



ASIC

Australian Securities & Investments Commission

REPORT 26

**Market assessment report:
Sydney Futures Exchange
Limited / SFE Corporation
Limited**

November 2003



ASIC

Australian Securities & Investments Commission

Annual assessment (s794C) report

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

**SFE Corporation Limited
ACN 000 299 392**

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Contents

Executive summary	3
How we conducted the assessment.....	3
Compliance by Sydney Futures Exchange Limited	4
Compliance by SFE Corporation Limited.....	4
Key observations and recommendations	4
1.1 The SFE group	6
1.2 Section 794C	7
1.3 Policy Statement 172	7
1.4 SFE report under s792F	9
1.5 The assessment process	9
 Section 2: Observations and recommendations .	10
2.1 Overall compliance	10
2.2 Ongoing work	10
2.3 Other issues.....	16
A1 Trading Operations.....	17
A2 Compliance & Surveillance (C&S).....	20
A3 Technology	24
A4 Legal	25
A5 Participant & Client Services (P&CS)	26
A6 Internal Audit (IA)	27
A7 Finance	30
A8 Strategy & Business Development (S&BD).....	31

Executive summary

This report summarises ASIC's assessment of compliance by Sydney Futures Exchange Limited and SFE Corporation Limited with their obligations under s792A(c) of the *Corporations Act 2001* (Act). SFE will be used in this report to refer to both licensed entities simultaneously. This is the first assessment since amendments introduced by the *Financial Services Reform Act 2001* (FSR Act) came into effect on 11 March 2002.

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

How we conducted the assessment

In conducting our assessment, we:

- reviewed policies and procedures for the conduct of SFE markets in general and their supervisory responsibilities in particular;
- evaluated information SFE provided to us on an ongoing basis as required by the Act;
- attended SFE offices and interviewed SFE group personnel; and
- examined extensive material obtained under the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

We also considered a draft version of the annual regulatory report to be given to ASIC by SFE as required under s792F of the Act. This section requires a market licensee to provide ASIC with an annual report on the extent to which the licensee complied with its obligations as a market licensee within three months after the end of its financial year. ASIC would like to acknowledge the assistance of SFE in providing a draft version of its report on 17 February 2003 to assist in our on-site visit.

SFE subsequently provided ASIC with the final version of its annual regulatory report on 27 March 2003. We have considered the contents of the final report in preparing this assessment.

While this is the first annual regulatory report produced by SFE under s792F of the Act, previous reports had been provided under a Deed between ASIC and SFE. The contents of such reports outlined the extent to which SFE had complied with requirements contained in the Deed, which were similar to those now contained in s792A of the Act.

We also considered how well SFE might comply with its obligations in the future. For more details about the assessment process, see Section 1.

Compliance by Sydney Futures Exchange Limited

In ASIC's view, Sydney Futures Exchange Limited 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.

Compliance by SFE Corporation Limited

In ASIC's view, SFE Corporation Limited had 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.

ASIC notes that as of May 2002 SFE Corporation Limited ceased to operate a market.

Key observations and recommendations

In Section 2 of this report, we summarise observations from our assessment. We also include some recommendations for SFE designed to assist SFE's own evaluation of compliance with its obligations as a market licensee and facilitate future ASIC assessments.

In our view, these matters do not cast doubt on SFE's current compliance, or indeed its likely ability to comply with its obligations during the next 12 months. Rather, they identify areas we will continue to discuss with SFE and expect to focus on during our next assessment.

Our key recommendations are that SFE:

- reviews the reporting of open interest positions and considers the need for more prescriptive rules in participant position reporting;
- considers the balance of enforcement activities between minor or technical breaches and more targeted or risk-based activities;
- improves record-keeping on regulatory decisions, particularly concerning the exercise of discretionary powers;

- develops clear escalation processes for penalty imposition where circumstances warrant; and
- considers the implications of changes in its regulatory scope to the activities of supervisory areas.

Section 1: Background

1.1 The SFE group

On 11 September 2000, SFE demutualised under a scheme of arrangement and became a public company limited by shares.

From 1 November 2000 to 15 April 2002, an exempt market for SFE shares was operated by Austock Management Limited (Austock).

On 16 April 2002 the listing of SFE shares moved from Austock to the Australian Stock Exchange (ASX). The main reason given for the ASX listing was to provide shareholders with the ability to more freely trade their SFE shares in a higher profile, more liquid and transparent market.

Under SFE's Constitution, a person is not permitted to hold more than the amount of voting power which is permitted by law. At present, the limit on the holding of the voting power in SFE is 15%.

At the time of our assessment the SFE group held two Australian market licences under s795B of the Act:

- one issued to Sydney Futures Exchange Limited covers the operations of SFE's futures and options markets other than wheat and sorghum contracts; and
- the other issued to SFE Corporation Limited covered the operations of SFE's wheat and sorghum markets.

SFE made a commercial decision to discontinue with the provision of a market for wheat and sorghum. Accordingly, the market operated by SFE Corporation Limited was primarily concerned with the closeout and settlement of open positions in these contracts. The last of the open positions in these contracts expired in May 2002 and consequently SFE Corporation Limited ceased to operate a market at this time.

