AQUA

A Market for Investment Products and Managed Funds

Consultation Paper & Request for Comment

Contents

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Due date for submissions

Submissions in response to the Market Consultation Paper should be received no later than Friday, 10 August 2007.

Meeting with ASX

ASX invites parties interested in face-to-face consultation to contact us to arrange a suitable meeting time.

Please contact ASX on 61 2 9227 0625 if you wish to arrange an appointment.

A. Introduction

What is AQUA?

ASX is introducing a new Rule and Market framework called the AQUA Market to allow quotation of structured products and managed funds on the ASX market. The focus will be on those financial products that do not fit neatly into the main ASX Equity Listing Rules or the established product set for Warrants.

What are AQUA Products?

AQUA products include Structured Products, Managed Funds and other products that meet the AQUA product definition that is outlined later in this document.

Some AQUA products are already traded on ASX. They have been either listed under the Equity Listing rules or quoted under the Warrant Market Rules. But neither framework was designed with AQUA products in mind and so the outcome is sub-optimal.

The distinctive element of the AQUA product definition is that AQUA products are third-party issued products that give investors exposure to an underlying asset or set of assets – but where the value of the assets is not under the control of the issuer of the AQUA product. AQUA products are derivative in an economic sense. The value of the product is linked to the performance of one or more underlying assets and not the financial performance of the issuer itself.

This fundamentally changes the regulatory policy considerations for ASX. The AQUA market is tailored to the needs of issuers and investors in exchange traded managed funds and structured products.

What Products are Not AQUA Products?

Financial products issued by Listed Property Vehicles, Listed Investment Companies, and operating companies are not AQUA products. These will continue to be listed and the financial products admitted for quotation under the ASX Equity Listing Rules.

Who Issues or Promotes AQUA Products?

ASX anticipates AQUA products will be issued by banks and other financial institutions such as fund managers. A framework of the proposed rules for Issuers or Product Providers is contained later in this document.

AQUA market rules will have regard to the economic structure of the financial products included in the AQUA product definition.

The criteria for AQUA Issuers will have regard to the different role played by the issuer of these products.

In this document, Issuer, Fund Manager, Responsible Entity and Product Provider are used throughout as being the entity approved as an AQUA product issuer.

Structured Products and Managed Funds will be AQUA Products

Structured Products (Securities and Derivatives)

Structured products are unsecured contractual obligations of the issuer that have been designed to meet the financial goals of investors. Structured products are AQUA products because:

1. The value of the product is linked to the performance of one or more underlying assets and not the financial performance of the issuer itself.
2. There is no economic rationale in paying a control premium for the issuer because investors are invested in the product and not the issuer's equity securities.
3. The issuer is a passive investor in the underlying assets and does not have legal or management control of the issuers of the underlying assets.
4. Structured products are issued by third parties.

Managed Funds

In the context of AQUA, a managed fund is a pooled fund that invests in underlying assets. Registered managed investment schemes (MIS) are AQUA managed fund products.

For a managed fund to take advantage of the AQUA framework, it will need to be structured with all of the following characteristics:

1. The value of the fund must be linked to the value of the underlying assets and not the financial performance of the fund manager or responsible entity.
2. There is no economic rationale in paying a control premium for the issuer via investment in the product because investors are invested in the product and not the issuer's securities.
3. The issuer is a passive investor in the underlying assets.
4. At this stage ASX considers that AQUA may be limited to open ended funds (i.e. funds where there are ongoing applications and redemptions in the primary market so the number of units on issue fluctuates according to demand).

The question of whether to limit AQUA to open-ended managed funds is posed at the end of this document. Please consider this and make comments on this point.

Decisions on whether managed funds fall within the scope of the AQUA rules will be considered by ASX on a case-by-case basis (*i.e.*, upon application for quotation of the AQUA product).

B. AQUA Market Structure

Overview

The AQUA rules will 'plug the gap' between the ASX Equity Listing Rules and the Warrants Rules by introducing a new set of rules and a new ASX market framework to deal with AQUA products issued by third parties.

The AQUA market will comprise two new ITS 'Integrated Trading System' markets:

1. The AQUA Trading Market; and
2. The AQUA Quotation Market.

The term 'market' in this context means another ITS '*market'* that will appear as a separate 'tab' on an ITS Trader Workstation.

The choice of which AQUA market a product will be quoted on is made by the product issuer or promoter.

AQUA Trading Market

This new proposed market will be covered by a new section - Section 10A in the ASX Market Rules.

