ASIC

Australian Securities & Investments Commission

REPORT 75

Market assessment report: Sydney Futures Exchange Limited

May 2006

Annual assessment (s794C) report

Sydney Futures Exchange Limited
ACN 000 943 377

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Contents

Executive summary

Section 794C of the *Corporations Act 2001* (Act) requires ASIC to assess how well a licensed market operator is complying with some of its obligations as the holder of a market licence. ASIC must assess whether a market operator has adequate arrangements for supervising the market(s) it operates.

This report summarises ASIC’s fourth assessment of compliance by Sydney Futures Exchange Limited (SFE) with its obligations under s792A(c) of the Act.

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

Compliance by SFE

1. We conclude that SFE has adequate arrangements for supervising its market, 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 operating rules.
2. SFE has made substantial and satisfactory progress in addressing matters we raised in our last report. In particular, considerable progress has been made with respect to the recording of decisions of SFE's Business Conduct Committee (BCC).
3. During the assessment period SFE presented a paper to the BCC entitled "Review of Rule Enforcement and Disciplinary Action Framework". The review covers some of the issues previously raised by ASIC. ASIC is supportive of the work SFE is doing in this area.
4. ASIC's assessment this year has produced a number of findings, which SFE has responded to in a constructive manner by already making or planning improvements where applicable. ASIC supports the improvements SFE has made or has suggested. In particular SFE is proposing rule changes to implement a new transparent, consistent and timely error resolution policy.

Our approach

ASIC uses the formal assessment process to examine whether a market licensee has been and is continuing to meet its 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.

As with our previous assessments, in this assessment we examined the day-to-day supervisory functions carried out by SFE. We paid particular attention to the extent to which SFE has responded to issues we raised in our previous assessment reports.

Generally our assessment reports focus on suggested areas of improvement in SFE's arrangements rather than on the more positive aspects that support our overall conclusion.

It is important to make it clear that none of the suggestions for improvement in this report detract from our conclusion that SFE's arrangements have met and continue to meet its statutory obligations.

The regulatory report SFE provided to ASIC and the Minister comprehensively reviews the supervisory and educational activities it undertook during the year. Those activities show the active role SFE plays as front-line supervisor of its markets and provides considerable support for our conclusion that it is complying with its supervisory obligations.

Section 1: Background

1.1 The SFE group

During the period of the assessment, SFE held an Australian market licence that permits it to operate a market in the financial products described on its licence. A copy of SFE's market licence is available on ASIC's website at www.asic.gov.au. Two SFE group entities, SFE Clearing Corporation Pty Limited and Austraclear Limited, hold licences to operate clearing & settlement facilities. ASIC's assessment of these licensees pursuant to s823C of the Act is set out in a separate report.

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 it operates is a fair, orderly and transparent market.

A market 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 in accordance with its obligations under the Act at the time of the assessment; and
- identify issues, which 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 - the ongoing interaction we have with SFE in our role as regulator of financial markets, an on-site inspection of books and records and interviews with SFE personnel, and the discussions we have with SFE about the issues that have arisen from our previous assessment processes.

In conducting our assessment we have particularly considered:

- the annual regulatory report given to ASIC by SFE issued 31 March 2005 as required under s792F of the Act;
- information we received from and about SFE in the ordinary course of our dealings with SFE as a market licensee, including:
  - information received as part of the rule amendment process;
  - interaction with SFE on a range of operational issues;

  - referrals of serious contraventions; and
  - SFE’s annual report for the year ended 31 December 2004;
- information from external sources, including media commentary and reports published by SFE;
- the operation of the market throughout the period;
- internal SFE material, including disciplinary and investigation files, internal reports and information collected by SFE on a continuous basis;
- discussions with senior SFE management; and
- comments made in interviews or discussions with a range of SFE personnel.

In conducting our on-site visit, we:

- interviewed SFE group personnel;
- reviewed policies and procedures for the conduct of SFE markets in general and their supervisory responsibilities in particular; and
- reviewed extensive material provided by SFE under the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

We served a number of notices that required SFE to give ASIC documents relating to a wide range of SFE activities. From 24 October 2005 to 28 October 2005 we also attended SFE offices in Sydney and during this on-site phase of the assessment we reviewed SFE operational records and spoke to personnel across all levels of SFE management.