The supervisory resources of SFE were provided on a group-wide basis using common staff and infrastructure. Therefore, our assessment, and this report, covers our simultaneous assessment of the adequacy of supervisory arrangements of both market licensees. However, due to the limited nature of trading activities undertaken in the markets provided by SFE Corporation Limited, and the common approach to supervisory activity across both licensees, our assessment concentrated on the supervisory activities and resources as they applied to the markets provided by Sydney Futures Exchange Limited.

1.2 Section 794C

The FSR Act, which came into effect on 11 March 2002, requires ASIC to conduct an annual assessment of each Australian market licensee. Section 794C of the Act says:

- “(1) ASIC may do an assessment of how well a market licensee is complying with any or all of its obligations as a market licensee under this Chapter. 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 792A(c), ASIC must do such an assessment at least once a year for each market licensee.*
- (3) As soon as practicable after doing an assessment under this section, ASIC must give a written report on the assessment to the licensee and to the Minister.”*

Paragraph 792A(c) states that a market licensee must:

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

- (i) handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market operates in the way mentioned in paragraph (a); and*
- (ii) monitoring the conduct of participants on or in relation to the market; and*
- (iii) enforcing compliance with the market’s operating rules;”*

Paragraph 792A(a) states that a market licensee must:

“... to the extent that it is reasonably practicable to do so, do all things necessary to ensure that the market is a fair, orderly and transparent market;”

1.3 Policy Statement 172

Our assessment is based on Policy Statement 172 *Australian market licences: Australian operators* [PS 172], which sets out what ASIC believes Australian market licensees should do to ensure compliance with their obligations. We issued [PS 172] on 6 March 2002 after extensive consultation with existing market operators.

It is important to note that:

- this is the first assessment of Sydney Futures Exchange Limited and SFE Corporation Limited as Australian market licensees;

- [PS 172] was only issued in March 2002; and
- s792A did not come into effect until 11 March 2002.

While market licensees may be moving towards practices that more closely meet the guidelines in [PS 172], we accept that it will take some time. We therefore applied the guidelines flexibly to take into account both the new obligations and, in particular, the long-standing practices of established licensees.

[PS 172.71] states that:

“Generally, a market licensee will best be able to ensure continuous compliance — and report on the extent of its past compliance for the annual report ... — if it actively plans:

- (a) what it will do to ensure compliance; and*
- (b) how it will monitor and assess its compliance.*

We think that such planning is especially important to ensure compliance with the supervisory obligation.”

[PS 172.86] addresses how ASIC will assess Australian market licensees’ compliance with their supervisory obligations:

“In assessing how well a market licensee is complying with its obligation in s792A(c) to have adequate arrangements for supervising the market, ASIC will consider how the market licensee:

- (a) handles conflicts of interest;*
- (b) monitors the conduct of participants;*
- (c) monitors trading and other market activity and (if relevant) disclosure by listed entities, to detect potential or actual non-compliance with the law or the market’s operating rules;*
- (d) deals with actual or suspected breaches of the law or the market’s operating rules, including remedial, disciplinary and other deterrent measures;*
- (e) deals with complaints about the market or participants;*
- (f) shares supervisory responsibilities and information with:*
 - (i) us; and*
 - (ii) operators of other markets and clearing and settlement facilities that have the same participants as the market licensee; and*
- (g) makes available and uses resources for conducting supervisory activities.*

Because a market licensee’s obligations are ongoing, ASIC will consider a market licensee’s likely future compliance with its obligations as well as its past and current compliance. We will not determine whether a market licensee is likely to comply in the future merely by reference to its past compliance.

1.4 SFE report under s792F

As previously noted this was the first report prepared by SFE under s792F of the Act, but previous annual regulatory reports, outlining similar self-assessment of compliance, have been prepared and discussed with ASIC.

SFE has clearly taken account of the recommendations made by ASIC about previous reports and has presented a considered analysis of the extent to which the SFE supervisory structure and activities represent compliance with its market license obligations.

ASIC would encourage SFE to consider the potential for future reports to contain greater detail outlining the adequacy of resources devoted to supervisory, as distinct from operational, activities.

1.5 The assessment process

In conducting our first assessment of SFE under s794C, we:

- analysed information we received from SFE in the ordinary course of our dealings with each entity as a market licensee, including:
 - information received as part of the rule amendment process;
 - referrals of serious contraventions;
 - statutory notifications;
 - liaison meetings and general correspondence;
 - SFE's most recent annual report; and
 - a draft of SFE's annual regulatory report under s792F;
- analysed information from external sources, including media commentary and reports published by SFE;
- interviewed key SFE staff with supervisory responsibilities; and
- reviewed internal SFE material, including policy and procedures manuals, investigation and inspection files, reports prepared for disciplinary committees and other internal management reports.

