



ASIC

Australian Securities & Investments Commission

REPORT 48

Market assessment report: Eurex Frankfurt AG

July 2005



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Annual assessment (s794C) report

Eurex Frankfurt AG
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Executive summary

This report is an assessment of compliance by Eurex Frankfurt AG (EFAG) with its obligations under s792A(c) of the *Corporations Act 2001* (the Act). EFAG is licensed to operate the financial market that is a futures and options contracts exchange and is known as Eurex Deutschland (Eurex) in this jurisdiction. EFAG is regulated in this jurisdiction by ASIC under Part 7.2 of the Act. However, the principal places of business of EFAG and Eurex are located in Germany, and the market is regulated under the regulatory regime of Germany.

Section 794C of the Act requires the Australian Securities & Investments Commission (ASIC) to assess how well a licensed market operator is complying with its obligations as the holder of a market licence and, in particular, whether a market operator has adequate arrangements for supervising the market it operates. This is our first assessment of EFAG, primarily covering the period from 10 March 2004 to December 2004.

Compliance by EFAG with statutory obligations

As a result of our assessment of EFAG, ASIC is satisfied that EFAG has and continues to have adequate arrangements for supervising its market. This assessment is based on the supervisory arrangements as described in section 2.1 of this report and taking into account the nature of the market and its participants.

Observations and recommendations

With regard to some other obligations, specifically the requirement to lodge certain documents and information with ASIC in a timely manner and with adequate information, we note that during 2004 we became concerned that EFAG had not made itself fully aware of each of its obligations as a market licensee.

ASIC and EFAG engaged in detailed communication to clarify EFAG's responsibilities and our expectations of Australian market licensees.

EFAG has advised ASIC that their reporting obligations have become part of its overall compliance monitoring program. We note that EFAG has lodged some of its recent reports and notifications in compliance with its obligations.

Section 1: Background

1.1 EFAG and the market

EFAG was granted an Australian market licence on 10 March 2004. The licence permits EFAG to operate its market, known as Eurex, in this jurisdiction. ASIC is responsible for regulating the market in this jurisdiction under Part 7.2 of the Act.

Eurex is a futures and options contracts exchange operated by EFAG through an electronic trading platform. Eurex has market participants connected to its platform from about 700 locations worldwide. In 2004, trading volume at Eurex exceeded 1.07 billion contracts. Institutions wishing to trade directly on Eurex via the Eurex trading system must be admitted as Eurex exchange members. Eurex does not permit personal memberships. At the time of our assessment, there was one Australian participant connected to Eurex. Eurex requires all Australian participants to hold an Australian financial services licence that permits them to trade in products of the same kind as those that can be dealt with on the market unless the participant is exempt under Australian law from the requirement to hold such a licence in relation to participation in the market.

Eurex offers trading in a wide array of equity, equity index, money market and fixed income futures and options. These futures and options products are purchased and sold by participants by inserting an order into the central book of Eurex's electronic trading system, where all orders are automatically sorted and matched by type, price and entry time. Prices on Eurex are publicly disseminated.

Eurex Clearing AG clears all trades on Eurex and operates as the counterparty to all transactions. Contracts are performed by settlement between "Clearing Members" and Eurex Clearing AG.

Regulation of EFAG in Germany

Eurex is a public law entity approved in the State of Hesse, Germany, as a public exchange under the German federal Exchange Act, Eurex does not have shareholders. EFAG is approved to operate Eurex as an exchange under the German Exchange Act pursuant to the decision of the Exchange Supervisory Authority dated 2 December 1998.

The legal structure of the German capital market involves the close interaction of federal and state legislation and exchange rules and regulations. In general, the business activities of the trading participants (banks, investment firms and other financial companies) are covered by federal law, with responsibility for regulatory oversight allocated to the German Federal Financial Supervisory Agency (*Bundesanstalt für*

Finanzdienstleistungsaufsicht) (“**BaFin**”). Also, BaFin has exclusive responsibility for ensuring co-operation with competent supervisory authorities of other countries both within and outside the European Union upon request and to the extent necessary for such authorities to discharge their obligations

In the State of Hesse, where Eurex is based, the Exchange Supervisory Authority supervises Eurex under the German Exchange Act. The Exchange Supervisory Authority has a wide range of powers. The German Exchange Act prescribes numerous criteria which the Exchange Supervisory Authority must be satisfied an applicant has addressed in applying to operate an exchange.