The AQUA Trading Market will provide a trading facility for structured products and managed funds that are not quoted under either Section 10 of the Market Rules (the Warrants Rules), or the ASX Equity Listing Rules.

Many potential AQUA products will have similar features to products currently quoted under the Warrant Market Rules or Equity Listing rules. A key driver for ASX introducing the AQUA framework is so that these products do not need to be "shoe horned" into a rules framework which can accommodate them in a technical sense but which has not been developed having regard to with their particular features.

In technical ITS trading terms the AQUA Trading Market on ITS will be similar in operation to the ASX Equity and Warrants Markets. While many of the products quoted will be different, the following will be the same as the ITS environment for warrants:

1. Continuous matching with an opening and closing auction,
2. Broker Identification disclosed,
3. Trading hours and all other sundry configurations.

AQUA Quotation Market

This proposed new market will be covered by a new section - Section 10B in the ASX Market Rules. The AQUA Quotation Market will provide a quotation/advertising (*i.e.*, non-trading) facility for AQUA products.

The facility will be for managed funds and structured products where the issuer does not need on-market trading of the product – but where CHESS settlement of off-market transactions may be attractive.

An issuer may not need the broker-based distribution that ITS offers because it has alternative distribution. Also, some products may not lend themselves to on-market trading – for example some managed funds, or products linked to assets where on-market trading is problematic.

The value to issuers of the AQUA Quotation Market is twofold:

1. AQUA provides access to CHESS settlement for products,
2. AQUA products will automatically be on dealer group approved lists and AQUA products which are registered managed investment schemes will be financial products to which Division 4 of Part 7.11 of the Corporations Act applies – an impediment for CHESS settlement of unlisted Managed Investment Schemes.[1]

The AQUA Quotation Market will not have continuous matching (trading). Only the product issuer will be able to enter 'orders' in the market (that nobody else can action), and all other market participants will be limited to 'read-only' access.

The product issuer may wish to put prices in the market for the same reason prices appear on fund manager web-sites – as an advertising tool.

If an investor or other market participant wishes to trade a product on this market, the participant will be required to contact the issuer directly to complete a transaction.

This transaction can then be reported on ITS by the product issuer. Where this occurs, ITS will route the transaction to CHESS for settlement.

New Coding Convention for AQUA Products

Products quoted under the AQUA Market will have a 6-letter ASX code.

Unlike the ASX warrant coding system, the new codes will not have any imbedded information such as particular letters of the alphabet signifying particular issuers or types of product. The code will serve as a generic identifier – for example a 6-letter alpha-numeric code such as 1A23B4.

AQUA product series could conceivably run into the thousands, from potential issuers or fund managers in the high tens if not low hundreds. A coding convention like the current warrant convention would not work in these circumstances, hence the decision to go to a generic coding convention.

Also, in an ITS environment, there is now a 30+ character identifier on ITS for each security traded, which negates the need for the trading ticker to be descriptive.

Disclosure Rules and Operational Rules & Arrangements for AQUA Products

General Disclosure Rules for the AQUA Market

There will be disclosure requirements for AQUA products across both AQUA market segments.

Issuers of AQUA products will need to observe the provisions of the Corporations Act which govern disclosure.

Given the fundamental conceptual differences between AQUA Products and Equity Listings, the ASX disclosure requirements for AQUA will not be the same or similar as the rules for the equity market.

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[1] Note that AQUA structured products may also be financial products to which Division 4 of Part 7.11 applies if a declaration to this effect is made by ASIC.

AQUA market disclosure rules will be similar to the ASX warrants market given both product suites are third-party issued products whose value is linked to the value of assets at arms length to the Issuer or fund manager.

This document does not provide further detail on the proposed AQUA product disclosure rules except to refer the reader to Chapter 10 of the ASX market rules where the warrant disclosure rules are detailed.

NTA Disclosure for AQUA Fund Products

AQUA will contain disclosure rules for managed funds in relation to NTA which will seek to inform investors about the NTA and investments of managed funds.

At this stage ASX proposes that fund managers must advise ASX about the NTA on a regular basis.

The disclosure requirements will be tailored to the style of the fund. For example:

1. Daily disclosure for Australian long-only equity funds (say)
2. Weekly or monthly disclosure for Australian long-short funds (i.e., more complex funds requiring longer timeframes)
3. Monthly in arrears for disclosure for international hedge fund-of-fund products (because that's as frequently as the product issuer itself will know)
4. Should all funds be required to disclose exact portfolio constitution once a year?

