



ASIC

Australian Securities & Investments Commission

REPORT 44

**Market assessment report:
ICAP Europe Limited**

June 2005



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C) report

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Executive summary

This report is an assessment of compliance by ICAP Europe Limited (IEL) with its obligations under s792A(c) of the *Corporations Act 2001* (Corporations Act). IEL is licensed to operate the financial market known as Fra-cross in this jurisdiction. IEL is regulated in this jurisdiction by ASIC under Part 7.2 of the Corporations Act. However, IEL's primary or "home" regulator is the Financial Services Authority (FSA) in the United Kingdom, from where Fra-cross is operated.

Section 794C of the Corporations 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 IEL, covering the 12-month period to December 2004.

Background

IEL operates a market in Australia that allows participants to realign their interest rate risk in relation to their respective forward rate agreement (FRA) portfolios. The system matches opposing FRA positions of participants. The contract formed between matched participants is a FRA. The participants in the market are wholesale participants who deal on their own accounts—i.e. there is no retail participation. Settlement of trades occurs directly between participants outside the system.

IEL was granted an Australian market licence under s795B(2) of the Corporations Act on 23 December 2003. Section 795B(2) lists alternative criteria for granting a market licence to an overseas-based operator, including 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 home regulator of that market.

IEL operates the market out of the United Kingdom and is authorised and regulated by the FSA there.

Section 794C(2) requires that ASIC conduct an annual assessment of IEL with respect to the adequacy of its arrangements for supervising the market. In conducting this assessment, we examined information from a range of sources including from IEL, FSA and information held by ASIC.

Observations and recommendations

As a result of our assessment of IEL, ASIC is satisfied that IEL 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.

With regard to some other obligations, specifically the requirement to lodge certain documents and information with ASIC in a timely manner, we note that during 2004 we were becoming concerned that IEL was either unaware of its obligations as a market licensee, or was unwilling to comply with those obligations. However, since then IEL has assured ASIC that those obligations have become part of its overall compliance monitoring program. To this end we note that IEL has lodged recent reports and notifications in compliance with its obligations.

Section 1: Background

1.1 IEL and the market

IEL was granted an Australian market licence on 23 December 2003. The licence permits IEL to operate its market, known as Fra-cross, in this jurisdiction. ASIC is responsible for regulating the market in this jurisdiction under Part 7.2 of the Corporations Act.

Fra-cross is an electronic matching system in FRAs. Global participation in the market is restricted to wholesale investors, typically banks or insurance companies, which act as principals in their dealings on the market. All Australian participants must be Australian authorised deposit taking institutions regulated by the Australian Prudential Regulation Authority.

Fra-cross enables interest rate swap and FRA traders to efficiently hedge their reset risk generated from the daily trading of derivatives. That is, it allows participants to realign interest rate risks caused by timing differences in the settlements of their FRA positions.

To use the system, participants input their FRA positions for particular dates into Fra-cross. IEL calculates and displays on Fra-cross an interest rate yield curve, based on prevailing market rates, which effectively sets the prices for any subsequent trades. The yield curve is fixed approximately half an hour before each matching 'run' allowing participants to check the interest rates that will be used in the ensuing run. This permits a participant to remove any of its positions if it finds any of the fixed interest rates unacceptable. The system then attempts to match the remaining positions in the system. A match on the system results in a FRA between the matched participants.

Participants control their credit risk exposures by specifying counterparty trading limits. Participants are responsible for settling trades with their trade counterparties in accordance with International Swaps and Derivatives Association (ISDA) documentation.

The market is not a major public market and operates as a closed system in accordance with the market rules and procedures. There were six Australian participants of the market as at September 2004.

Regulation of IEL

Fra-cross has been operating in the United Kingdom since January 2002. IEL is subject to the supervision and regulation of FSA in the United Kingdom. IEL is permissioned under the Alternate Trading Systems regime of the FSA (discussed further in section 2.2 below).

All trades concluded through Fra-cross are subject to UK laws, regulations and market conventions.

