



ASIC

Australian Securities & Investments Commission

REPORT 86

Market assessment report: IMB Ltd

October 2006



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C and s823C of the Corporations Act) report

**IMB Ltd
ACN 087 651 974**

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Executive summary

Section 794C of the *Corporations Act 2001* (Act) requires ASIC to assess how well a licensed market operator is complying with its obligation to have adequate arrangements for supervising the market(s) it operates. Section 823C requires ASIC to assess how well a clearing and settlement (C&S) facility licensee complies with its obligations to have adequate arrangements to supervise its C&S facility.

IMB Ltd (IMBL) was issued its licences on 8 July 2005. This report summarises ASIC's first assessment of compliance by IMBL with its obligations under s792A(c) and s821A(c) of the Act.

This report describes our assessment, conclusions and key recommendations for areas of improvement.

Generally our assessment report focuses on suggested areas of improvement in IMBL's procedures rather than on the more positive aspects that support our overall conclusion. It is important to make clear that none of the suggestions for improvement in this report detract from our conclusion that IMBL's arrangements have met and continue to meet their statutory obligations.

Compliance by IMBL

We conclude that IMBL has adequate arrangements for supervising its market and clearing and settlement facility, including arrangements for:

- handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner;
- monitoring the conduct of participants in the market; and
- enforcing compliance with its market rules.

Our approach

ASIC uses the formal assessment process to examine whether market and C&S licensees have been and are continuing to meet their supervisory obligations. We also use the process to identify areas where improvements may be needed to enable the licensee to meet its obligations in the future.

For this assessment, we confirmed material provided to us in the licence applications and examined in detail the day-to-day market supervisory functions and clearing and settlement obligations carried out by IMBL, in particular the requirement to create proper instruments of transfer.

Section 1: Background

1.1 IMBL

IMBL has operated a market for its own shares since 1989, when it issued 10 million one-dollar permanent shares. In October 1999, IMBL split each share into two 50-cent shares. IMBL's constitution limits share ownership to a five percent holding.

IMBL is not listed on an "official list" as defined in the Act. The IMBL market only quotes one product, being IMBL ordinary shares, so it has no official list. Similarly, IMBL has not issued a fund-raising document, so it is not a listed disclosing entity as defined in the Act.

Accordingly, IMBL is not subject to statutory obligations to disclose immediately material developments that a reasonable investor would expect should be disclosed. In ASIC's view this is an anomaly in the Act, as investors and shareholders who trade securities on a licensed financial market are entitled to expect that material information about those securities is made available in a timely way.

To address this anomaly, at the time it was licensed, IMBL agreed to the inclusion of a condition on its licence that requires IMBL, first - to provide as soon as practicable to ASIC information about all price sensitive developments that a reasonable investor in IMBL shares would expect to be disclosed, and second - to make that information available to the market. IMBL does this by placing the relevant information on its website.

A number of shareholders on IMBL's register are nominee companies, which trade IMBL shares as the legal owner. Otherwise, all share trading is conducted directly by the beneficial owners of the shares, with no intermediation.

IMBL is an authorised deposit-taking institution (ADI) under the Banking Act 1959 (Cth) and is regulated by APRA. In addition to holding an Australian market licence and C&S facility (CSF) licence, it holds an Australian Financial Services Licence (AFSL) that permits IMBL to carry on a financial services business in deposit and payment products, general insurance products, life risk insurance products and retirement savings account products.

The market licence and CSF licence permit IMBL to operate a market and CSF in the financial products described on its licences. Copies of IMBL's market and CSF licences are available on ASIC's website at www.asic.gov.au/markets.

1.2 The assessment process

ASIC's role

Section 794C of the Act requires ASIC to assess at least once a year how well a market licensee is complying with certain of its obligations as a market licensee. The assessment must consider whether the licensee has adequate arrangements for supervising the market, including arrangements for handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market operates in a fair, orderly and transparent way.

Section 823C of the Act requires ASIC to assess at least once a year how well a CSF licensee is complying with certain of its obligations as a clearing and settlement licensee. The assessment must consider whether the licensee has adequate arrangements for supervising the CSF 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.