From 24 February 2003 to 7 March 2003, we spent some time at SFE offices in Sydney and spoke to a number of business units (see the Appendix). On 27 March 2003, we held an "exit" interview with SFE to discuss our preliminary findings. We have also sought and received SFE's comments on both the factual matters set out in this report and our observations and recommendations.

Section 2: Observations and recommendations

2.1 Overall compliance

After making our assessment, ASIC concludes that Sydney Futures Exchange Limited and SFE Corporation Limited each 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 assessment process, and the present operating conditions (including trading volumes and financial products traded on each market):

- 1 Documented policies and procedures for supervisory areas are satisfactory and appear to be adhered to.
- 2 There was a high degree of system availability throughout 2002 and SFE undertook substantial testing to ensure back-up facilities remained functional.
- 3 In most instances, the operating rules and guidance notes provide a good framework for a fair, orderly and transparent market.
- 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 There was a high degree of communication and cooperation between the various business units with supervisory responsibilities.
- 6 SFE demonstrated a commitment to educating participants in their obligations under the operating rules and providing forums for the discussion of significant issues on a timely basis.
- 7 SFE actively shares information on supervisory matters with ASIC and with other market operators.
- 8 SFE devotes substantial staffing and technological resources to operating and supervising its market.

2.2 Ongoing work

Notwithstanding our conclusion on overall compliance, ASIC believes that, in the following areas, SFE should undertake further assessment of its own compliance and support ongoing development of its procedures, to ensure continued compliance with its obligations to adequately supervise the market. SFE should:

- review whether the present approach to open interest reporting provides sufficient certainty and consider whether more prescriptive rules are required;
- review the focus of its enforcement activities to ensure that there is not an overemphasis on minor, rather than significant, breaches;
- review record-keeping practices for regulatory decisions;
- continue to review the effectiveness of its disciplinary committees to ensure consistency in the application of penalties and ensure guidelines are in place for the escalation of penalties in appropriate cases; and
- review the scope of its participant supervision activities in view of the increased reliance placed on SFE participants to take responsibility for the activities of their clients.

It should be stressed that, in ASIC's view, these matters have not as yet manifested themselves in any way to threaten the objectives of a fair, orderly and transparent market. They are based on the material available to ASIC at the time of our assessment.

Open interest

Market participants use published open interest figures as an indicator of market depth and liquidity. In an environment of 24-hour electronic access to global markets, trading decisions, including contract selection, are influenced by reference to the depth and liquidity of alternative markets. Accurate reporting of open interest is therefore a vital component in the provision by SFE of a transparent market.

SFE highlighted in its annual regulatory report that during the year it had encountered a situation where the reported open interest had been inflated due to incorrect reporting by some participants. The reporting problems were attributed to a combination of poor processing methods at a non-clearing full participant combined with a more general lack of understanding of the system capabilities of the new clearing system (SECUR) introduced in December 2001. The divergence between the reported and true open interest appears to have taken some time to develop to a point where SFE recognised the inappropriate trend and instigated remedial action.

ASIC has discussed with SFE its stated preference for ongoing participant education and persuasion rather than implementing formal rules dealing with closeout processes and open position reporting. SFE notes that the measurement of open interest is a complex process and it will remain an imprecise method of determining market depth regardless of methodology. Further it distinguishes between errors in reporting that result from varied interpretations of closeout

methods and those that occur due to inadequate back-office procedures of participants.

SFE is confident that the level of understanding by participants of the SECUR system functionality has improved sufficiently so that the problems experienced in reported open interest are unlikely to be repeated. Notwithstanding this confidence, SFE has stated that it will continue to actively review open interest reporting and enforcement policies to support increased quality in reporting.

ASIC supports the continued focus in this area and recommends further consideration of alternative calculation methodologies that may better reflect the depth and liquidity of the market. SFE should consider if there is a need for more prescriptive rules in the reporting of open interest.

Focus of enforcement activities

We note the substantial increase in referrals made by the Trading Operations business unit to the Compliance & Surveillance business unit during 2002 as a result of increased real-time market surveillance activity. Further we note that SFE has introduced and promoted a process of self-reporting of minor breaches by participants. However, during the same period there has been no change in the staffing levels of the Compliance & Surveillance unit to deal with these referrals and reports.

While the number of incoming items referred to Compliance & Surveillance has increased substantially, there has been a decrease in the number of serious matters that Compliance & Surveillance has either referred to a disciplinary committee or to ASIC.

We note that there is a high degree of activity by the Compliance & Surveillance unit on minor rule breaches. While enforcement of rules is an important part of ensuring compliance, there needs to be a balance between activity targeted at technical breaches and activity targeted at breaches that have a greater impact on the provision of a fair, orderly and transparent market.

The substantial reduction in the number of participants and therefore the lower number of inspections SFE will need to undertake should facilitate a more tailored or focused approach to the business activities and compliance history of each participant. ASIC recommends that a more risk-based approach be applied to the SFE inspection process.

Record-keeping of decisions

ASIC has concerns with the level of record-keeping involved in key regulatory decisions made during the year. This is particularly the case where those decisions involved the exercise of discretion by SFE staff in cancelling trades.

