



ASIC

Australian Securities & Investments Commission

REPORT 62

Market assessment report: Sydney Futures Exchange Limited

November 2005



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C) report

**Sydney Futures Exchange Limited
ACN 000 943 377**

November 2005

Contents

Contents.....	2
Executive summary	3
Conclusions	3
Our approach	4
Form of this report	4
Section 1: Background	5
1.1 The SFE group	5
1.2 The assessment process.....	5
1.3 Focus of this assessment report.....	6
1.4 SFE responses and changes since our second assessment.....	7
Section 2: Conclusions and recommendations	9
2.1 Overall compliance.....	9
2.2 Observations and recommendations for future action	9

Executive summary

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

This report summarises ASIC's third 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.

Conclusions

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 progress in responding to the recommendations in our last report. We commend SFE in particular for:
 - commencing an internal review of the adequacy of disciplinary decisions made by the Markets Practices Committee (MPC) and the Business Conduct Committee (BCC);
 - implementation of a checklist that sets out all the necessary tasks to be undertaken (and any associated documentation required) prior to introduction of new products or initiatives;
 - changing its penalties structure for serious and repeat breaches of its operating rules; and
 - the establishment of a Group Compliance unit, whose objective is to monitor SFE's ability to meet its obligations on a consistent, timely and effective basis.

Further detail is set out at section 1.4 below.

3. The scope and number of issues raised in this report are reduced this year, but there are still some areas that we think need to be addressed. We have made recommendations in this report about:
 - the formalisation of agreements between SFE and its swap and bond dealer settlement price providers;
 - record keeping practices in relation to disciplinary decisions made by the BCC and MPC;

- the continued monitoring of resources available for SFE's supervisory functions; and
- the need for an organisation-wide document that encompasses the conflict handling arrangements of all of SFE's business units.

Further detail about these observations and recommendations is set out at section 2.2.

Our approach

Our formal assessment of licensed market operators has two aspects.

- *The historical aspect:* we use the assessment process to examine and report on the extent to which we consider a market licensee has, since our last assessment, met and is continuing to meet its supervisory obligations;
- *The future aspect:* we also use the assessment process to identify and comment on areas of suggested improvement, that have the potential to affect the market operator's ability 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 their 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.

Form of this report

In previous reports, we provided a detailed account of the role of individual SFE business units, identified areas where we thought a change in supervisory practice of the business unit may be needed, and made recommendations for further action.

This report concentrates on the main areas where we think SFE needs to make changes in the interests of continuing compliance with its supervisory obligations. Apart from those main recommendations, we comment only briefly on business units where we wish to acknowledge SFE's response to previous recommendations, or to suggest further action.

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 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 the first and second processes.

In conducting our assessment we have particularly considered:

- the annual regulatory report given to ASIC by SFE as required under s792F of the Act and covering the period 1 January 2004 to 31 December 2004;
- 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 most recent annual report;
- 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;
- comments made in interviews or discussions with a range of SFE personnel; and
- discussions with senior SFE management.

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. 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 recommendations. The key recommendations arising from that assessment were that SFE should:

- continue to actively monitor the level of resources available to the Compliance and Surveillance business unit to undertake its supervisory functions;
- undertake a review of the results of disciplinary actions and their effectiveness in enforcing compliance with the operating rules; and
- develop practices and procedures that identify the various stages of product development and establish the documentation requirements and regulatory outcomes at each stage.

Much of this assessment has involved a review of various changes made by SFE in response to the above issues.

We have reviewed the adequacy of the practices of those business units that have a direct supervisory function, or play a role in SFE's overall supervisory arrangements.

We also reviewed the process and procedures of the Legal unit, particularly in relation to their rule amendment processes and their interaction with other business units.

During this assessment we also reviewed the adequacy of SFE's processes leading up to the delivery cycle of its deliverable futures contracts.

We also considered the quality of the 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.

