



ASIC

Australian Securities & Investments Commission

REPORT 57

**Market assessment report:
ASX Settlement and Transfer
Corporation Pty Limited /
Australian Clearing House
Pty Limited**

September 2005



ASIC

Australian Securities & Investments Commission

Annual assessment (s823C) report

**ASX Settlement and Transfer
Corporation Pty Limited
ACN 008 504 532**

**Australian Clearing House Pty
Limited
ACN 001 314 503**

September 2005

Contents

Executive summary	3
How we conducted the assessment.....	3
Compliance by ASTC and ACH.....	3
Section 1: Background	4
1.1 The ASX group.....	4
1.2 The split of the National Guarantee Fund.....	4
1.3 The assessment process	5
Section 2: Observations and recommendations	8
2.1 Overall compliance	8
2.2 Observations	9
2.3 Recommendations.....	10

Executive summary

Australian Clearing House Pty Limited (ACH) and ASX Settlement and Transfer Corporation Pty Limited (ASTC) hold licenses to operate clearing and settlement facilities (CS facility licences). ASTC and ACH are both wholly owned subsidiaries of Australian Stock Exchange Limited (ASX).

This report summarises ASIC's assessment under s823C of the *Corporations Act 2001* (Act) of the compliance by ACH and ASTC with their obligations under s821A(c) of the Act.

How we conducted the assessment

In conducting this assessment, ASIC:

- interviewed ASX group personnel;
- reviewed policies and procedures relating to the conduct of ASTC and ACH's CS facilities;
- reviewed extensive material provided to ASIC by ASX, ACH and ASTC under the *Australian Securities and Investments Commission Act 2001* (ASIC Act); and
- considered the annual regulatory report given to ASIC by ASTC and ACH pursuant to s821E of the Act.

Compliance by ASTC and ACH

In ASIC's view, ASTC and ACH each has adequate arrangements for supervising its respective clearing and settlement facility, including arrangements for:

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

Section 1: Background

1.1 The ASX group

ASX currently holds an Australian Market License (AML) that permits it to operate a market in the financial products listed on its license. Two of its wholly owned subsidiaries, ASTC and ACH, hold CS facility licences.

Following the restructure of the clearing and settlement arrangements within the ASX group in 2004, ACH now provides all clearing services and ASTC provides all settlement services, for transactions entered into on the market operated by ASX.

The infrastructure and services that support the operation of ASTC and ACH's clearing and settlement facilities are largely provided through ASX Operations Pty Limited (ASXO), another wholly owned subsidiary of ASX. ASXO provides operational resources to ACH and ASTC using common staff and infrastructure.

1.2 The split of the National Guarantee Fund

The National Guarantee Fund (NGF) is a fund administered by Securities Exchanges Guarantee Corporation Limited (SEGC). In March 2005, the Minister made a direction to SEGC pursuant to section 891A of the Act to transfer certain funds in the NGF to ACH. The transfer of the funds facilitated ACH's ability to comply with the Reserve Bank of Australia's (RBA) financial stability standards for central counterparties (RBA standard), which is currently \$110 million

In conjunction with this payment, the responsibility for providing clearing support was also transferred from the NGF to ACH. To this end, it is a condition of the Minister's direction (and a condition of ACH's amended CS facility licence) that the funds transferred from the NGF to ACH can be used only for this purpose.

To further assist ACH in meeting clearing losses, amendments were made to the ACH Clearing Rules that allow ACH to seek funds from participants in certain circumstances.

One circumstance in which ACH may seek funds from participants according to these amendments is where one or more clearing losses have exhausted all the money transferred to ACH from the NGF (pursuant to the direction made by the Minister under section 891A of the Act), ACH's liquid assets and any insurance recoveries. Based on the current RBA standard, this would mean that a clearing loss or losses would need to be at least \$110 million.

A further circumstance in which ACH may seek funds from participants according to these amendments is where there has been a clearing loss, but the final sum of the clearing loss is not yet known. Where funds are obtained in this

circumstance and the final loss or losses do not exhaust all the sources of money referred to above, ACH is obliged to repay the funds to participants.

These amendments also limit (or "cap") the amount of funds ACH can seek from an individual participant, and from participants overall, in relation to a clearing loss or losses. This cap is calculated as a percentage of the prevailing RBA standard.

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.*

Pursuant to section 823C of the Act, the RBA must assess whether a CS facility licensee is complying with its obligations under section 821A(aa) of the Act. The annual assessments by ASIC and the RBA are completed independently.

Conduct of ASIC assessment

The ASX group is structured so that the same business units perform functions relating to the operation and supervision of the markets operated by ASX and the clearing and settlement facilities operated by ASTC and ACH.

This report only covers the activities of these business units in so far as they relate to the operation of the clearing and settlement facilities.