These questions are posed again at the end of this document.

Operational Rules and Arrangement for the AQUA Market

The AQUA rules will also contain what could be described as basic market operational rules – such as disclosure around distributions or dividends. These rules will be the same as the current rules for all current listed equities and quoted warrants and are designed to allow for orderly trading.

The operational rules for the AQUA Trading Market and AQUA Quotation Market will differ because the Quotation Market is a bulletin board rather than a facility on which bids and offers are matched.

AQUA Market administration – *i.e.*, ASX management of AQUA Issuer & Product applications will be managed from the ASX division that currently manages applications for the quotation of warrants. The Supervisory approvals process will also be identical to the warrants market.

AQUA Market Fee Structure

ASX will publish a fee schedule for the AQUA market at a later date.

AQUA Market Launch Timetable

Development of the AQUA rules will follow the usual process of review by ASIC and non-disallowance by the Minister.

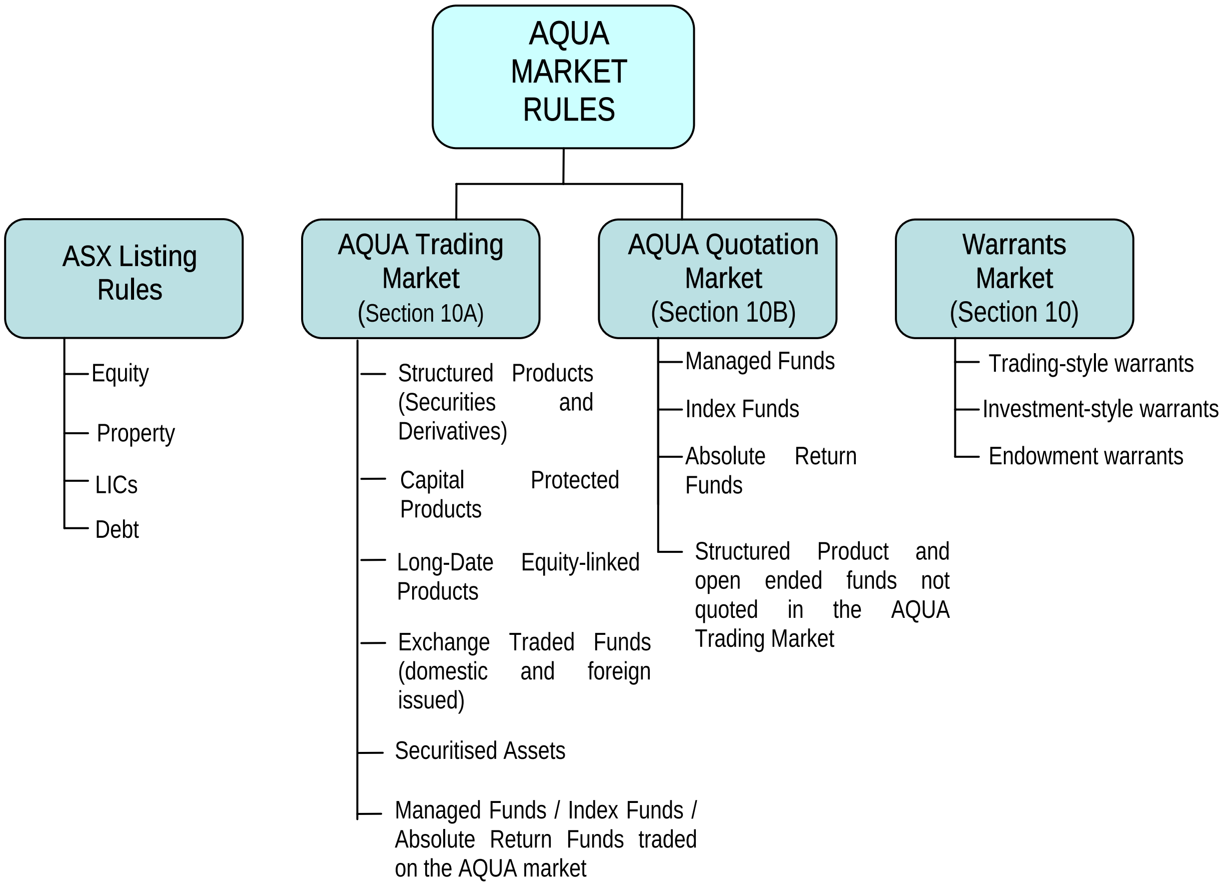
Implementation of the AQUA market also requires regulatory declarations from ASIC in relation to certain AQUA products.

