

February 2019

# ASX 24

Obligations Review 2018

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# Executive summary

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## Purpose of this report

Australian Securities Exchange Limited (**ASX 24**) is licensed to operate the ASX 24 derivatives market (derivatives market) in New Zealand. The FMA is required to report at least once every two years<sup>1</sup> on how well ASX 24 is meeting its licensed market operator obligations<sup>2</sup>. This review covers the period 1 July 2016 to 30 June 2018. This is our second review of ASX 24 since its licence came into effect on 1 December 2014.

The Australian Securities and Investments Commission (**ASIC**) is ASX 24's primary regulator. We therefore focused our review on whether ASIC was satisfied with ASX 24's compliance during the review period. See the Appendix for details about how we carried out our review.

## Conclusion

We are satisfied that, during the review period, ASX 24:

- ensured, to the extent reasonably practicable, that its licensed market was fair, orderly and transparent
- had adequate arrangements for notifying disclosures from participants in its market, and for continuing to make them available
- had adequate arrangements for handling conflicts between its commercial interests, and the obligation to ensure its market operates in a fair, orderly and transparent manner
- had adequate arrangements for monitoring the conduct of participants in its markets
- had adequate arrangements for enforcing compliance with market rules
- had sufficient resources (including financial, technological and human resources) to operate its licensed market properly.

Our conclusion is based largely on ASIC's oversight of ASX 24 and its view of ASX 24's compliance, including previous assessments relevant to the operation of ASX 24 carried out under the Australian Corporations Act 2001 (**Corporations Act**).

ASIC has said that it has no reason to believe that ASX 24 was not compliant with its market operator obligations under the Corporations Act during the review period.

Monitoring the conduct of participants means monitoring all persons trading on licensed markets, including authorised participant firms and their clients. This would generally include surveillance of trading activity. Under the Corporations Act, ASX 24 must monitor and enforce compliance with its operating rules, which govern the behaviour of its participant firms; while ASIC has responsibility for real-time market surveillance. We are satisfied this provides appropriate supervision of the conduct of all participants in the derivatives market.

We are also satisfied that, since our last review, ASX 24 has taken the required steps to comply with two licence conditions that were outstanding as of the date of our prior report.

See the 'Findings' section of this report for details.

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<sup>1</sup> A condition of ASX 24's licence is a review every two years. The licence is available on our website [here](#).

<sup>2</sup> A market operator's full obligations are set out in the Appendix.

# ASX 24

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## Overview

ASX 24 operates the derivatives market. Products traded on the market include futures and options on indices, interest rates and energy.

In the year ended 30 June 2018, approximately 156 million futures and options on futures contracts were exchanged on the derivatives market<sup>3</sup>.

ASX 24 is part of the ASX Group, which also operates the ASX securities market (**securities market**), and provides market services such as clearing and settlement.

## ASX 24's licence

ASX 24 was an authorised futures exchange under the Securities Markets Act 1988. Under the transitional provisions of the FMC Act, it was deemed to hold a financial product market licence from 1 December 2014. The conditions of ASX 24's licence were largely carried over from the authorised futures exchange notice. ASX 24's licence can be viewed on our website<sup>4</sup>.

ASX 24's home jurisdiction is Australia, and ASIC is the primary regulator of its market operations. Its market operator obligations in Australia are contained in the Corporations Act. It is also subject to the ASIC Market Integrity Rules (Futures Market) 2017<sup>5</sup>, ASIC Market Integrity Rules (Securities Markets and Futures Markets) Amendment 2018 (No. 1), and ASIC Market Integrity Rules (Futures Markets – Capital) 2017 (together **Market Integrity Rules**).

A condition of ASX 24's FMC Act licence is that New Zealand investors must be informed that ASX 24 is regulated primarily under Australian law.

ASX 24 is required to give the FMA half-yearly information about trading participants who offer derivatives in New Zealand through the derivatives market.

As at 30 June 2018, 19 trading participants were authorised to transact New Zealand derivatives on the derivatives market. We do not require ASX 24 to monitor, or report, on the extent of trading in New Zealand derivatives by these participants, or by New Zealand investors.

ASX 24 must also notify us if it intends to make any material changes to the rules for the derivatives market. Rule changes must be approved by ASIC and the Australian Minister for Revenue and Financial Services.

## ASX Group and ASX Compliance

The ASX Group includes two licensed market operators and four licensed clearing and settlement systems. The group also includes ASX Compliance Limited (**ASX Compliance**).

ASX Compliance has a separate board of independent, non-executive directors, and has overall responsibility for ensuring that all licensed entities in the group meet their regulatory obligations. This means that most of ASX 24's

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<sup>3</sup> ASX Limited Annual Report 2018

<sup>4</sup> <http://fma.govt.nz/assets/Market-Operators-Licences/ASX-Ltd-Financial-Product-Market-Licence-2014.pdf>

<sup>5</sup> Previously ASIC Market Integrity Rules (ASX 24 Market) 2010.

policies, procedures, systems, governance and other arrangements that satisfy its market operator obligations are designed and administered by ASX Group. Examples include:

- financial, technological and human resources for all licensed entities are managed at a group level
- Market Operations, which includes trading operations, surveillance and the market announcements office, carries out those services for both licensed markets
- ASX Compliance is responsible for managing conflicts for the whole group, and for monitoring and enforcing the rules of both the derivatives and securities markets.