ASIC has reviewed the work and work practices of the relevant business units to assess the level of compliance by ASTC and ACH with their obligations under section 821A(c) of the Act. Our inquiries focused on operations, risk management and supervisory practices and also used information obtained during our assessment of ASX as a market licensee.

The following individual business units were reviewed:

- Clearing and Settlement Operations;
- Risk Management;
- Compliance Services; and
- Investigations and Enforcement.

ASIC also:

- analysed information available from external sources, including information from international regulatory bodies and reports published by ASX;
- had regard to the publications and recommendations made by the Joint Task Force on Securities Settlement Systems of the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO);
- analysed information we received from and about ASTC and ACH in the ordinary course of our dealings with each of them as CS facility licensees, including information received as part of the ACH and ASTC restructure process and the most recent annual regulatory reports provided by these entities;
- interviewed key staff with operational and supervisory responsibilities;
- reviewed internal ASTC and ACH material, including disciplinary and investigation files, internal reports and information collected by ASTC and ACH on a continuous basis; and
- noted the report prepared by RBA on its assessment under section 823CA(1) of the Act.

ANNUAL ASSESSMENT (s823C) REPORT—ASTC AND ACH

ASIC has discussed the results of this review with ACH and ASTC and has sought its comments on both the factual matters and conclusions set out in this report.

Section 2: Observations and recommendations

2.1 Overall compliance

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

ASIC's conclusion is based on the following observations:

- key management and staff responsible for the operation and supervision of the clearing and settlement facilities demonstrate a high level of operational expertise. This view is supported among other things by:
 - the competence, knowledge and expertise of personnel involved in operating the clearing and settlement facilities;
 - the very high operational reliability of the facilities; and
 - the absence of any significant supervisory issues from 1 July 2003 to 30 June 2004;
- ACH and ASTC have good and reliable technology in place that enable them to provide a fair and effective clearing and settlement facility. There were no serious facility failures or disruptions during the period covered by this assessment;
- ACH and ASTC are active and vigilant in financial risk management. Operational personnel and management involved in risk management are knowledgeable and experienced and demonstrate a commitment to sound risk management practices;
- ACH and ASTC 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
- operational files on supervisory decisions that we reviewed demonstrated that decision-making on supervisory matters generally follows sound procedures, and that ASTC and ACH actively pursue breaches of their operating rules and conduct ongoing supervision of their participants.

2.2 Observations

Management of risk

The risk management functions of ACH and ASTC are housed within the Risk Management business unit. These functions deal with both prudential and clearing issues.

Prudential risk management (PRM)

The PRM team is part of the Risk Management business unit and ensures that ASX participants, who assume market risk, and ACH participants, who assume counterparty risk, meet risk-based capital liquidity requirements.

ASX participants must meet the capital requirements of ASX Market Rules as set out in Rule 1A (a risk based capital requirement). ACH participants must meet the capital requirements of the ACH Clearing Rules. ACH participants are required under the ACH Clearing Rules to comply with either the risk based capital requirements, net tangible asset requirements or "other" capital requirements.

ASTC participants, who are not also ASX or ACH participants, are required to lodge performance bonds. The Compliance Services business unit monitors settlement participants' compliance with the bond requirements.

Clearing Risk Management (CRM)

The CRM team is also part of the Risk Management business unit and manages the counterparty risk that ACH accepts as central counterparty to the transactions that it clears. ACH's counterparties are participants that clear trades and therefore its risk management activities only cover ACH participants.

CRM focuses on monitoring the risk profiles of ACH participants, monitoring the ability of these participants to meet margin payments, and calculating daily margins for every client of a participant.

Structural change

Since ASIC's last assessment of ASTC and ACH, a major change in the reporting structure and decision making responsibilities has taken place with the creation of the ASX Supervision division. Most notably, the Compliance Services business unit, responsible for promoting and supervising compliance by participants with the ASX, ACH and ASTC rules and applicable law, became part of (and reports to) this new division.

In ASX's view, this structural change has the major benefit of creating a clear separation between the commercial and regulatory functions of ASX group licensees, which is now more readily recognised by participants. It was also noted that the change has had functional benefits for supervision of the ASX group

licensees generally, as there has been an improvement in the interaction between the supervisory units (i.e. Compliance Services, Investigations & Enforcement and Surveillance) now housed together within the Supervision division.

2.3 Recommendations

Based on the material available to ASIC at the time of this assessment, ASIC has no recommendations to make in relation to the clearing and settlement facilities operated by ACH or ASTC.

However, ASIC notes that in response to its recommendations in its previous assessment, the Risk Management business unit has introduced a "risk development function" to review policies and procedures relating to CRM to ensure that they take account of global developments in risk management practices and respond to any changes in the Reserve Bank of Australia's Financial Stability Standards. ASIC will review the effectiveness of this new function in due course.