SFE argues that the exercise of discretion involves judgments that can only be made when an event occurs giving weight to the specific facts of the matter at the time. While we accept that flexibility of approach is a necessary ingredient in the exercise of discretion, it is also true that the retention of corporate intelligence of previous decisions can guide and support future judgments.

ASIC has reviewed the results of some key regulatory decisions made by SFE during 2002. The lack of record-keeping on key decisions made it difficult to undertake an effective review and evaluation of procedural processes and consistency of decisions as part of our assessment.

ASIC supports the introduction of the “Fair Orderly & Transparent” (F/O/T) rapid management response team as an appropriate forum for making timely decisions that consider SFE’s regulatory objectives. This team is also well placed to undertake formal reviews of the bases for decisions, the weight given to various issues and the effect of particular actions on the operations of the market.

We feel that greater discipline in producing a record of decisions would add further transparency to the exercise of discretion by SFE. This would facilitate increased understanding of the process involved and aid in future comparability.

We also recommend that some specific guidance be developed and shared with market participants as an indicator of how SFE intends to exercise its discretion in certain limited circumstances. We do not view this as limiting the flexibility of SFE in its approach to its supervisory activities, but rather it introduces a benchmark of consistency against which the facts of a particular matter and the reasoning of the SFE in reaching a decision can be reasonably assessed.

Disciplinary committees

SFE has in place two separate disciplinary committees: the Market Practices Committee (MPC) and the Business Conduct Committee (BCC). The MPC is mainly comprised of executive representatives of participants and acts as a peer review dealing with trading-related matters. The BCC hears non-trading matters as well as appeals against the decisions of the MPC. The Chairman of the BCC is also a member of the MPC in order to maintain consistency of approach between the two committees. Ensuring consistency of penalty across participants in like breaches has also been a focus of the committees.

ASIC noted during its assessment that the imposition of financial penalties relative to other outcomes has reduced substantially. SFE submits that the nature of participant behaviour improved and as a result the number, and seriousness, of matters presented to these committees decreased between 2001 and 2002. In particular, recidivist breaches, which attracted higher financial penalties, were greater in number in 2001. SFE also advised that non-financial penalties such as compliance undertakings, may involve a participant incurring significant costs.

In ASIC's view the size of financial penalties can send important signals to the market about the seriousness of matters. We propose to keep this issue under review and will revisit the trends in penalties in our next assessment.

SFE has undertaken the development of a matrix for use by the disciplinary committees in determining appropriate penalties. At the time of our assessment the SFE Board was considering the results of the review and the suggested matrix. ASIC is supportive of the SFE approach to categorisation of breaches to give greater guidance to the committees on the appropriate level of financial penalties. We recommend that guidance on the use of the matrix should include a clear process for escalation of penalties in circumstances of continued or subsequent breaches.

ASIC is supportive of the SFE review of its policy in publishing the results of disciplinary committees, particularly the decision to remove anonymity of participants in market disclosures of disciplinary results. The public exposure of breaches by a participant can on occasions generate a speedier response by the participant in improving compliance structures than the imposition of an anonymous financial penalty. SFE expects the change of approach to be effective by mid-2003 and ASIC will monitor the results of this initiative.

SFE has noted a recent trend among some participants to request hearings and appeal the decisions of the disciplinary committees. It can be expected that the change in approach by SFE to name those penalised has the potential to increase the trend. It will be vital that SFE maintains a robust approach to the imposition and publication of penalties, in the face of any resistance from participants, in order to uphold the ideals of fair, orderly and transparent.

Regulatory scope

SFE has clearly articulated its view, both in words and actions, that the regulatory role of a market operator in supervising the actions of both direct and indirect market users, post the introduction of the FSR Act, has shrunk relative to the responsibilities of ASIC. This is highlighted by the SFE actions during 2002 to cancel the participant status of Associates as well as removing the term Registered Representative from its Operating Rules.

ASIC agrees with the proposition that, as a market operator, SFE's responsibility is limited to supervision of activity on its market. Some of the measures adopted by SFE in response to this are, in our view, likely to place a greater burden on SFE participants to take responsibility for the activities of their clients. We also think that this will require SFE to broaden the scope of its supervision of participants to ensure that they are adequately monitoring the orders placed through them as participants.

Associate Participants

Section 1148 of the Corporations Act (as was in force on 10 March 2002) required futures brokers to be a member of a futures exchange or futures association. At that time SFE performed the role of both futures exchange and futures association. SFE cancelled Associate Participant status on 30 September 2002. This action prompted ASIC to give class order relief [CO 02/1013] to those who were previously Associate Participants to avoid them being subject to the FSR regime before the end of the transition period or until such time as they apply for, and are granted, an Australian financial services (AFS) licence. That is, the relief attempted as far as possible to maintain the status quo had they continued to be members of SFE.

SFE has noted that historically a large proportion of complaints received relate to the activities of Associate Participants. SFE suggests that as it no longer has responsibility in supervising the activities of this class of people the Compliance & Surveillance unit will be able to redirect their resources towards more focused supervision of participants.