## Findings

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As ASIC is ASX 24's primary regulator, our review focused on whether ASIC was satisfied with ASX 24's compliance during the review period. We have, however, also considered reports and information relevant to the operation of the ASX 24 market, including but not limited to group licence reports.

### ASIC's oversight of ASX 24

ASX Group must report to ASIC each year on whether it has complied with all of its market operator obligations for both the derivatives and securities markets.

Until 2013, the Corporations Act also required ASIC to annually assess a market operator's compliance with a number of its obligations. The last such assessment report for ASX Group was published in July 2014<sup>6</sup>. ASIC concluded that the group had met its statutory obligations for the relevant assessment period.

Changes in the legislation mean that ASIC can now choose to assess at any time whether ASX Group complies with any or all of its market operator obligations. This allows ASIC to monitor the group's market operator arrangements on a risk basis. It also allows ASIC to target compliance reviews against specific obligations, based on its risk assessments.

If ASIC has concerns or queries about market operations, either from this reporting, its own monitoring activities or other sources of information such as complaints, it raises matters with ASX Group as necessary.

ASIC's risk-based monitoring helps to determine if more detailed reviews are necessary. Under this structure, in 2016 ASIC has reviewed and reported on ASX Group's resources for managing cyber resilience and its listing standards for the securities market<sup>7</sup>. In September 2018 and November 2018, ASIC reported on the ASX Group's technology governance and operational risk standards, and issued a market assessment report about Yieldbroker Pty Limited (of which ASX is 49% shareholder). More details on these reviews are included below.

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<sup>6</sup> The report is available at <http://download.asic.gov.au/media/1344638/rep401-published-28-July-2014.pdf>

<sup>7</sup> The listing standards do not apply to ASX 24.

## Matters arising during the review period

### *Thematic reviews of ASX Group*

ASIC has not published any reviews of ASX 24's compliance specifically, but has released two reports that provide context relevant to our review:

- How well ASX Limited has managed its technology resources (Report 592); and
- Where ASX Limited has conflicts of interest, whether these are appropriately managed. For instance ASIC's report on Yieldbroker Ltd discusses potential conflicts of interest in relation to ASX's 49% shareholding of Yieldbroker.

### *Technology and Governance review*

In September 2016, ASX Group experienced a major trading system outage that impacted the entire Australian equities market. Following the outage, ASIC undertook a review of ASX Group's operational and technological management of that incident. The review of that outage identified a number of failings on the part of ASX Group. These included technological and operational issues, which were compounded by instances of human error.

In the report, ASIC made a number of recommendations for both ASX Group and ASX market participants, and indicated their intention to undertake a wider review of ASX Group's management of technology governance and operational risk.

In September 2018, ASIC published a report titled "*Review of ASX Group's technology governance and operational risk management standards*" which outlined the findings of this wider review. The review benchmarked ASX Group's technology governance and operational risk management arrangements against internationally recognised technology governance and risk management standards. The review identified areas for improvement. It found ASX Group's practices were comparable to those of other exchanges in the global financial market infrastructure industry but lagged behind better practices in the broader financial services sector.

ASX Group recognises the areas for improvement identified in the review. It is undertaking an extensive work programme to implement all of the recommendations, and had commenced work on many of these either before the review started or before the recommendations were finalised. The programme of work that ASX Group is undertaking is being closely supervised by ASIC and the Reserve Bank of Australia, with KPMG providing semi-annual independent progress reports.

### *Changes to market operating rules*

During the review period, ASX introduced a number of amendments to ASX 24 Market Rules and ASX 24 Market Rule Procedures. Amendments made on 18 January 2017 were specific to trading on behalf of New Zealand customers, and were targeted at meeting the licence conditions. These amendments are further explained in the section below.

## ASX 24's compliance with its licence conditions

In our previous review, we noted that ASX 24 had not yet met two of its licence conditions, in that ASX 24 must:

- require trading participants to inform New Zealand clients of the differences between trading derivatives on an Australian market and a New Zealand market

- ensure that trading participants making regulated offers<sup>8</sup> of derivatives in New Zealand are licensed under the FMC Act if required.

When we agreed on the conditions for the licence, ASX 24 notified us that it would be unable to meet these conditions immediately, as ASX 24 would have to impose the corresponding obligations on its trading participants, which would require amendments to the existing operating rules for the derivatives market. We were comfortable that ASX 24 would make arrangements to comply as soon as practicable, and had no reason to believe that there had been any harm to New Zealand clients in the meantime.

On 18 January 2017, ASX 24 made amendments to the operating rules to introduce requirements that ensure that where the participant is making regulated offers in New Zealand, it is appropriately licensed in New Zealand and has made certain disclosures to its clients. ASX 24 trading participants are also required to provide an annual attestation on 31 January each year, stating either that they are not required to be licensed as a derivatives issuer<sup>9</sup>, or where a licence is required, that the participant holds a current licence.