IEL's market licence was granted under s795B(2) of the Corporations Act, which lists alternative 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 and the home regulator of that market.

In granting the market licence to IEL, it was determined that the regulatory regime of the United Kingdom is sufficiently equivalent to the Australian regulatory regime in terms of investor protection and market integrity outcomes for a market of the type of Fra-cross.

While IEL is required to comply with each of its obligations under the Corporations Act and any conditions imposed on its licence, ASIC necessarily relies to some extent on the regulation of IEL and Fra-cross undertaken by FSA to be satisfied that IEL is complying with its Australian obligations.

In this regard we note that ASIC has an effective cooperative relationship with FSA under a memorandum of understanding entered into by ASIC and FSA dated 24 June 2002. ASIC and FSA are also signatories to the IOSCO Multilateral Memorandum of Understanding.

1.2 The assessment process

Notwithstanding our reliance on the home regulator to ensure that investor protection and market integrity issues are regulated, ASIC also undertakes an annual assessment under s794C(2) of the Corporations Act to determine whether a licensee complies with its obligations in s792A(c) of the Corporations Act relating to supervision of the market.

Our reliance on the home regulator is in part necessity, due to the geographical restrictions of the market facility being located in another country, and to minimise duplicity of regulation.

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 Ch 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 IEL was based on information that ASIC had at hand, and information obtained from IEL and from FSA. An ASIC staff member was also afforded an opportunity to visit IEL's London office while in the United Kingdom.

Specifically, in conducting our assessment under s794C, we:

- analysed information received from and about IEL in the ordinary course of our dealings with IEL;
- reviewed IEL's most recent annual report, IEL's annual regulatory report under s792F, and a six-monthly market report under s9 of IEL's market licence;
- sought additional information from IEL for the purpose of this assessment;
- interviewed IEL's compliance officer and other staff;
- obtained information from the FSA about the market and IEL; and
- also considered how well IEL might comply with its obligations in the future.

Section 2: Observations and Recommendations

ASIC is satisfied that IEL has and will continue to comply with its obligations under the Corporations Act. Section 2.1 addresses our requirement under s794C(2) to assess the adequacy of IEL's supervisory arrangements. Section 2.2 discusses other areas of compliance that were noted during the assessment period.

2.1 Supervision of the market

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

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

1. In its application for an Australian market licence, IEL 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 evidence by, the granting of IEL's market licence.
2. IEL 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. FSA confirmed that it had no concerns with IEL's supervision of Fra-cross.
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 Corporations Act requires that IEL 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.

IEL's arrangements include a written compliance policy for handling conflicts between IEL and its participants, and between a participant and another participant. The compliance department of IEL is responsible for ensuring that compliance with the policy is followed within the firm.

Monitoring the conduct of participants

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

The inputs used to develop the yield curve that then form the basis for matching prices in the Far-cross market are predetermined by IEL and are obtained from recognised independent sources. All participants can view the prices at which they will be dealing before they enter into a transaction. If a participant does not like the rates, it can remove its orders from the system prior to the matching run. Orders remaining in the system will be matched in accordance with a non-discretionary trading algorithm.

As a result, the conduct of participants in the system has no effect on the prices of trades concluded via Fra-cross. That is, trades concluded through the system are based on independent pricing that cannot be manipulated because participants are not able to negotiate the rates at which they trade and can only decide to take part in a matching run or withdraw all or part of their interest.

In addition, the Fra-cross user agreement contains provisions that:

- (a) require participants to participate in the market as principal only;
- (b) relate to system access, codes and security; and
- (c) make participants responsible for completing and documenting trades with counterparties on the basis of ISDA documentation.

Enforcing compliance with the market's operating rules

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

The user agreement entered into by IEL and each participant granting each participant access to the system constitutes the operating rules of the market for the purposes of the Corporations Act. The user agreement gives IEL powers to enforce breaches of the agreement, including giving IEL the right at any time to withdraw, suspend or modify the availability of all or part of the system in its absolute discretion with or without notice to a participant.