After our visit, we corresponded and had discussions with SFE about our findings and their proposed responses to a number of issues we raised. Where appropriate, our report reflects SFE's responses.

1.3 Focus of this assessment report

In our last assessment report we made a number of observations and recommendations about improvements in SFE's supervisory arrangements.

The current assessment involved a review of various changes made by SFE in response to these key recommendations and other issues that we had raised in previous assessments as well as issues that came to our attention during the assessment period. In addition to this we sought an understanding and SFE's explanation in relation to issues that came to our attention during the assessment period. The key issues we examined were SFE's trading platform outages and SFE's error trade cancellation policy.

We continued to focus on SFE's rule enforcement and disciplinary action framework and on the quality of SFE's arrangements for managing conflicts of interest. We reviewed the procedures, practices and relevant events and interviewed a number of individuals to help us form a view as to how well the conflict handling arrangements are understood across the organisation, and how they are implemented in practice.

We also sought reassurances generally about the adequacy of the practices of those business units such as Compliance and Surveillance and Business Operations Derivatives that have a key supervisory role. We looked in particular at the quality and consistency of supervisory outcomes to assure ourselves that SFE is meeting its statutory obligations to supervise its market.

Section 2: Observations and recommendations

2.1 SFE is meeting its obligations

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

This conclusion is based on the following observations drawn from information gathered during the formal part of our assessment process, our observations on the basis of our regular contact with SFE and the present operating conditions (including trading volumes and financial products traded on the market):

1. SFE has good market infrastructure (including technology) to support its obligations to maintain a fair, orderly and transparent market. Although some market disruptions came to our attention during the course of the assessment period, SFE's trading platform still managed above 99.5% availability for the majority of its products.
2. The operating rules and guidance notes provide an adequate framework for a fair, orderly and transparent market.
3. Key supervisory areas that monitor the conduct of participants and trading have adequate procedures in place.
4. During the course of our interviews, key management and staff responsible for supervision demonstrated a strong commitment to their supervisory role and a high level of expertise in the operations of the market.
5. Our review of operational records on supervisory decisions showed that:
    - decision-making on supervisory matters is sound;
    - SFE conducts ongoing supervision of its participants.
6. SFE demonstrated a strong commitment to educating participants in their obligations under the operating rules.
7. SFE shares information on supervisory matters with ASIC.

2.2 Other observations and recommendations for future action

Formalised agreements with settlement price providers

In our last assessment report we recommended SFE should enter into formalised agreements with its panel of swap and bond dealer settlement price providers. SFE agreed in principal with the recommendation and asserted that, wherever possible, SFE negotiates formal agreements for settlement price provisions. SFE reiterated that in the instances where formal agreements are not currently in place (principally in relation to the swap and bond dealer price providers) the process for provision of prices to SFE is firmly entrenched in the business procedures of the current price providers.

SFE does have formal agreements in place with settlement providers for the majority of their products and ASIC will continue to monitor agreements for any new products as part of our ongoing reviews of SFE's operating rule changes. It would be ideal for SFE to have formal agreements in place for settlement prices for all of its products. However, the current arrangements with the swap and bond dealers are longstanding and the panel is made up of reputable financial institutions. We will monitor the situation over time.

Supervisory committees

Recording regulatory decisions

In our last assessment report we recommended the following in relation to the minutes of the BCC and the Markets Practices Committee (MPC):

- that they should act as a paper trail of decisions made by the BCC and MPC, particularly as they form the basis of the written decision provided to the participant; and
- any disciplinary decision made should articulate the committee's reasons for making a particular finding to enable the participant to understand the reasoning process adopted.

ASIC reviewed the minutes of the BCC and MPC for matters considered during the period December 2004 to October 2005. SFE has made significant progress with respect to the BCC minutes. The minutes reviewed now clearly reflect the deliberations that took place and the decisions made by the BCC.

The MPC minutes were less detailed than the BCC minutes. This may be due to the fact that the MPC minutes we reviewed largely concerned matters that were less serious in nature to those dealt with by the BCC. If the MPC considers a serious rule breach, ASIC would expect that the relevant minutes contain more detail than those reviewed by ASIC as part of its assessment.