1.4 SFE responses and changes since our previous assessment

In our previous report we made a series of observations and recommendations about the adequacy of SFE's human resources in the Compliance & Surveillance business unit, disciplinary actions and their effectiveness in enforcing compliance with the operating rules and practices and procedures at various stages of product development. Some of these comments were relevant to the group as a whole while others were more specific to particular operational business units. SFE has undertaken a significant amount of work to improve its various arrangements. This process is ongoing and is having a positive impact on the effectiveness of SFE's supervision of its market in accordance with its obligations under s792(c) of the Act. Significant examples of changes since our last assessment are:

- the creation of a group compliance function that reports directly to the General Manager, Risk and Compliance as well as an indirect reporting line to the Corporate and Risk Management Committee;
- commencement of an internal review of the adequacy of disciplinary decisions made by the Markets Practices Committee (MPC) and the Business Conduct Committee (BCC);
- increases in severity of disciplinary action and fines (where warranted) against participants for significant breaches and for repeat breaches of the operating rules. SFE has also recently established a practice of naming participants who have been found to be breaching SFE's operating rules and in doing so have met and/or exceeded certain breach thresholds;
- implementation of process where all fines issued by Business Operations Derivatives unit (within the scope of that unit's powers) are referred to Compliance & Surveillance for notification to ASIC;
- creation of a database that captures and maintains details about the Trading Manager's use of discretionary powers in relation to trade cancellation and fines; and
- inclusion of clearing platform outages within the scope of public notification process of core system and platform outages.

SFE has made some other significant changes to ensure that its market continues to be fair, orderly and transparent, as described below.

Distribution and market access

On the back of substantial volume increases the SFE commenced planning of a proposed upgrade of all core participant access infrastructure in the second half of 2004. The implementation includes an upgrade of all the communication links to both the core production and business recovery sites in addition to a client infrastructure upgrade. Implementation commenced in October 2004 and will conclude during the second half of 2005.

Expiry oversight

Due to certain events and activities approaching and around the expiry of the December 2003 and March 2004 bond futures contracts SFE raised concerns regarding potential threats to the orderliness of its bond futures contract expiries. Combined with continuing growth in the size of the SFE's bond futures market and the activity occurring later in the expiry cycle (resulting in much larger and more concentrated futures holdings in the final trading days), the SFE was prompted to review its approach to market surveillance during bond contract expiries.

The SFE consulted and liaised with relevant regulators and government bodies regarding the ongoing level of physical bond issuance required to support the SFE's bond futures baskets and to maintain liquid and orderly derivatives markets. In addition the SFE introduced more formalised internal monitoring and reporting processes surrounding these contract expiries and also extended its procedures for market oversight to more effectively oversee (from a supervisory perspective) the rate of growth in the bond futures market activity and as a result, better manage the potential orderliness issues arising and thereby preserve long term confidence in ongoing market integrity.

SFE introduced expiry position concentration limits (EPCL) effective for the December 2004 and ongoing bond futures contracts expiries. The SFE's EPCL are limits which are applicable to the 3 year and 10 year Treasury bond futures contracts and are based solely on spot month net open positions at the end of the trading day prior to expiry and are enforceable intra-day over the remainder of the contract life. The EPCL are hard limits which apply to all market users on a 'level playing field' basis, although the SFE reserves the right to utilise its discretion regarding application of EPCL within a corporate group.

Section 2: Conclusions and recommendations

2.1 Overall compliance

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. No serious market failures or disruptions came to our attention during the course of our assessment. Subsequent to our assessment there have been several disruptions to the market as a result of system failures in a short space of time. ASIC and SFE are in discussions in relation to these disruptions and the system failures. We will look at these recent incidences in more detail during our next assessment of SFE.
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 generally sound;
 - SFE conducts ongoing supervision of its participants.
6. SFE has good market infrastructure (including technology) to support its obligations to maintain a fair, orderly and transparent market.
7. SFE demonstrated a strong commitment to educating participants in their obligations under the operating rules.
8. SFE actively shares information on supervisory matters with ASIC.

2.2 Observations and recommendations for future action

Notwithstanding our conclusion on overall compliance, ASIC believes SFE should make improvements to, or review, a number of specific arrangements for the operation and supervision of the market to ensure continued compliance with its obligations under the Act.

Some of these matters have been raised to varying degrees in our previous assessments. Accordingly, we indicated to SFE the need to give a higher priority to these improvements. We will continue to work with SFE in the implementation of our recommendations.