The ASX system configuration changes and minor system development work which are required for the AQUA market are underway.

ASX's current timetable is for the AQUA rules and AQUA system changes to be in place for Q1 calendar 2008.

ASX Rule Framework Overview for AQUA

The diagram below outlines where AQUA fits in the ASX operating rule framework. Also included is a ‘best fit’ description for products that may suit each market.



C. Section 1 – AQUA Product Scope

AQUA Product Definition

The definition of AQUA products is intended to capture third-party issued products that give investors exposure to an underlying asset or set of assets.

The business concept of AQUA products is:

1. AQUA products are '*derivative*' in an economic sense.
2. That is, they give investors exposure to the performance of some underlying asset(s).
3. The products have been designed to give holders a specified financial outcome (*e.g.*, – returns linked to a basket of S&P/ASX 200 shares).
4. The products are issued by arms-length third parties.
5. The products do not form part of the Issuer or Fund Manager's equity or debt capital.
6. The Issuer or Fund Manager is not responsible for keeping the market informed about the price or value of the underlying assets.

These are the key points of differentiation between AQUA products and equity and debt products.

Definition of Underlying Asset

A key characteristic of AQUA products is that the value of the product is linked to the value of the underlying asset(s), and not the financial performance of the product issuer.

ASX will not publish lists of what assets are acceptable underlying assets, or what assets AQUA funds can invest in.

In considering the suitability of products for AQUA quotation one of the factors to which ASX may have regard is the level of price transparency in the underlying asset(s). For example

1. Where the underlying assets are quoted securities, the price is readily accessible from the underlying market.
2. Commodity prices and interest rates are also readily available to investors – note that ASX has quoted warrants over assets such as Gold and Oil on this basis.
3. For overseas securities or indices, where the securities are traded on a regulated market information is readily available. ASX has previously quoted products over NASDAQ, NYSE and Tokyo Stock Exchange securities and indices based on the ready availability of price and security data on the shares and indices in question.

D. Section 2 – Issuer Eligibility Requirements

Requirements for Approval to Issue or Promote AQUA Products

An issuer, fund manager or RE must be approved by ASX to issue AQUA products that will be quoted in the AQUA Market.

Issuer approval and product approval are two stages in the quotation process.

To obtain Issuer approval, the issuer will have to

1. Meet one of the eligibility criteria outlined below; and
2. Be able to demonstrate it has adequate facilities, personnel and financial resources for the purposes of meeting its obligations under terms of the product and the AQUA rules.

Eligibility criteria – AQUA Product Issuers, Fund Managers, Res

General Comments

The eligibility criteria are designed to set an appropriately high benchmark to maintain investor confidence and ensure the integrity and stability of ASX markets.

In deciding the appropriate criteria, the ASX starting point was that the market should be as open as possible to a wide number of participants. That is, there should be no unnecessary barrier to enter the market.

This has to be balanced against the need to have requirements that minimise systemic market risk that could arise from the financial failure of an issuer or product provider. In light of this risk we propose to distinguish between issuers in terms of what sort of products can be issued.

ASX proposes to introduce a new concept of '*market-risk*' products, being those products that put the issuer at risk of financial failure if it does not manage its own risk position in relation to those products.

'*Market risk*' products can generate systemic risk for the market as a whole. Warrants are an example of market risk products and so the threshold for Warrant Issuers on ASX is the highest access test for participation in ASX markets.

'*Market risk'* products in AQUA markets will only be able to be issued by Issuers that meet the current warrant issuer requirements.

A typical '*market-risk'* product that is traded on ASX today is a BHP call warrant or a BHP instalment where the issuer needs to hedge its exposure in the cash and derivative markets.

A typical non-'*market risk'* product is an open-ended ASX 200 ETF where the issuer has raised funds from investors and uses those funds to invest in ASX 200 stock. In the ETF example, the issuer's risk is covered by the fact that there is stock in the ETF vehicle representing each unit issued to investors.

ASX intends to define '*market risk*' products as those satisfying the following tests:

- The issuer's exposure to investors is covered by less than 80 *per cent* by assets held in the vehicle issuing the product, or in a trust or custodial arrangement in respect of the product.

- In the opinion of ASX, the issuer would need to undertake hedging activity in the underlying asset or derivatives of this asset in respect of more than 20 *per cent* of its exposure to investors as a result of the product.