2.2 Other observations

Obligations to notify ASIC

IEL has a number of ongoing obligations under the Corporations Act, including when and in what circumstances it must lodge documents or

notify ASIC of specified events. In a number of instances, outlined below, ASIC noted that a pattern of non-compliance might have been developing regarding reporting and notification obligations. Particularly, a number of documents and notifications were lodged late and not until after being prompted by ASIC. We became concerned that IEL had not made itself fully aware of each of its obligations as a market licensee and took the opportunity to raise this in our discussions with IEL.

To allay this concern, IEL noted in its annual regulatory report that it had now incorporated its various licensee obligations into IEL's overall compliance monitoring program. Since then we have noted that notifications and reports have been lodged in a timely manner.

Regulation of Fra-cross in the United Kingdom

During the assessment period IEL notified ASIC under s792B(4)(b) of the Corporations Act that there had been some changes to the regulation of Fra-cross by FSA. FSA introduced the ATS regime in April 2004 under which Fra-cross sought and received additional approval. The requirements FSA imposed are listed in the Appendix to this report. The more significant of those are:

1. *Fair and orderly trading*—IEL must have appropriate arrangements, having regard to, among other things, the nature of the system, financial products traded and the market participants, in place designed to ensure:
 - (a) efficient pricing and the equitable treatment of users;
 - (b) a trading methodology that enables fair and orderly trading; and
 - (c) that sufficient information about quotes, orders and completed transactions is made available to users.
2. *Timing of publication*—Information about quotes, orders and transactions should be made available in a timely manner.
3. *Monitoring of trading*—IEL must have appropriate arrangements in place that enable it to monitor transactions undertaken on Fra-cross to identify suspected breaches of any rules relating to fair and orderly trading on Fra-cross and conduct that may constitute market abuse, and report suspected material breaches to the FSA.

We note that s792B(4) of the Corporations Act requires a market licensee to notify ASIC as soon as practicable if there is a significant change to the regulatory regime applying in relation to the market in the home country. IEL notified ASIC of the imposition of the ATS regime on 26 November 2004, nearly eight months later, after being prompted by ASIC.

However, IEL submits that it did not consider the introduction of the ATS regime to be a significant change to the regulatory regime applying to IEL in the United Kingdom because it believed the requirements imposed under the ATS regime already applied to it under the FSA's regulatory regime in another form.

As part of its assessment of IEL, ASIC sought information from FSA about FSA's regulation of IEL during the assessment period. FSA informed ASIC that nothing had come to its attention that caused it any concerns that might have a bearing on the operation of Fra-cross in this jurisdiction. FSA also confirmed that IEL's permission was varied with effect from 1 April 2004 by the imposition of the ATS requirements as outlined above.

Reporting obligations

Annual regulatory report

IEL lodged its s792F annual regulatory report for the period 23 December 2003 to 31 March 2004 with ASIC on 26 November 2004.

ASIC notes that this report should have been lodged by IEL on or before 30 June 2004. The delay in lodging the report is in part due to a misunderstanding on behalf of IEL and of ASIC about the correct reporting period and consequently, the date the report was due. IEL has since undertaken to ensure that all future regulatory reports are lodged within the required time.

Reports required by licence

Section 9 of IEL's market licence requires IEL to lodge with ASIC a report each six months that provides information about the volumes traded on Fra-cross in Australia and globally, and lists all Australian participants. IEL lodged its first s9 report for the period 1 April to 30 September 2004 on 26 October 2004, within the required period for lodgment.

IEL name change

On 24 August 2004 IEL informally notified ASIC that it had changed its name from Intercapital Europe Limited to ICAP Europe Limited. ASIC advised IEL on 26 August 2004 that it must formally notify ASIC of the change under Part 5B.2 Division 2 of the Corporations Act. IEL was also advised that it should lodge an application seeking to have its market licence varied to take account of the change in name in accordance with s797A(1) of the Corporations Act.