Formalised agreements with settlement price providers

During an operational audit conducted in 2004, SFE's Internal Audit identified the lack of written agreements between SFE and third party settlement price providers of the following products:

- 3 year and 10 year Australian Treasury bond futures and options contracts: and
- 3 year and 10 year interest rate swap futures contracts.

Although an informal agreement exists with price providers to provide bond and swap prices when contacted by SFE staff, there is no requirement to provide these prices at expiry of the relevant futures contracts. Internal Audit recommended that SFE should enter into formalised written agreements with the swap and bond dealers to increase the integrity of the process and to minimise potential problems with obtaining the prices in the future.

This recommendation was not implemented as some providers preferred to have informal agreements. However, 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. Providers are generally only removed from SFE's approved list by default (due to business mergers, cessation of service provision etc.). In addition, as part of the quarterly expiry preparation process, SFE staff validate ahead of time the ongoing availability of all settlement price providers.

Recommendation 1

ASIC agrees that SFE should formalise the current process through a written agreement between SFE and its panel of swap and bond dealer price providers. SFE has advised it agrees in principal with the recommendation and asserts that, wherever possible, SFE negotiates formal agreements for settlement price provisions. SFE has also advised that this matter is under further consideration as part of a project initiative examining various ways to further enhance the bond futures settlement process.

SFE asserts that in the meantime where a settlement price provider indicates their desire not to formalise an agreement, SFE will continue to pro-actively address the potential risk of failure of obtaining settlement prices by the procedures described above. We will continue to monitor the extent to which this issue is appropriately addressed.

Record keeping of supervisory committees

In our last assessment report, we recommended that the SFE introduce procedures requiring minutes taken at MPC and BCC meetings to:

- more fully reflect the discussion that takes place during the course of the meeting;
- include details of why a particular penalty is imposed; and
- indicate whether the recommendation of the Compliance and Surveillance staff member is being followed.

ASIC has reviewed documents held by SFE that relate to matters considered by the MPC and BCC for the period February 2004 to December 2004. There has been some improvement in the content of the minutes. A note is now included stating whether the recommendations of the Compliance and Surveillance staff member were followed, and whether publication of the name of the participant the subject of the disciplinary action was considered. However, ASIC remains of the view that the minutes prepared are still not reflective of the deliberations that take place or of the decisions made by the BCC or MPC.

Recommendation 2

In ASIC's view, the minutes 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. 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. The format of the minutes should be amended to include this information.

SFE has noted our recommendation, however SFE has advised that both the BCC and MPC are satisfied with the content and quality of minutes produced as being an accurate and substantive reflection of meeting discussions and decisions. ASIC will further review minutes of the BCC and MPC in its next annual assessment of SFE for the purpose of ascertaining that the minutes are of an appropriate standard.

Resources

In our previous report, we recommended that SFE should continue to monitor the level of resources available to the Compliance and Surveillance business unit to undertake its supervisory functions.

ASIC acknowledges that SFE has made a substantial effort in the cross training of staff between its various supervisory business units and has also been successful in employing experienced staff. However, staff turnover has the potential to impact on SFE's capacity to fulfil its supervisory obligations.

Recommendation 3

We recommend that SFE continues to closely monitor the level of available resources in its key supervisory business units.

SFE has noted our recommendation and advises that as a component of its business management framework, SFE continually monitors resourcing levels within all business units. ASIC will review this issue in the next annual assessment for the

purpose of assessing the level of resources deployed in its key supervisory business units.

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.

SFE has various arrangements that are intended to focus on avoidance of conflicts of interest, in preference to occurrence and management of conflicts. One of SFE's compliance arrangements is said to be 'value-related', through the espousal, sponsorship and promulgation of a core set of values and principles, to create an appropriate culture, environment and commitment. Another compliance arrangement is 'process-related' and constitutes organisational structures, policies and procedures, that aim to capture, codify, promulgate and implement the core set of values and principles.

Recommendation 4

ASIC has 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. 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. We suggest that Group Compliance be the business unit that develops and expands an SFE conflicts framework document to improve the identification of conflicts situations, and management of any identified conflicts.