However ASIC notes that those people previously known as Associate Participants will still take part in the markets conducted by SFE and trade through SFE participants. SFE must remain mindful of the potential for the actions of this class of people to have an effect on its ability to provide fair, orderly and transparent markets. SFE has taken the step of producing a market bulletin for participants, confirming that a participant can be found to have breached the Operating Rules due to the actions of their clients. It is vital that future enforcement action by SFE, while recognising the limit of its jurisdiction, supports the position of holding participants accountable for the actions of their clients.

ASIC expects that the increased level of inspections of participants anticipated by SFE will include some consideration of the methods employed by participants to monitor and filter the orders of their clients. This is particularly the case for those clients who act in a broking capacity, to ensure that they do not have an adverse effect on the fairness, orderliness or transparency of the market.

Registered Representatives

As a direct consequence of the introduction of the FSR Act licensing regime and the details provided in ASIC Policy Statement 146 *Licensing: Training of financial product advisers* [PS 146], SFE from 15 November 2002 removed the concept of Registered Representative from its Operating Rules.

The SFE Registered Representative regime was initially introduced to provide training requirements and to set a standard of educational quality for participants' employees in the futures industry at a time when no other organisation offered an alternative facility.

SFE has advised participants that the removal of the Registered Representative status will not diminish SFE's right to take disciplinary action against participants and their representatives/employees/officers where the activities of those individuals are in breach of the Operating Rules.

The move by SFE away from providing a regime of registration of individuals who are suitably qualified to undertake activities on behalf of its participants may have an impact on overall compliance with the SFE Operating Rules. We propose to monitor whether the loss of the information gathering and tracking of the previous registration process has an impact on SFE's ability to undertake its supervisory functions.

2.3 Other issues

Memorandum of Understanding

The current ASIC/SFE Memorandum of Understanding (MOU) requires a rewrite to take account of FSR Act amendments and developments in the operating arrangements that support our regulatory relationship.

There have already been staff level discussions between ASIC and SFE on the form of a new MOU. It is planned that a renegotiated MOU will be in place this year.

Liaison

More frequent liaison is required between ASIC and SFE to facilitate improved sharing of information between our organisations in order to effectively carry out our respective responsibilities.

Appendix: Individual business units

This appendix explains in more detail our assessment process for individual business units of SFE and our specific observations and recommendations about those units. Where possible, we have not repeated matters already dealt with in our overall recommendations and, accordingly, the points set out below we regard as more narrowly focused on those business units.

We note that many of these business units undertake functions relating to the supervision of the clearing and settlement facility licence held by SFE Clearing Corporation Limited. This report does not cover our assessment of the adequacy of supervisory arrangements of the clearing and settlement licensee as required by s823C of the Act.

A1 Trading Operations

Role of unit

Trading Operations covers activities of market operation, market data and participant admission and access, and has specific responsibility for the “proper market operation” regulatory obligations to the extent that they cover access, availability and market integrity.

Trading Operations essentially performs the “interface” between SFE and the marketplace and some of its key functions include:

- processing cancellation and objections to trades;
- real-time monitoring of orders and trades;
- referrals to the Compliance & Surveillance unit;
- helping to manage system outages;
- providing access to SYCOM and the SFE market — both technical and business development sides;
- providing a help desk;
- general SYCOM maintenance issues and driving SYCOM changes; and
- the Trading Operations Manager assists the F/O/T rapid management response team address critical issues that may impact SFE’s supervisory capabilities.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- Trading Operations policies and procedures;
- selected complaints received by the unit;
- various registers and spreadsheets;
- specific matters that involved an exercise of supervisory discretion;
- block trade registrations;
- strip trade registrations;
- files outlining the basis of fines issued by the Trading Operations Manager;
- files of correspondence from four major SYCOM outages; and
- files on two key supervisory decisions relating to possible trade cancellations.

On-site visit

We interviewed the following to gain a better understanding of the unit's role in the supervisory functions of SFE:

- General Manager, Business Operations;
- Manager, Trading Operations; and
- Manager, Access & Distribution.

We were also provided with a tour of the unit, an overview of the systems used to monitor the market and a demonstration of how the systems and software are utilised.

Observations

We observed:

- Documented policies and procedures were generally good and provided clear explanations of the unit's operational activities.
- Managers and staff showed a clear understanding of their role within the supervisory framework of SFE.
- Market monitoring is a combination of human and system-based activities. The unit appeared to have access to substantial technology for undertaking market monitoring including SYCOM alert capabilities, externally provided alert software and monitoring of information vendors. Human-based activities included direct review

of trading activity and consultation with participants on market conditions.