Regulation of EFAG in Australia

EFAG's Australian market licence was granted under s795B(2) of the Act, which lists criteria for granting a market licence to an overseas-based operator. These criteria include a requirement that the regulatory regime of the home country is sufficiently equivalent in terms of investor protection and market integrity outcomes to the Australian regulatory regime. Consequently, our approach to regulating overseas-based markets places a degree of reliance on the regulatory regime imposed by the home regulator of that market.

While EFAG is required to comply with each of its obligations under the Act and any conditions imposed on its licence, ASIC necessarily relies to some extent on the regulation of Eurex undertaken by the Exchange Supervisory Authority to be satisfied that EFAG is complying with its Australian obligations.

In this regard we note that ASIC and the BaFin are signatories to two memoranda of understanding concerning consultation, cooperation and exchange of information.

1.2 The assessment process

ASIC undertakes an annual assessment under s794C(2) of the Act to determine whether a licensee complies with its obligations in s792A(c) of the Act relating to supervision of the market.

Section 794C(1) permits ASIC to extend the scope of its annual report to assess how well a licensee complies with any or all of its obligations under Chapter 7 of the Act. We have extended the scope of this report to include a number of matters of compliance noted during the assessment period.

How we conducted this assessment

Our assessment of EFAG was based on information that ASIC had at hand, and information obtained from EFAG and from BaFin.

Specifically, in conducting our assessment under s794C, we:

- analysed information received from and about EFAG in the ordinary course of our dealings with EFAG;
- reviewed EFAG's annual regulatory report under s792F, and a six-monthly market report under s14 of EFAG's market licence;
- sought additional information from EFAG for the purpose of this assessment;
- obtained information from the BaFin about Eurex and EFAG; and
- also considered how well EFAG might comply with its obligations in the future.

Section 2: Observations and Recommendations

After making our assessment, ASIC concludes that EFAG has and will continue to comply with its obligations under s792A(c) of the Act. Section 2.1 addresses our obligation under s794C(2) to assess the adequacy of EFAG supervisory arrangements. Section 2.2 discusses other areas of compliance that were noted during the assessment period.

2.1 Supervision of the market

Our conclusion is based on the following observations drawn from information gathered during the assessment process:

1. In its application for an Australian market licence, EFAG described a number of arrangements for supervising its market. These arrangements were assessed as being adequate to satisfy the requirement under s792A at the time of, and as evidenced by, the granting of EFAG's market licence.
2. EFAG confirmed to ASIC that the arrangements for supervising the market had not changed in any material way from the description provided in its application for a market licence.
3. BaFin confirmed that it and the Exchange Supervisory Authority had no concerns with EFAG's supervision of Eurex.
4. During our assessment, nothing came to our attention to suggest that the supervisory arrangements were not operating properly.

Brief descriptions of the supervisory arrangements follow.

Handling conflicts of interests

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

The German regulatory regime ensures that the responsibility for the supervision of the market rests with a public law entity (in this case, Eurex) that does not receive a commercial return from the market. Although the public law entity is staffed with persons employed by the commercial operator (EFAG), the highest level decision making is made by persons that are not employed by the operator.

The highest executive body in relation to the Eurex market is the Exchange Council, composed of 24 representatives of trading Members, issuers and investors. The Exchange Council is responsible for making

all decisions of major importance, including the adoption of the Exchange's rules and regulations. The Exchange Council is also responsible for appointing and supervising the Exchange Management. Exchange Council approval is also required for decisions regarding the introduction of new trading and settlement systems. The Exchange Council is elected for a three-year term. Exchange Council members include banks, financial services institutions, other issuers and investors. Its diverse composition ensures that the interests of a broad range of Members are taken into account when basic policy decisions concerning the Eurex market are made. The Exchange Council represents the interests of both the public and the trading community.

Monitoring the conduct of participants

Paragraph 792A(c)(ii) of the Act requires that EFAG have adequate arrangements for monitoring the conduct of participants on or in relation to the market.