SFE has noted our recommendations and advises that it has more formally codified its conflict handling arrangements between its commercial interest and its supervisory responsibilities into a single policy document available on SFE's intranet. ASIC will review this policy document as part of its next annual assessment of SFE.

Other matters

Group Compliance

SFE has established a Group Compliance function that reports directly to the General Manager, Business Risk with an indirect reporting line to the Corporate & Risk Management Committee.

The duties and responsibilities of Group Compliance are based on high level priorities ratified by the board. The need for a compliance function within SFE is in part driven by changes in market regulation (particularly under the Corporations Act and the RBA's Financial Stability Standards) and the desire by SFE to ensure compliance with the "spirit" and not just the letter of the law. The Compliance Policy, which has the approval of the board, seeks to ensure that SFE has established a compliance

framework that conforms to Australian Standard (AS3806–1998—Compliance Programs).

The Compliance Plan 2004 states that the core objective of the Group Compliance function is to identify and monitor SFE's ability to meet its obligations on a consistent, timely and effective basis. Group Compliance will achieve this objective by:

- designing and assisting in the implementation of a consistent compliance management framework that:
 - identifies SFE's relevant compliance requirements and outlines the risks associated with non-compliance
 - develops the compliance requirements into policies, standards and procedures
 - integrates compliance mechanisms onto SFE daily operations
 - ensures appropriate employee understanding and knowledge about compliance requirements
 - enables monitoring and reporting to ascertain the effectiveness of process
 - provides relevant regular reporting of SFE GC issues for appropriate oversight
- providing practical and commercial insight into compliance requirements
- 'champions' the development of a compliance culture that intrinsically integrates compliance into the fabric of daily business operations and activities
- enabling regular review of compliance mechanisms to ensure they remain relevant
- maintaining links with external bodies and conducting research in order to gain insight into emerging compliance requirements / issues
- analysing information that has been collected as a result of external links / research that provides insight that benchmarks SFE's compliance within the industry.

We believe that the creation of a Group Compliance role by SFE is a positive move. Given the short time that the unit has been operating, we will follow-up on the initiatives that Group Compliance intend to implement during a future assessment. We make no recommendations in this report for Group Compliance.

Legal unit

SFE's Legal unit (Legal) provides legal services to support the business and corporate functions of the group and the licensed entities within it, with particular responsibility for supporting business development by obtaining the necessary approvals from regulators, corporate governance, and company secretarial matters.

The Legal unit's involvement in matters pertaining to SFE's licence obligations is generally confined to provision of internal advice associated with the exercise of powers by disciplinary committees, assistance with negotiation of agreements relating to the operation of markets or particular financial instruments and drafting of amendments to operating rules.

During our assessment we took the opportunity to better understand the process undertaken by SFE in relation to operating rule changes. We reviewed policies and procedures relating to rule changes and files covering rule changes for each licensee as well as interviewing senior legal personnel.

The procedures and practices in place in relation to the rule change process appear to be adequate. We make no recommendations in this report for Legal.

Deliverable futures contracts

During the assessment period SFE identified a potentially serious issue relating to a particular Greasy Wool futures contract expiry. SFE initiated an investigation to identify whether any of its participants were in breach of either its operating rules or the Act. As there was no evidence that any breaches occurred there was no action taken in relation to the particular matter.

As part of our assessment we took the opportunity to review the adequacy of SFE's processes leading up to the delivery cycle of its deliverable contracts and in particular the Greasy Wool futures contract.

SFE advised that approaching expiry of the deliverable Greasy Wool futures, it reviews the participants and users in the market and the positions held by those participants and users with regard to their previous history with deliveries. Approaching expiry, SFE will also investigate the amount of physical deliverable wool that passes through the various auction centres. SFE also monitors the futures price in comparison with the physical. If the prices do not appear aligned, SFE makes further enquiries about the reasons for any anomalies.

ASIC believes that at the time of our assessment SFE had adequate arrangements and resources in place to monitor both the deliverable futures contracts and the underlying product approaching delivery. We make no recommendations in this report in relation to processes undertaken by SFE approaching the delivery period for SFE's deliverable futures contracts.