- There appeared to be a significant level of staff access and discretion in setting parameters for the trigger of system-based alerts.
- Trading Operations staff have either worked at SFE for some time or are former brokers/traders and therefore have a good understanding of the products traded on the market, the potential influences on prices and the usual trading patterns of participants.
- Trading Operations staff were involved throughout the year in the provision of training sessions and real-time guidance to participants on interpretation of the trading rules and SYCOM functionality.
- Most documentation, including correspondence, is captured electronically including capture of all telephone conversations.
- Although there is limited scope for the Trading Operations Manager to exercise discretion there was insufficient documentation on the bases for exercise of discretion by the Trading Operations Manager, especially where a determination is made as to “extraordinary circumstances” when a cancellation request is received after the 5-minute cut-off.
- There was a lack of consistency in the level of detail contained in referrals of unusual trading activity made to the Compliance & Surveillance unit. However there did appear to be substantial ongoing dialogue between the two departments on matters being investigated where Trading Operations staff had particular experience or expertise.
- SFE refers to the substantial decrease in the number of deals cancelled during the year as a measure of the ability of the exchange to introduce market-integrity-supporting infrastructure. This activity has focused on identification of products that have traditionally had a high incidence of cancellations and introducing market makers to support the price discovery process as well as applying more direct monitoring of market conditions. This explanation may not adequately recognise the level of the cancellation fee and the potential for imposition of a fine by the Trading Operations Manager as being other factors in the overall reduction of cancellations.
- The majority of market system halts were planned events to coincide with times of low market activity.
- There are documented procedures in place in the event of unplanned system outages and SFE advised during our visit that it is considering a system that will act as a temporary back up in the event of system outages at a critical time to enable the continuation of trading.

- The Trading Operations area is accommodated in a physically secure area but substantial interaction with other SFE business units takes place on a planned and as needed basis.

Recommendations

We recommend:

- Further training should be provided for staff in the appropriate level of information to be included in a referral to the Compliance & Surveillance unit for investigation.
- There should be more detailed procedures for sign-off of amendments to system alert parameters.
- Further guidance should be provided to Trading Operations on the exercise of manager discretion, including examples of previous decisions.
- A file should be maintained that includes documentation on each previous specific decision involving discretion to support both the consistency of approach and our assessment process.

A2 Compliance & Surveillance (C&S)

Role of unit

C&S is the primary supervisory unit of SFE charged with monitoring participant conduct and enforcing compliance with SFE Operating Rules.

On 1 June 2002 the previously separate departments of Compliance and Surveillance were merged to form one department. This restructure took advantage of the complementary skills contained in each department to achieve synergies and support the overall regulatory structure. C&S:

- undertakes investigations of market activity on the basis of internal referrals, specific complaints or as a result of computer-generated exception reports — an investigation may result in a referral to an SFE disciplinary committee or to ASIC;
- schedules inspections of participants to assess general compliance with obligations; and
- provides various training, consultation and advisory activities to assist participants in their understanding of and adherence to SFE Operating Rules.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- C&S policies and procedures;
- standard inspection program template;
- C&S “Agenda” document;
- complaint files;
- investigation files;
- participant inspection files;
- participant correspondence files; and
- surveillance reports.

On-site visit

We interviewed the following to gain a better understanding of the unit’s role in the supervisory functions of SFE:

- Manager, C&S (three separate individuals);
- General Manager, Business Risk; and
- Chairman, Business Conduct Committee.

We participated in the weekly agenda meeting attended by all members of C&S. We also spent time with several staff in the C&S unit to observe the generation and analysis of exception reports and the general electronic filing methods of the unit.

Observations

While the two areas have merged into a single department, lessening key person risk, the integration process could be taken further. The various managers still have day-to-day focus on their respective areas and staff tend to specialise in compliance or surveillance activities.

Documentation

The file structure and document control procedures across the range of C&S files inspected were mixed. It was clear that information was on occasions requested from participants but it was impossible to establish from files held by C&S what the participant provided as distinct from material sourced internally. Where follow-up action was planned, the files often did not show the results, including the final report and recommendation of disciplinary activity, the participant

response to the final report or the imposition of disciplinary action, in a way that could be easily assessed.

Monitoring of current matters

The “Agenda” document is kept up to date and provides sufficient detail to be able to establish the current status of a matter as well as the previous actions undertaken. All general correspondence in and out of C&S is circulated to staff to maintain awareness across current activities. At the weekly staff meeting a verbal update is given on all matters, particularly where a major or technically complex issue is involved. Specific attention is given to the expected outcome of the matter, the next steps in achieving that outcome and the anticipated timing. In this way staff also use the matter update session as a discussion of current workload and capacity to undertake new matters.

C&S staff have established lines of communication with other business units and make use of the technical skills of Trading Operations staff where appropriate.

Financial and position monitoring

The weekly staff meeting includes an update of the general level of trading activity in the market, the spread of trading across participants and any changes to position concentrations at both a participant and client level. During contract settlement periods this discussion will also include a report on discussions with major position holders of their intended actions approaching settlement. The monitoring also considers the reporting of participant net tangible asset positions and allows for potential early warning of deterioration.

One tangible result from the increased focus by SFE on the daily position files provided by participants has been a substantial number of disciplinary actions for late lodgment. While enforcing stricter compliance with lodgment timings may underline the importance of these figures in the minds of participants, some caution is needed to avoid C&S focusing too much on pursuing technical breaches at the risk of missing larger supervisory issues.

