a covered or naked short sale, by market opening the next trading day. Ambiguity in s1020B of the Act around the disclosure of 'covered' short sales has probably contributed to this.
- 121 ASIC initially wrote to ASX in March 2008 suggesting measures to improve short sale transparency under the market rules. Subsequently the Government has foreshadowed legislative reform to enhance the disclosure of covered short sales. The Reserve Bank of Australia has also encouraged the disclosure of stock lending transactions, which facilitate covered short selling. The possible reform of regulation concerning short selling is with Treasury. ASX has committed to work with the Government when amendments are decided on. ASIC does not require anything further from ASX in this regard.



## 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
Clearing and settlement facility	C&S facility
Corporations Act	The Corporations Act 2001 (Cth)
CSO	Chief Supervision Officer
GE Operations	Group Executive - Operations
SBO	SFE Business Operations
SFE	Sydney Futures Exchange Limited
SFECC	SFE Clearing Corporation Pty Limited
SSA	Supervisory Services Agreement
SYCOM	Sydney Computerised Overnight Market