



ASIC

Australian Securities & Investments Commission

REPORT 56

Market assessment report: SFE Corporation Limited

August 2005



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Annual assessment (s823C) report

**SFE Clearing Corporation Pty Limited
ACN 050 615 864**

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Executive summary

This report summarises ASIC's assessment of compliance by SFE Clearing Corporation Pty Limited (SFECC) with its obligations under s823C of the *Corporations Act 2001* (Act).

How we conducted the assessment

In conducting our assessment, we:

- reviewed policies and procedures for the conduct of the SFECC CS facility in general and its supervisory responsibilities in particular;
- analysed extensive material provided under the *Australian Securities and Investments Commission Act 2001* (ASIC Act); and
- interviewed SFE Group personnel

For more details about the assessment process, see Section 1.

Compliance by SFECC

In ASIC's view, SFECC has adequate arrangements for the supervision of its CS facility, including arrangements for:

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

Section 1: Background

1.1 Role of SFECC

A pre-requisite for the successful operation of any financial market place is the existence of an efficient and financially sound clearing service.

The primary function of SFECC is to act as a central counterparty clearing organisation. In fulfilling this role it also undertakes the following activities:

- trade registration, allocation and contract novation;
- position reporting and trade processing;
- guarantee and risk management; and
- collateral and treasury management.

Through the process of novation SFECC becomes the principal to all trades and liable to perform against all contracts to which it is a party and effectively ‘guarantees’ performance to other clearing participants. Performing this central counterparty function enhances the reliability of a clearing and settlement facility but also introduces exposures to credit or potential default risks that SFECC must manage. In doing so, SFECC undertakes a number of specific monitoring, analysis, pre-emptive and restorative activities to ensure that the interests of clearing participants and their clients are protected and the integrity of the facility is maintained.

The Business Operations business unit is responsible for the establishment and ongoing adherence to procedures that effect processing of clearing, settlement, expiry and delivery activities. Primary responsibility for the prudential review and monitoring of clearing participant exposures and the resultant risk management activities lies with the Risk Operations business unit.

1.2 The SFECC Board

The SFECC board has minimal representation from SFE executives and instead draws upon the members of the parent Board. Arguably this assists in its oversight and consideration of issues from a whole of organisation perspective.

As both the commercial performance of SFECC and its compliance with its obligations as a CS facility licensee are integrally connected with the ongoing financial strength of clearing participants, the board also includes representation by risk management professionals from a number of financial institutions.

1.3 The assessment process

Section 823C

The Act requires ASIC to conduct an annual assessment of each Australian CS facility licensee.

Section 823C of the Act says:

- (1) ASIC may do an assessment of how well a CS facility licensee is complying with its obligations as a CS facility licensee under this Chapter (other than its obligations under paragraph 821A(aa)). In doing the assessment, ASIC may take account of any information and reports that it thinks appropriate, including information and reports from an overseas regulatory authority.*
- (2) In respect of the obligation in paragraph 821A(c), ASIC must do such an assessment at least once a year for each CS facility licensee.*
- (3) As soon as practicable after doing an assessment under this section, ASIC must give a written report on the assessment to the Minister and a copy of the written report to the RBA.*

Paragraph 821A(c) states that a CS facility licensee must:

- (c) have adequate arrangements (whether they involve a self-regulatory structure or the appointment of an independent person or related entity) for supervising the facility, including arrangements for:

 - (i) 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*
 - (ii) enforcing compliance with the facility's operating rules.**

As mentioned above, ASIC does not assess how well a CS facility licensee is complying with its obligations under paragraph 821A(aa) of the Act. The Reserve Bank of Australia (RBA) must undertake an assessment, at least once each year, of CS facility compliance in this regard.

The annual assessments of ASIC and RBA are completed independently.

Conduct of ASIC assessment

The SFE group is structured so that the same business units perform functions relating to the supervision of both the market licence held by Sydney Futures Exchange Limited (SFEL) and the CS facility licence held by SFECC.

During time spent at the SFE offices in Sydney from 23 February 2004 to 27 February 2004 we reviewed the work and work practices of relevant business

units to assess the level of compliance with obligations of each licence simultaneously.

As part of our assessment of SFECC we undertook reviews of the following individual business units:

- Business Operations;
- Compliance & Surveillance;
- Technology;
- Participant and Client Services;
- Internal Audit;
- Business Development – SFE Clearing; and
- Risk Operations.

Much of this report focuses on the role played by the Risk Operations business unit and should therefore be read in conjunction with our report on the compliance by SFEL with its obligations as a market licensee dated April 2005 to obtain greater detail regarding the roles of other business units.

In conducting our assessment of SFECC, we:

- considered the recommendations and relevant international standards developed by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO)
- analysed information we received from SFECC in the ordinary course of our dealings with it as a CS facility licensee including liaison meetings and general correspondence;
- had regard to the draft and final versions of the annual regulatory report given to ASIC by SFE (as required under s821E of the Act);
- interviewed certain SFE staff with supervisory and/or operational responsibilities; and
- reviewed extensive material provided to us by SFECC under the *Australian Securities and Investments Commission Act 2001* (ASIC Act)

We discussed our initial observations with the General Manager – Business Risk at the conclusion of our on-site visit.

1.3 Focus of this assessment report

In our previous assessment of SFECC we were primarily concerned with understanding the division of responsibilities amongst various business units with responsibility for operation of the CS facility and those carrying out monitoring, supervisory or enforcement activities.