After an extensive delay, ASIC received the relevant notifications and application on 1 March 2005. ASIC's companies register was amended

on 10 March 2005, and the Minister varied IEL's licence on 11 May 2005.

System outages

IEL notified ASIC on 17 December 2004 that the Australian dollar run on Fra-cross scheduled for 30 November 2004 was cancelled. The cancellation was due to market volatility and not a result of system failure. Clause 6 of the Fra-cross user agreement gives IEL the power to abort a run at any time, including in unusually volatile market conditions. The cancellation of a matching run in such circumstances is in keeping with the obligation to run a fair, orderly and transparent market.

The following run on 14 December 2004 took place without incident.

Appendix

The FSA imposes the following requirement on IEL as operator of financial markets under its ATS regulatory regime. The requirements to a large degree reflect the regulatory outcomes that the Corporations Act and ASIC policy set out to achieve for this type of financial market. IEL's permissions, including its ATS requirements, are available on the FSA's website (www.fsa.gov.uk). IEL's ATS requirements are as follows:

1. ***Fair and orderly trading***—The firm must, in relation to the operation of an ATS, have appropriate arrangements in place designed to ensure: (a) efficient pricing and the equitable treatment of users; (b) a trading methodology that enables fair and orderly trading; and (c) that sufficient information about quotes, orders and completed transactions is made available to users.
2. ***Timing of publication*** (1) For the purposes of requirement 1, information about quotes, orders and transactions should be made available in a timely manner. In particular, information should be made available to users close to the time when the quote or order is given or the transaction is executed. Information may be made available to persons other than users with a reasonable delay. (2) The firm may make information about a large order, quote or transaction available to users under requirement 1 at a time later than that specified in (1), but only to the extent reasonably necessary to protect the interests of the relevant user who placed the order, gave the quote or executed the transaction.
3. ***Monitoring of trading*** (1) The firm must, in relation to the operation of an ATS: (a) have appropriate arrangements in place that enable it to monitor transactions undertaken on the ATS to identify suspected breaches of any rules relating to fair and orderly trading on the ATS and conduct that may constitute market abuse; (b) report suspected material breaches of its rules relating to fair and orderly trading on the ATS or suspected market abuse to the FSA and other appropriate organisations; and (c) supply relevant information to the FSA as soon as practicable regarding the suspected breaches or suspected market abuse and provide full assistance to the FSA in investigating the suspected breach or suspected market abuse. (2) The functions referred to in (1) may be performed by the firm itself or by another person (such as the operator of a regulated market for the particular investment) under a formal arrangement with the firm. (3) In (1), "rules" includes protocols, procedures or terms of, or established under, any agreement between the firm and a user.
4. ***Meaning of "appropriate arrangements"*** In requirements 1 and 3, "appropriate" means appropriate having regard to the nature of the

system, the nature and liquidity of investments traded on the system, the experience of users, the extent to which the wider market in the particular investment involves private customers, and the significance of the system in the overall market for the investment and, also in relation to requirement 3, the susceptibility of the investment traded to market abuse.

- 5 ***Access to sufficient publicly available information*** (1) The firm must, in relation to the operation of an ATS, provide, or be reasonably satisfied that there is publicly available, sufficient information to enable users who are customers to make a reasonably informed judgement about the value of each investment traded on the system and the risks associated with that investment. (2) In (1), "sufficient" means sufficient taking into account the nature and experience of users of the system who are customers and the type of investment traded on the system. (3) For the purposes of (1), if an investment is admitted to trading on an Recognised investment exchange, a regulated market or an European Economic Area commodities market (and is not suspended from trading on the RIE or market), the firm may be reasonably satisfied that there is publicly available sufficient information about that investment to enable users who are customers to make a reasonably informed judgement about the investment.
- 6 ***Interpretation*** An expression in these requirements which is defined in the Glossary forming part of the Financial Services Authority's Handbook of rules and guidance has the same meaning in these requirements.