Trading surveillance and exception reporting

Only 25% of the current suite of system-generated reports were regarded by C&S staff as being of value in establishing unusual trading behaviour that may require further investigation.

Review of surveillance reports was not a designated function within the unit and although all reports were maintained electronically there was no method of sign-off that a report had in fact been reviewed and actioned.

The C&S unit was undertaking analysis of how the system-based review of SYCOM trading history might be improved to take account of new functionality.

The level of resources assigned to this project was minimal and progress appeared slow.

Disciplinary committees

Referrals made by C&S to the SFE disciplinary committees were generally very detailed. Typically they involved a substantial amount of data and analysis including trading details and records of conversations as well as information requests and review of explanations by participants.

It is difficult to draw definitive conclusions from a comparison of the results of disciplinary actions from year to year without a detailed classification process of breach types, repetitious behaviour and market impact. We note that in items that came before the peer review committee the imposition of fines reduced from 71% of matters in 2001 to 48% of matters in 2002. Over the same period the imposition of fines by the BCC reduced from 34% to 15%. We propose to review these figures again in our next assessment to see if the imposition of fines has continued a similar trend and to seek such further explanation as necessary.

Inspections

In undertaking inspections SFE makes use of a rolling calendar to ensure all participants are visited within a certain timeframe. Discussions with managers confirmed the results of our review that there was a substantial disparity between the planned and actual frequency of inspections undertaken. SFE expects this problem to be resolved by the decrease in the number of participants to be inspected in the future. We further note that the length of time taken to complete an inspection varied greatly and feel that for larger participant inspections the process would be aided by the application of project management principles.

The level of information gathering undertaken prior to a participant inspection was inconsistent, ranging from very comprehensive to almost non-existent. The sources of information also varied with some analysts making use of only internally generated information while others undertook cross checking against data obtained from ASIC or the participant itself.

The C&S unit uses a standard inspection program template for all inspections undertaken. The template provides guidance to staff that the tests included in the program may need to be adapted to take account of the sophistication of compliance systems of individual participants. From our review of inspection files it appears that the inspection template was used without modification to reflect the size or different business models of various participants. While the consistent use of the template leads to a high degree of comparability between inspections it does not allow for identification of other risk areas or more targeted inspections based upon information already available to SFE.

Recommendations

We recommend:

- a review of file management processes and document control procedures (in particular finalisation of inspections should include a summary of recommendations and outcomes);
- the introduction of some form of risk assessment methodology to assist in the planning of inspections from both a timing and scope perspective (this should include a specific analysis of previous complaints data to target potential problems);
- a direct responsibility be assigned for monitoring of exception and general trade surveillance reports on a timely basis;
- surveillance reporting methods be updated to take account of previous system changes;
- further monitoring of the integration and cross training of C&S staff to ensure the planned efficiency improvements are achieved; and
- the introduction of project management principles to large-scale activities, particularly major inspections.

A3 Technology

Role of unit

This unit is, directly and through outsourcing, responsible for maintaining SYCOM and supporting other lesser significant systems. It is divided into three principal teams: Technology Infrastructure; Projects; and Administration and Internal Systems.

Since May 2001, when business rules were rewritten to permit it, the unit has preconfigured and connected interface boxes to allow clients of participants, including out-of-jurisdiction clients, to directly connect to the SYCOM trading platform and, subsequently, the remote monitoring and maintaining of the connections.

The unit also manages upgrade projects and in-house contract compliance testing.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- technology unit policies and procedures;
- files on system outages and stoppages;

- independent internal audits of systems and new projects; and
- contingency planning and testing (including stress testing).

On-site visit

We interviewed the following to gain a better understanding of the unit's role in the supervisory functions of SFE:

- Chief Information Officer; and
- Manager, Administration and Internal Systems, Technology Division.

Observations

The SFE Internal Audit unit performs regular technology audits of existing platforms and new projects. A risk matrix is used to identify issues on which to focus and a report is submitted to the SFE Board's audit committee. The audits have raised some issues, and it is recognised that accuracy of record-keeping is one area that requires improvement.

We also observed:

- Overall functionality is excellent by world standards with SYCOM uptime at 99.93%.
- SYCOM is based on a relatively simple technology platform to which further capacity can be added as required.
- All but two stoppages in the period reviewed were planned to implement fixes for known software faults and shutdowns were controlled to minimise disorder to the market. A current project aims to establish parallel systems to act as a temporary back-up in the event of a system outage at a critical time.
- SFE currently has a systems support agreement with an external provider, pursuant to which support and maintenance of the SYCOM system is on a 24-hour basis.

Recommendations

The Technology unit should establish a methodology for separating supervisory costs from other budget elements.

A4 Legal

Role of unit

The Legal unit provides in-house legal services to both operational and supervisory units of SFE.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- Legal unit policies and procedures;
- register of rule amendments; and
- files on rule amendments undertaken during the period.

On-site visit

We interviewed the following to gain a better understanding of the unit's role in the supervisory functions of SFE:

- General Counsel; and
- senior lawyers.