A licensee's obligations are ongoing, and whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance. We therefore use the assessment process to:

- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market and the adequacy of the arrangements a CSF licensee has in place for supervising its clearing and settlement facility in accordance with its obligations under the Act at the time of the assessment; and
- identify issues that in our view need, or may need, to be addressed to ensure ongoing compliance.

Assessment process

ASIC's assessment and the views expressed in this report are a combination of processes.

We served a number of notices under the Australian Securities and Investments Commission Act 2001 that required IMBL to give documents to ASIC.

On 5 and 6 June 2006 we visited IMBL's offices in Wollongong, New South Wales. During this on-site phase of the assessment we reviewed IMBL operational records and spoke to a range of IMBL managers.

After our onsite visit was completed we provided a draft of this report to IMBL. Where appropriate, our report reflects IMBL's responses.

1.3 Focus of this assessment report

We sought to confirm that descriptions of arrangements for supervising the market and the CSF as elaborated in IMBL's licence applications were accurate. That is, we looked at whether the arrangements described in IMBL's application had been implemented and whether those arrangements were operating satisfactorily.

Section 2: Observations and recommendations

2.1 IMBL is meeting its obligations

After making our assessment, ASIC concludes that IMBL has adequate arrangements for the supervision of its market and CSF in accordance with its obligations under s792A(c) and s821A(c) of the Act.

2.2 Other observations and recommendations for future action

Conflict management

Paragraph 792A(c)(i) of the Act requires IMBL to "...have adequate arrangements for handling conflicts of interest between its commercial interests... and the need to ensure that the market operates (in a fair, orderly and transparent way)..".

In order to handle conflicts of interest, a market licensee must first identify those that exist in its particular circumstances. IMBL has identified the potential conflicts of interest that may unduly influence its commitment to run a fair, orderly and transparent market. The predominant conflicts of interest flow from operating a market in its own shares and include:

- (a) the conflict between IMBL's interest in reducing costs to its business generally and its duty as a licensee to run a fair, orderly and transparent market and a fair and efficient CSF; and
- (b) the conflict between the duty to monitor against insider trading by its employees, directors and related parties and the temptation for IMBL staff responsible for market supervision to avoid regulatory interventions that may offend senior IMBL managers and directors.

In relation to the first of the above conflicts, technical infrastructure and market staff are drawn from existing ADI resources, so the market has available at short notice considerable additional technical and personnel resources. We conclude that IMBL's resourcing of its market and CSF is more than adequate. This is likely to remain the case because IMBL market and CSF staff also have non-licensee roles with the ADI and the temptation to reduce costs is, accordingly, not strong.

As explained in section 1.1, IMBL is not a listed disclosing entity, and its securities are not traded on a market that has an official list. It is therefore not subject to consequential director trading and continuous disclosure obligations contained in sections 205G and 674 of the Act.

Continuous disclosure obligations were instead imposed on IMBL through licence obligations.

The conflicts that do exist in the IMBL market primarily relate to staff and director ownership of IMBL shares. These interests have the potential to adversely affect the policing of

disclosure obligations imposed by the market licence. Market supervisory staff potentially are in a position where they may prefer their interest in retaining their employment, and employer's favour, to their duty to ensure that IMBL staff and directors do not trade on the basis of insider information. Similarly, these types of staff interests may adversely affect their duty to enforce disclosure rules that may require the IMBL board to provide information to the market that the board would prefer not to disclose. In practice, this means IMBL market staff potentially are exposed to undue influence from executive managers and directors, and may as a consequence not adequately supervise continuous disclosure requirements and/or not act upon indications of insider trading or other forms of market manipulation.

We saw no evidence during our assessment that any party had exerted undue influence or pressure against market supervision staff. Similarly, we saw no evidence that market supervision staff had made inappropriate or conflicted decisions.

Transparency of price formulation

The statutory obligation to run a "fair, orderly and transparent" market is a composite obligation, not three severable requirements. A key part of the overarching obligation is to make available to the market pre- and post-trade price information, as far as is practicable and without compromise due to a conflicting interest to constrain costs.