Publication of disciplinary committee findings

The SFE has published a policy and guidelines on when a finding of a disciplinary committee will be published that names the participant(s) involved. To date the SFE has publicly named several participants for serious rule breaches in accordance with this policy. ASIC has previously expressed concerns to the SFE on the apparent reluctance by members of the MPC to consider naming as a penalty in all but the most serious of cases.

A situation arose during the course of an MPC meeting in 2005 where the naming of a participant ought to have been considered by the MPC as it clearly fell within the published SFE policy. In this instance, the MPC did not make any recommendation on publication and a SFE staff member present at the meeting queried the MPC on the issue.

The MPC expressed its concerns about the real and perceived conflict of interest inherent in a peer group making a recommendation on naming of market participants and suggested that naming be considered by BCC whose members have no direct market involvement.

ASIC would like to commend the SFE for responding to this conflict issue quickly and decisively and changing its policy to avoid the need for the MPC to make recommendations in regard to naming, whilst maintaining the role of the BCC in making such recommendations.

SFE review of rule enforcement and disciplinary action framework

In a previous assessment report dated April 2005 ASIC recommended that the SFE undertake a review to ensure that disciplinary action imposed by the SFE continues to act as a sufficient deterrent to enforce compliance with SFE operating rules. The review should specifically consider the:

- types of penalties imposed by supervisory committees;
- balance between administrative, financial and other disciplinary penalties;
- relevance of commercial impact to a participant in setting financial penalties; and
- comparative level of penalties imposed vis-à-vis similar market operators globally.

SFE is currently in the process of reviewing its rule enforcement and disciplinary policies.

ASIC commends SFE for commencing a review of its current arrangements. SFE has already made some changes as a result of this review. ASIC notes that several recent penalties have reached or were close to the maximum financial penalties limit available to SFE under its current policies and determinations. ASIC recommends that SFE undertake a comparison analysis of financial penalties imposed by similar market operators globally before reaching any final conclusions about whether the level of financial penalties is adequate.

Resources

In our previous reports, we recommended that SFE should continue to monitor the level of resources available to the Compliance and Surveillance business unit as well as other key supervisory business units.

During this assessment period there continued to be significant staff turnover in the key supervisory business units. We note however that in the Compliance and Surveillance business unit SFE has been able to employ well-experienced and expert staff as replacements for those who moved on. The Business Operations Derivatives business unit has developed a new training programme for new recruits with the view of training a core group of people to a level where each individual is capable of performing all tasks across the business unit. ASIC acknowledges that SFE has continued to make a substantial effort in the cross training of staff between its various supervisory business units and has also been successful in employing experienced staff.

Conflict handling arrangements

Section 792A(c) of the Corporations Act requires a market licensee to have 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 the market operates in a fair, orderly and transparent manner.

ASIC has once again concluded that SFE has adequate arrangements in place for handling conflicts between its commercial interests and the need to ensure that the market operates in a fair orderly and transparent manner. In our last report however, we recommend that these arrangements should be compiled in one centrally held document which describes the broader conflict handling arrangements across the organisation as well as including each business unit's responsibilities for its own conflict handling arrangements. In our recommendation we suggested that Group Compliance be the business unit that develops and expands a SFE conflicts framework document to improve the identification of conflicts situations and management of any identified conflicts.

In October 2005 SFE finalised a document titled "Conflict of Interest Arrangements". The purpose of the document is to identify the structural arrangements that are in place to control or avoid actual or perceived conflicts, consistent with legislatively imposed requirements.

The internal paper confirms that employees have a responsibility to put SFE's supervisory responsibilities before SFE's commercial interests. It contains a number of appropriate statements concerning conflict arrangements, such as providing that SFE management from revenue centres are not to be involved in the conduct of compliance and surveillance or disciplinary proceedings, nor do they have any power to waive the operation of operating rules.

However, the document is not as comprehensive or sophisticated as might be expected for a market of SFE's stature. Accordingly, the recommendation made in our last report concerning conflict arrangements has not been fully addressed. We recommend that SFE continues to develop and refine its centralised conflict arrangements as suggested in the recommendation made in our last report.