Under ASX 24's licence<sup>10</sup>, ASX 24 is required to provide a compliance report to the FMA every second financial year. The report is due to the FMA within three months of ASX 24's financial year-end. For this reporting period, ASX 24 did not provide the report by the required deadline. In our discussions with ASX 24, they have informed us that they are currently remapping their key compliance obligations, which will be automated following the introduction of a new Governance, Risk and Compliance (GRC) application. With the implementation of the GRC application pending, ASX 24 has introduced additional controls to manage reporting requirements.

## Conclusion

Other than in respect of the timing of its compliance report, we are satisfied that ASX 24 complied with the market operator obligations under the FMC Act during the review period. The reasons are:

- ASIC's risk-based monitoring has not led to reviews of ASX 24's compliance with any of its obligations.
- ASIC has said that it has no reason to believe that ASX 24 was not compliant with its market operator obligations under the Corporations Act during the review period.
- We have not received any complaints about the operation of the ASX 24 derivatives market in New Zealand.
- ASX Group General Licence Review reports gave us no reason to believe that ASX 24 was not compliant in all material respects with its market operator obligations.

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<sup>8</sup> As defined in the FMC Act

<sup>9</sup> Under Part 6 of the NZ Financial Markets Conduct Act 2013

<sup>10</sup> At clause 12 of the licence

# Appendix: How we conducted our review

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## Our role

Under the FMC Act, we are required to periodically review how well a licensed market operator is meeting its obligations, and to publish a written report.

## Market operator obligations

In the FMC Act, 'market operator obligations' means:

- the general obligations contained in section 314 of the FMC Act:
  - to ensure, to the extent reasonably practicable, that each of the licensed markets is fair, orderly and transparent
  - to have adequate arrangements for notifying disclosures from participants in its markets, and for continuing to make them available
  - to have adequate arrangements for handling conflicts between its commercial interests and the obligation to ensure its markets operate in a fair, orderly and transparent manner
  - to have adequate arrangements for monitoring the conduct of participants in its markets
  - to have adequate arrangements for enforcing compliance with market rules
  - to have sufficient resources (including financial, technological and human resources) to operate its licensed markets properly
- an obligation to respond to any request from us to make changes to market rules (section 333)
- an obligation to provide us with an annual self-assessment of how it complies with its obligations (section 337)
- an obligation to act on our, or the Minister's<sup>11</sup>, direction if it has failed to meet any of its obligations (sections 340 to 342)
- any obligation imposed as a condition of a market operator's licence.

## Approach

A market operator that is authorised and regulated in an overseas country may be licensed under the FMC Act if certain conditions are met.

A key requirement is that the home jurisdiction regulating and supervising the market operator should provide a level of investor protection and market integrity that is comparable to the FMC Act<sup>12</sup>. This allows us to rely on the overseas regulator to assess and monitor the capability and compliance of the market operator.

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<sup>11</sup> New Zealand Minister for Commerce and Consumer Affairs

<sup>12</sup> The original authorisation of ASX 24 as a futures exchange was assessed under a similar requirement in the repealed Securities Markets Act 1988. ASX 24 was deemed to have a licence from 1 Dec 2014 as it moved to the FMC Act regime.

ASX 24's market operator obligations in the Corporations Act are largely equivalent to its FMC Act obligations. ASX 24 does not have an obligation in Australia to carry out surveillance of real-time trading activity. This function has been carried out by ASIC since 2010.

ASX 24 must report to ASIC annually on how it complies with its market operator obligations. ASIC may assess, at any time, how well ASX 24 is complying with any or all of the obligations. These provisions are also equivalent to those in the FMC Act.

## Information reviewed

Our review included liaising with ASIC about:

- its ongoing oversight of ASX 24
- any matters or concerns raised with ASX 24 during the review period
- how ASX 24 addressed those matters; and
- ASIC's overall view of ASX 24's compliance with its market operator obligations.

We also looked at the following:

- reports provided by ASX 24 on its compliance with its obligations for the years ended 30 June 2017 and 2018 (as required under section 337 of the FMC Act). These were the same reports ASX provided to ASIC under the Corporations Act
- ASX 24 operating rule amendments intended to address its New Zealand licence conditions
- information on the ASX website about how ASX meets its market operator obligations for both the securities and derivatives markets. This included:
  - how ASX interprets its obligation to operate fair, orderly and transparent markets
  - how ASX meets its obligation to have adequate arrangements for monitoring and enforcing compliance with the operating rules of its markets
  - how ASX meets its obligation to manage conflicts between commercial and regulatory interests, and a summary of its conflict-handling arrangements
  - the ASX Compliance board charter, which sets out the roles and responsibilities of ASX Compliance
- past reports by ASIC on ASX's compliance with its market operator obligations<sup>13</sup>.

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<sup>13</sup> These reports are available on ASIC's website at <http://www.asic.gov.au/regulatory-resources/markets/licensed-market-and-clearing-and-settlement-facility-assessment-reports/>