Currently, share price information (highest and lowest offers, last sale price, volume for each trading day and weighted average price and volume per week) is available to participants over the telephone, from sales centres and via the IMBL website. The share price information on the IMBL website under the heading 'Daily Trading Details' is uploaded continuously. The daily share price information which appears on the website is delayed by 5 minutes, which is flagged to participants on the same page under the heading 'Disclaimer'.

Further, if a participant requests share price information via telephone or at a Sales Centre, the information quoted by IMBL staff is drawn directly from IMBL's share trading system. This information is continuously updated and is always current (i.e. not subject to a 5 minute delay as in the case of the IMBL website). During our on-site visit we were able to confirm that retail shareholders availed themselves readily of the opportunity to telephone market supervisory staff to query price and volume. Given the nature of the market, the consistent lack of price volatility, and stable volume and number of trades per day, the arrangements IMBL has in place in relation to price transparency are adequate.

Supervision

Disclosure obligations

Under clause 9 of its market licence, when IMBL becomes aware of information that is not generally available, and a reasonable person would expect, if the information were generally available, it would have a material effect on the price or value of ordinary shares in IMBL, IMBL must as soon as practicable lodge a document with ASIC containing the information and make the document available on IMBL's website.

The risk associated with inadequate continuous disclosure is that insiders such as IMBL directors and employees with privileged access to price sensitive information will trade IMBL shares on the basis of that undisclosed knowledge.

Procedures

IMBL recognises that even though section 205G of the Act does not apply to its directors, any trading by its directors in IMBL securities is potentially price sensitive information. Accordingly, IMBL procedures require that trading by IMBL directors or employees is routed through IMBL Member Services so that a determination may be made as to whether the trading should be immediately disclosed to the market as an announcement, and/or whether the trade is permissible under IMBL's Share Trading Guidelines which deal with insider trading.

We reviewed IMBL policies and procedures for identifying price sensitive developments and processing of announcements of material developments to its market. We also examined procedures for controlling IMBL staff and director trading, and surveillance directed to identifying possible insider trading.

Before each monthly board meeting IMBL's Executive Group meet and are required to discuss any matters that may be required to be disclosed to the market. Identified matters are then referred to the board. At each board meeting a standing agenda item requires the directors to consider whether there are any matters that need to be disclosed.

IMBL issued 36 press releases in the 12 months following the issue of its licences, but made only seven market announcements, none of which resulted in a substantial share price movement. We examined the 36 non-market releases to assess whether there were any matters that may have potentially constituted a price-sensitive development. We did not identify any instances where IMBL failed to disclose a material or price sensitive matter to the market.

IMBL placed its half-year and annual financial reports on the market announcements webpage.

Price-sensitive developments can occur at any time, and IMBL will not always be able to delay announcements until the convening of monthly board meetings. Presently, any matters that require immediate disclosure which arise prior to scheduled executive management and board meetings must be raised with the IMBL Chief Executive and, if required, a special Executive Meeting will be called to discuss the item. If agreed at this meeting, the matter will be notified to the Chairman of the board for his consideration.

During the 12-month assessment period no unscheduled potentially price-sensitive developments eventuated. So we were not in a position to determine how long this escalation process would take.

Even if the process were to take a few hours, the potential for insider trading or occurrence of a disorderly market is real. Because IMBL does not currently have procedures for suspension of trading pending an announcement, those in possession of price sensitive information potentially have the opportunity to trade on the inside information between the time it becomes known within IMBL and the time it is announced to the market as a whole.

While we saw no evidence that insider trading is occurring on the market prior to announcement of material or price sensitive matters, IMBL should ensure it has arrangements in place to eliminate or minimise the possibility of such activity taking place.

Recommendation 1

IMBL should have procedures to halt trading on its market pending management and/or board consideration of whether an announcement of material or price-sensitive information is required.

In response, IMBL has advised us that it intends to implement new procedures to address this. IMBL will:

- (a) add the requirement to suspend trading and the procedures for doing so to existing continuous disclosure procedures and the work procedures followed by IMBL market operations staff; and
- (b) include in the share trading pages on the IMBL website an explanation that IMBL may be required to suspend trading from time to time in order to give effect to its continuous disclosure obligations.