Other matters

Interruptions to SFE's trading system

Since our last assessment SFE's SYCOM® trading system experienced approximately 14 interruptions as a result of market halts and system failures. The majority of these problems occurred during the period May 2005 to August 2005. ASIC became concerned with the regularity of these interruptions and wrote to the SFE requesting they provide an explanation as to causes of these interruptions and details of actions taken to combat the interruptions. We also had discussions with senior SFE staff during our visit to SFE premises in October 2005.

SFE advises that the outages were a series of diverse mostly unrelated events arising from either upgrades to the system, participant initiated events, normal production and managed refreshes of the system.

In May 2005 changes were made to the SYCOM® host to allow for the future introduction of post trade anonymity and a general maintenance upgrade to address non-critical faults and implement a number of system management efficiencies. In total four events occurred as a result of problems and fixes associated with the upgrade. SFE advised that there are no residual issues associated with the upgrade.

A participant initiated event can arise under a combination of significant SYCOM® account maintenance and high volumes of trading activity. According to SFE this potential issue only culminates into an event if the participant logon and download process is unmanaged, thereby causing download delays that can affect the integrity of one SYCOM® service that eventually affects the multiple services resulting in failure of SYCOM®. SFE advise that these factors were experienced by one participant who attempted a large position transfer from another participant in one unmanaged batch rather than being managed over a couple of trading sessions. This resulted in two failures and one managed refresh.

SFE advises that managed refresh outages relate to the need to stop production during the week to allow a fix to be implemented in relation to a previous event. In these events SFE already is aware of a possible problem within the system, and rather than waiting for the problem to impact the system in the future, SFE stops production during a quiet period of trading to allow the fix to be implemented. SFE submit that this is a direct consequence of operating a 24 hour market where there are no periods during the week that naturally allow the performance of either fixes or maintenance. This is in contrast to those markets that do not operate 24 hours and therefore have a significant portion of each day for maintenance.

ASIC acknowledges the efforts made by SFE to develop fixes for these problems. Taking into account all the events that occurred in 2005, SFE advises that SYCOM® still achieved an overall availability percentage during 2005 in excess of 99.7%. However if these sorts of interruptions to SYCOM® continue to occur with similar frequency, ASIC recommends that SFE consider engaging external systems experts to assess the reliability of and maintenance practices of SYCOM®. Further ASIC recommends that SFE examine whether there is currently sufficient time for performance of fixes and maintenance to SYCOM®.

Error resolution policy

Since the last assessment there were three significant price movements on the SYCOM® trading system during the night session which were not caused by activity in the underlying Australian or worldwide markets. We examined two of these price movements during our assessment. One of the price movements was for approximately 45 basis points and another one was for approximately 125 basis points and these movements occurred within an extremely short time span. The SFE did not cancel any trades in relation to the first price action, however a significant number of trades were cancelled in relation to the second price action.

At the time of these occurrences both SFE and ASIC received complaints. The complaints were generally due to frustrations as a result of being affected by the movement and to a greater extent the complainant not being aware of any SFE cancellation policy in relation to major market movements. Immediately after each incident SFE's Business Operations Derivatives referred the matter to Compliance and Surveillance and in each instance Compliance and Surveillance staff initiated a full and in depth investigation into the actions of various participants during the relevant trading sessions.

SFE's investigations concluded that the price movement occurred due to a combination of participants triggering stop-loss orders, the market at the time being illiquid as well as some participant traders not taking care in executing their orders. On completion of their investigation SFE found no evidence to suggest that orders were entered into SYCOM® specifically to achieve a spike in the market or to mislead the market. SFE did however write to several participants to remind them that in addition to acting in accordance with client instructions, participants have obligations not to disrupt the maintenance of a fair, orderly and transparent market.

ASIC reviewed all the material provided by SFE relating to each price movement and reviewed the procedures SFE has in place for trade cancellation. In each instance ASIC was satisfied that SFE made decisions in line with its internal procedures. However we were concerned by the lack of transparency and to some extent the possibility of potential inconsistent decision making in relation to these sort of situations and other error trade scenarios. During ASIC's interviews with SFE senior officers, it was acknowledged that the current cancellation trade policy had potential room for improvement, and that it was currently a case-by-case basis as opposed to a general framework articulating when trades would be cancelled.

SFE is developing a more comprehensive error resolution policy which should be finalised in the near future.