The assessment covered by this report continued to examine the work done by those units. We paid particular attention to the methods used by SFECC to monitor exposures, satisfy itself of the adequacy of its margining activities and take restorative action when necessary.

The SFE group derives financial benefit from the level of trading that takes place on its market. We therefore considered the handling of conflicts between SFECC's commercial interests and the provision of its services in a fair and effective way by reference to the integrity of the position monitoring and risk management processes of SFECC. In addition we wanted to ensure that these activities were carried out in an equivalent manner across all participants and independent of any commercial influence.

Section 2: Observations and recommendations

2.1 Overall compliance

It is ASIC's assessment that, based on the information collected for our review and given the present operating conditions, SFECC has adequate arrangements for the supervision of its CS facility in accordance with its obligations under s821A(c) of the Act.

Our conclusion is based on the following observations:

- operating rules provide an adequate framework for the operation of a fair and effective facility;
- satisfactory procedures are in place for the key supervisory areas and our review of operational files did not identify any instances where procedures were not followed;
- continued focus on automating certain workflows has resulted in a reduction in the level of potential risk due to human error;
- SFECC is active in monitoring participant and market positions and the impact of these on required margins and the receipt of margins in real-time;
- SFECC has reliable technology in place to support the outcomes of a fair and effective CS facility. This is reflected in the absence of any serious facility failures or disruptions during the period under review;
- stress-testing to calculate potential loss exposures of participants under various scenarios is performed daily;
- key management and staff responsible for the operation and supervision of the CS facility demonstrated a high degree of expertise in the functions and processes involved; and
- we found no evidence that would indicate inappropriate handling of conflicts between the commercial interests of the licensee and the provision of its services in a fair and effective way.

2.2 Observations

Based on the material available to ASIC at the time of our assessment ASIC makes the following observations.

Monitoring of exposures

In managing the credit exposure that SFECC has to its clearing participants, the primary tool used is the application of a variety of initial, mark-to-market and other margins. SFECC also undertakes daily stress testing and maintains a clearing guarantee fund to be applied as necessary in the case of a participant default.

The Compliance & Surveillance and Risk Operations business units examine clearing participants' open positions on a daily basis, in accordance with trigger limit levels which have been notified to ASIC and/or the RBA.

Where limits are breached, action may be taken to protect SFECC, including by calling additional margins. The various trigger limits used may pertain to:

- each participant's position portfolio concentration relative to the relevant open interest;
- stress test exposure limits as ratified by the SFECC Board; and/or
- each participant's capital based position limit (set at 200% of a Participant's net tangible assets).

Conflict handling arrangements

The Business Development business unit (BD) interacts with other SFEL and SFECC business units as a consequence of their ongoing liaison with participants. This may involve potential rule amendments, suggested changes to contract specifications or trading platform functionality, changes to margin parameters etc. BD's role only involves the provision of information to the relevant commercial or supervisory business unit. In particular, where a change to the operating rules is contemplated there are established processes for consideration of supervisory issues in isolation from any commercial interests.

During 2003, management responsibility for the key SFECC supervisory unit Risk Operations (RO) moved to the General Manager – Business Risk. The General Manager – Business Risk does not have any responsibilities for commercial aspects of the SFE business and reports directly to the SFECC Board on RO activities as well as clearing participant activities to the extent that they may impact the provision of a fair and effective facility.

One of the initiatives introduced by RO under the stewardship of the General Manager – Business Risk that exemplifies the ongoing and active approach to risk management was the preparation of a paper for the SFECC Board establishing enhancements to the margining function.

Identifying other risk areas

The Internal Audit (IA) business unit conducts operational audits of business units, the frequency of which is based upon a detailed internal risk assessment. During 2003 two audits were undertaken for SFECC. The only significant finding was a reliance on key people for the completion of specific tasks in SFECC. SFECC have responded to this by implementing further training and automation of tasks where possible.

IA has also been responsible for the planning, coordination and execution of a new SFECC initiative of Participant Operational Reviews (PORs). Initial planning for the PORs took place in the latter half of 2003 and implementation commenced in 2004. The primary focus of the PORs is not to identify non-compliance with the SFEL or SFECC Rules but rather to identify areas of systemic weakness or operational risk at a participant. POR's are quite separate from the ongoing financial exposure monitoring of participants, but may act as an additional early warning signal of potential risk for SFECC. The results of individual PORs are reported to the Risk Steering Committee and if relevant, the SFECC Board.

2.3 Recommendations

Based on the material available to ASIC at the time of our assessment ASIC makes the following recommendations.

System integrity and performance

SFE have traditionally provided advice to ASIC of any major halts or outages to the trading platform (SYCOM) including detail of the cause and steps taken to resolve. This procedure has not previously covered similar halts or outages to the clearing system (SECUR). We recommend that SFECC implement a procedure to ensure ASIC is advised of such system problems.

SFECC's Business Operations business unit indicated at the time of our assessment that it was their intention that any major system outage should be reported to ASIC in a timely manner and they would update their procedures to reflect this.

SFE Clearing Operation Manual

It is recommended that SFECC's Business Operations business unit update this document to reflect any changes and additional responsibilities associated with the amalgamation of trading and clearing operations.

SFECC have advised ASIC that a review of the procedures relating to clearing operations has been undertaken to take account of staffing and process changes.