Monitoring insider share transactions

For much of the review period, IMBL's procedures for monitoring employee share trading required that directors and staff trade only within stipulated calendar windows. Market operations staff must check shareholder names against lists of identified "insiders". These procedures were therefore subject to human error.

On one occasion, IMBL supervision staff detected director trading of a substantial parcel of shares, which had been executed without the director notifying the IMBL Chairman as required under the market's rules and procedures. Market staff escalated the matter to the CEO shortly after the unapproved trade was identified. The CEO in his turn advised the Chairman. The CEO also confirmed with the recalcitrant director that he understood his future obligations. No disciplinary action was taken by the Chairman and the board. Escalation of the matter from staff to the CEO, and the CEO's discussions with the Chairman and the director concerned, demonstrated that no undue influence was exercised on supervisory staff to ignore the breach.

Shortly before our on-site inspection, IMBL initiated an automated alert program to detect IMBL director and staff trading. When an alert occurs, market staff are required to escalate the matter. Only the market manager is then able to approve retention of the order in the market. These automated alerts are an improvement on the manual checking procedure.

Monitoring potential market abuse and documentation of supervisory decisions

Market staff identified some aberrant off-market transfers at a discount to prevailing prices, and, on one occasion, a transfer of shares off-market followed immediately by significant purchases on-market by the same party, which increased the price of the shares. All these trades were referred to supervisors who contacted the parties for explanations.

Decisions to take no further action were documented in emails, which were then placed on individual market participant files. In our view, the decision to take no further action was correct in the circumstances. However, in order to more fully meet its obligation to supervise the market, we recommend that IMBL make some changes to enhance its record keeping systems. This is particularly important, given IMBL's obligation to refer suspected contraventions to ASIC, and to notify ASIC about any disciplinary action IMBL takes against participants in the market. More detailed records will also assist IMBL staff, managers and the board to make informed and appropriate supervisory decisions.

Recommendation 2

IMBL should maintain a central register of all matters raised with supervisors by staff operating the market and C&S facility which may identify a breach of the operating rules or market abuse of any kind. The register should note action taken as a consequence, including references to file records retained on individual participant or policy files, and should record whether the matter either has been referred to ASIC in accordance with s792B(2)(c) of the Act, or has been notified to ASIC following disciplinary action by IMBL under the market's operating rules.

Clearing and settlement

The clearing and settlement facility operated by IMBL is of a limited nature. In order to trade, an investor must also hold a bank account with IMBL. As noted above, many investors using the market are retail investors directly accessing the market rather than via a nominee or intermediary.

The clearing and settlement facility operated by IMBL forms the clearing and settlement arrangements for the market. There is a close relationship between infrastructure (including the operating rules) for the market and for the clearing and settlement facility.

In order to participate in the market a person must be a member by guarantee of IMBL. In order to facilitate clearing and settlement, an IMBL member must have both a share account, which is in effect an electronic record of shareholder details, shareholding and trading transactions, and a dedicated savings account called a "trading account" with IMBL before a share order can be accepted as lodged with IMBL. All participants are able to sell shares on the market, however only IMBL members by guarantee with sufficient funds in IMBL accounts to meet the purchase price, stamp duty and \$33 (including GST) transaction charge, may submit buy orders. IMBL believes that most of the persons trading on the market do so on their own account and it is not necessary to be a broker to be able to buy and sell shares on the market. There is, nonetheless, some intermediation by persons in the market as nominee companies acting on behalf of clients, some of whom may be retail clients.

The RBA has amended its financial stability standards, which apply to securities settlement facilities, to exempt facilities settling less than \$100 million per year. Accordingly, IMBL's settlement and clearing facility does not have to comply with s827D of the Act.

We make no recommendations that relate to the IMBL C&S facility.

Compensation arrangements

Because there are nominee company participants on the IMBL share register that intermediate trading on behalf of beneficial owners of IMBL shares, IMBL is required to have compensation arrangements to recompense beneficial owners were there to be a fraud or defalcation by their nominee participant. To fund the compensation scheme, IMBL established a \$1 million compensation fund through an irrevocable letter of credit issued by Westpac Banking Corporation.

No claims for compensation have been made since the issue of market and C&S facility licences to IMBL.

We sighted the signed original irrevocable letter of credit.