Australian participants in the Eurex market are subject to the same supervision imposed on current Members in other jurisdictions. Because Eurex is a fully automated electronic exchange, it is in a position to monitor and examine compliance of each exchange Member with all laws, regulations, terms and conditions and other rules governing trading on Eurex. Because all transactions are executed through Eurex's central computer system, the details of all transactions are recorded automatically.

The Trading Surveillance Office is responsible for monitoring trading on the Eurex market and settling exchange transactions. This body systematically records all data regarding trading and settlement and conducts necessary investigations in cases where circumstances indicate a possible violation of the Eurex market Exchange Rules. If the Trading Surveillance Office discovers that violations of exchange regulations are occurring or that other conditions exist that may impair the orderly conduct of the trading or settlement of transactions, it must report such violations to the Exchange Management and the Exchange Supervisory Authority.

Enforcing compliance with the market's operating rules

Paragraph 792A(c)(iii) of the Act requires that EFAG have adequate arrangements for enforcing compliance with the market's operating rules.

The rules of the Eurex market are binding under the law of Germany. In the event that a participant defaults or is found to be in breach of its obligations to observe the rules and regulations of the exchange, under various sections of the German federal Exchange Act, the Disciplinary Committee, the Exchange Management and the Exchange Supervisory

Authority are variously empowered to reprimand, issue fines or suspend or cancel the participant's admission to the Eurex market and take any other disciplinary action as deemed necessary. Suspension and cancellation of admission is simply and effectively achieved by taking appropriate technological measures. However, the Exchange Management will issue an order in writing to the same effect to the offending exchange member or trader. The cancellation of orders and quotes and the closing of a defaulting participant's positions are also achieved electronically on the Eurex system.

2.2 Other observations

Obligations to notify ASIC

EFAG has a number of ongoing obligations under the Act, including when and in what circumstances it must lodge documents or notify ASIC of specified events. In some instances, outlined below, ASIC became concerned with EFAG's approach to its reporting obligations. We raised our concerns with EFAG and provided them with greater detail of our expectations.

To allay our concerns, EFAG advised that it had made some organisational changes and it believes it will now be able to meet its reporting obligations in a timely and detailed manner.

Since the changes were implemented, notifications and reports have generally been lodged in a timely manner and with adequate detailed information.

Reporting obligations

Annual regulatory report

ASIC notes that this report should have been lodged by EFAG on or before 31 March 2005. EFAG submitted that it missed the respective due date to file the annual regulatory report with ASIC because it was the first time that EFAG had to file this report and that the scope of the reporting requirements was not completely clear to EFAG at the time. ASIC does not accept that the requirements were insufficiently clear but has provided further clarification of our expectations.

EFAG has undertaken to ensure that all future regulatory reports are lodged within the required time.

Reports required by licence

1. Section 14 of EFAG's Australian market licence requires EFAG to lodge with ASIC a report each six months that provides information about the volumes traded on Eurex in Australia and globally, and lists all Australian participants. EFAG lodged its first report for the period

1 Jan to 30 June 2004 on 21 July 2004, and its second report for the period 1 July 2004 to 31 December 2004 on 2 February 2004. ASIC acknowledges that the detail in these reports was sufficient to satisfy EFAG's obligations.

2. Under subsection 793D(3) of the Act and subsection 12(4) of its Australian market licence, EFAG must provide ASIC with a written notice if a change is made to the operating rules of the market as soon as practicable after the change is made. The written notice must provide information as required by the Act and the conditions of EFAG's Australian market licence.

EFAG was not fully aware of its obligation in relation to this issue and the initial notifications did not provide the information as required by the Act and its licence conditions. We became concerned with the lack of awareness and raised this issue in our communications with EFAG.

We note that the most recent notification has provided all the information as required by the Act and the licence condition.

System outages

EFAG notified ASIC in its 2004 annual regulatory report that the Eurex system was available to participants for a monthly average of 99.986% of the time, which equates to an average downtime per month of less than 2 minutes and 18 seconds. This indicates that no significant system outages have occurred that would necessitate notification to ASIC.