ASX will retain full discretion to determine which products are '*market-risk*' products and will exercise this discretion based on its experience in the ETO, warrant, cash-equity, and futures markets.

The eligibility criteria apply equally to Australian and overseas issuers.

Issuers of 'market-risk' products

(1) Bank

The entity is subject to the Banking Act or is a body regulated by APRA.

(2) Assets + licence + debt rating

The issuer holds an AFSL or is regulated by an overseas regulatory authority that makes it subject to adequate prudential supervision, has net tangible assets which are sufficient (currently set at $200m for the warrants market) to support the issue of the products and has a long term investment grade debt rating or equivalent by a rating agency acceptable to ASX.

These are requirements imposed on the issuer (in the case of a managed fund, the responsible entity).

Issuers of other products ('non-market risk')

Both (1) and (2) above, and

(3) Responsible Entities

The entity is a responsible entity of a registered MIS under the Corporations Act, which requires it to be regulated as to size, ongoing audit compliance obligations and is coupled with the requirement to hold an AFSL.

(4) Listed entity + AFSL

The entity is admitted to the Official List and holds an AFSL covering the issue of the products.

(5) Government

The entity is a government or a Commonwealth or State authority.

(6) Guarantee

This category covers issuers that do not meet any of the eligibility criteria but are able to obtain a guarantee from an entity that does. In this case an issuer may be approved by ASX if the issuer has arranged for its obligations in relation to the product to be guaranteed, or benefits from an arrangement which is equivalent in its effect to such a guarantee. The guarantee must be:

1. unconditional and irrevocable for the life of the product;
2. provided by an entity which satisfies one of the eligibility criteria; and
3. granted in favour of holders.

(7) Issuing fully covered products only

The entity proposes to only issue products that are '*Fully Covered*' (see definition of "Fully Covered Warrant" in Section 2 of the ASX Market Rules).

(8) Sponsor (for an Issuer of '*market-risk*' products)

This is another new concept for products quoted on ASX. It is intended to capture products that global financial institutions have on issue in other jurisdictions.

The sponsor model will apply to:

1. A bank or other organisation that meets the criteria to be an issuer of '*Market Risk*' products,
2. Where the '*Market Risk*' issuer agrees to be the 'Sponsor' under AQUA rules of an AQUA product on ASX,
3. Whether the sponsoring '*Market Risk*' issuer is the actual issuer of the AQUA product or not.

This will allow international products that meet the AQUA definition to be quoted on both AQUA markets provided a local sponsor (being a '*Market Risk*' issuer) agrees to the terms of sponsorship outlined below.

AQUA Product Sponsorship: ASX intends to apply any and all rules to the Sponsor that would apply to the issuer and its AQUA product if the issuer of the AQUA product were applying itself.

For example, if the Australian branch or subsidiary of a global bank wants to sponsor a range of AQUA products that its parent group issues and markets in the US (say) – then the AQUA rules will allow the product to be quoted with the local sponsor assuming all the responsibilities to ASX of the issuer - as if it was the actual issuer.

(9) Issuer approved by ASX and not objected to by ASIC

ASX may still approve an entity to issue products if it does not meet any of the eligibility criteria above – provided ASX and ASIC does not object. This is a "catch all" provision (similar to the existing provisions for warrant issuers) to give ASX and the market the flexibility to consider and deal with unanticipated circumstances.

E. Section 3 – Investor Spread, Market Making, Minimum Issue Size

Investor Spread or Market Making

'Investor Spread' and Market Making are two alternative measures designed to provide liquidity in products traded on ASX.

ASX markets currently use both avenues:

1. The cash equity market uses the investor spread test to achieve a level of liquidity:
    a. Currently – Upon listing - 400 shareholders with $2,000 of shares each,
2. ASX derivative markets use a range of market making models:
    a. ETO Market Making,
    b. Warrant Market Making,
    c. Debt, equity & other Futures Market Making.

Both models have merit in different circumstances. High quality market making is arguably the optimal model for liquidity provision. However, in some circumstances, for example for small company IPOs, market making may be difficult or even impossible to achieve. So the investor spread test tries to ensure a reasonable number of pre-quotation investors.

We seek input on which model is appropriate for the AQUA market, or whether a combination of the two models is appropriate. For example, the rules for the AQUA Trading Market could combine both models and offer Issuers, Fund Managers, REs a choice to:

a. Elect to comply with the existing equity spread requirements (as above);
b. Elect to comply with a market making regime.

We also seek input on which market making regime is appropriate for the AQUA Trading Market – that currently used for ETOs or that used for Warrants.

As the AQUA Quotation Market is not a trading market no investor spread or market making is required.

Minimum Issue Size at Commencement of Trading

Minimum issue size requirements are used by exchanges to ensure both liquidity and as a sensible limit on product issues.

ASX has a minimum issue size limit of $2m NTA for listed companies, and $15m for LICs. However there is no minimum issue size requirement for open-ended products where there is a market maker (such as a BHP Instalment product) – because the issuer/market maker is able to issue new securities and provide ongoing liquidity.

Therefore the issue of a minimum size requirement for AQUA products will be linked to the measure to provide liquidity, as discussed above. (Note: this will not apply to AQUA Quotation Market products).

For AQUA products traded on the AQUA Trading Market – where a Market Making model applies - the minimum issue size will be $nil.

For AQUA products traded on the AQUA Trading Market - if an Investor Spread model applies - the minimum issue size will be $5m.

One of the questions ASX is asking for feedback on in the next section is – '*should ASX limit AQUA to open-ended vehicles*'. If the end-result is that AQUA also includes closed-end vehicles, then these will also be limited to a minimum issue size of $5m.

F. Other Issues

Determination of Issue Price for Managed Funds

An amendment to ASIC Class Order 05/26 (Constitutional provisions about the consideration to acquire interests) may be necessary in relation to AQUA products.

CO 05/26 states that the constitution of a registered managed investment scheme does not have to make adequate provision for the issue price if it instead provides a formula to determine the issue price. Where interests in a registered scheme are not quoted on a financial market the formula must be based on the net tangible assets of the scheme. Where interests in a registered scheme are quoted on a financial market the formula must be based on the market price of the interests.

We understand that providers of managed investment schemes may prefer to determine the issue price by reference to the net tangible assets of the scheme, and that this may be a deterrent to quoting interests in those schemes on ASX if CO 05/26 applies as currently drafted. Hence, it may be necessary to request an amendment to or exemption from CO 05/26.

We would appreciate comments on whether such an exemption or amendment is required, and if so, why it is more appropriate to determine the issue price by reference to the net tangible assets of the scheme. This question is posed at the end of this document.

AQUA Market – Request for Comment

Your views on AQUA are important in setting the AQUA framework. Please answer the questions below in as much detail as possible. All responses are confidential.

Responses are requested by Friday 10 August 2007. If you have any queries, please contact Richard Murphy at: richard.murphy@asx.com.au or (02) 9227 0720.

1 Should ASX limit AQUA to open-ended vehicles or should closed-ended vehicles also be allowed? Why?

2 Should ASX consider formulaic NTA disclosure such as:

1. Daily disclosure for Australian long-only equity funds (say)
2. Weekly or monthly disclosure for Australian long-short funds (i.e., more complex funds requiring longer timeframes)
3. Monthly in arrears for disclosure for international fund-of-fund products (if that's as frequently as the issuer itself will know)
4. Should funds be required to disclose yearly portfolio constitution?

Or should NTA disclosure be on a daily basis with ASX discretion to allow different timeframes?

3 Is $5m NTA a reasonable minimum size requirement for AQUA managed funds (assuming they can choose the investor spread test as opposed to market making)?

4 Is it appropriate for AQUA managed funds (where there is a market maker) to start trading with no minimum size requirement?

5 Are the ETO or Warrant Market Making arrangements the appropriate model for market making of AQUA products?

6 Should Issuers, fund managers and REs have a choice to comply with existing equity spread requirements as opposed to a market making regime to provide liquidity in AQUA products?

7 Do you see any issues around the generic coding system proposed for AQUA products (i.e., the code will convey no information about the product)?

8 Is there sufficient scope around the proposed approval of entities as issuers/promoters of products?

9 Do you see any issues with the '*Market Risk*' designation when it comes to ASX approval of entities as issuers/promoters of products?

10 Is there sufficient scope in the definition of AQUA Product?

11 Do you see any issues with the AQUA Trading Market and AQUA Quotation Market concepts?

12 Is it necessary to request an amendment to or exemption from ASIC CO 05/26 so that the issue price of a registered managed investment scheme traded on ASX may be determined by reference to the net tangible assets of the scheme rather than the market price of interests in the scheme? If so, why it is more appropriate to determine the issue price by reference to the net tangible assets of the scheme?

General Comments

13 What other suggestions, if any, would you like to see made to enhance AQUA in general?