Observations

There is a formal procedure for requesting services from the Legal unit. Although the request form allows a business unit to nominate projects that the Legal unit is working on that can be delayed to accommodate the new request there is no information about how decisions are made concerning legal resourcing. The Legal unit does not have any business plan and there was no evidence of any planning methodology being applied to a major project lead by the unit (the major rule rewrite).

The procedures indicate that the Legal unit will assess whether ASIC needs to be notified of any changes on an informal basis. It appears that the unit effectively project manages rule changes.

There is a dedicated senior legal person with responsibility to liaise with each business unit.

Recommendations

The Legal unit is sufficiently important to SFE's supervisory operations that it would be desirable for more extensive planning on the use of SFE's legal resources to occur.

A5 Participant & Client Services (P&CS)

Role of unit

The P&CS unit processes participant admission applications and undertakes ongoing administrative activity including changes of membership status.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- P&CS policies and procedures; and
- participant applications for 2002.

On-site visit

We interviewed the Manager, P&CS, to gain a better understanding of the unit's role in the supervisory functions of SFE.

Observations

We observed:

- The policies and procedures to be followed for admission applications are well documented.
- Substantial information was provided in support of applications for admission.
- The timing and thoroughness of the review of information relating to applications made during the period seemed appropriate.
- P&CS has established lines of communication with other supervisory units.

Recommendations

ASIC has no specific recommendations for P&CS.

A6 Internal Audit (IA)

Role of unit

IA has a number of responsibilities within the SFE group. These responsibilities can be divided into three functional areas:

- project work;
- operational audits; and
- ad hoc issue reporting.

Project work

IA is involved in major SFE group projects and performs both a compliance role and provides consultative services to the project sponsor.

The approach of IA staff to provide consulting services, along with their exposure to the breadth of SFE group activities, has meant that operational areas tend to view them as facilitative to business development and therefore include them at an early stage of project planning. IA initially assesses projects against a risk matrix to establish overall business impact and sign-off levels.

The business unit and IA agree from the outset what role the IA officer appointed to the project team will take in delivering the project in addition to the compliance function.

IA project responsibilities have previously encompassed:

- ensuring projects undertaken are in line with the group’s strategy, and are managed appropriately;
- providing project management expertise throughout the project to ensure processes and methodologies are understood and consistently applied; and
- ensuring any concerns or issues in relation to the project processes that may be highlighted by completion reviews, IA or project stakeholders are brought to a satisfactory close.

Historically, between 60 and 70% of IA’s time has been spent on project-related work. SFE has recently introduced a Project Management Office (PMO) function as a dedicated resource to undertake the activities outlined above. IA estimates that it now allocates approximately 30% towards project-related activity and as a result is better placed to focus on higher risk issues and undertake more frequent operational audits.

IA continues to provide an independent assessment of the progress of project work and adherence to project governance standards in a quarterly report to the SFE Board’s audit committee.

Operational audits

IA undertakes a process of ranking each business unit according to a risk matrix in order to establish the critical nature of the work undertaken. The frequency and priority of business unit operational audits is a direct result of its ranking on the risk matrix (i.e. high, medium, low). High risk or business critical areas will be on an audit cycle substantially shorter than that of other, less critical, areas.

The risk matrix is also used to identify specific issues of focus and persons to speak to within a business unit. The risk-based approach continues with each operational audit having a “generic program” common to all business units and a “tailored program” relevant to the specific business functions of the unit being audited. The audit will focus on the risk measurement and control methods implemented within the individual unit. This extends to IA reviewing training schedules and investigating key person risk.

During an operational audit, IA works closely with the business unit manager to resolve particular risk issues and agree on a timeframe for implementation of recommendations. Once action is agreed, IA makes use of a database to monitor progress of the business unit in implementing changes. There is however a clearly defined process for immediate escalation where, during an audit, IA assigns a risk rating of high or critical to any function of the business unit.

Ad hoc issue reporting

The CEO, the SFE Board's audit committee, General Manager Business Risk, or Manager IA may initiate ad hoc reporting requirements. These activities are generally undertaken over a short timeframe in order to provide an immediate assessment and potential response to a specific concern.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- Operational Audit report — Communication & Networks 09/02;
- Operational Audit report — Internal Technology 07/02;
- Operational Audit report — Technology Operations 06/02; and
- Operational Audit report — Production and Clearing Systems Support 04/02.

On-site visit

We interviewed the Manager, IA, to gain a better understanding of the unit's role in the supervisory functions of SFE.

Observations

We observed:

- IA does not directly assess the adequacy of resources, particularly human, when undertaking operational audits of supervisory business units.
- IA does not appear to assess adequacy of arrangements for handling conflicts of interest between SFE's commercial interests and supervisory responsibilities.
- IA involvement in initial project planning and development of risk mitigation strategies appears dependent upon the relationship of the Manager, IA, and the business unit manager rather than any formal delegation.

Recommendations

ASIC has no specific recommendations for IA. However IA might be well placed to provide training or support to C&S in developing skills in the areas of risk targeting and project management.

A7 Finance

Role of unit

Although the Finance unit does not have any direct supervisory functions the unit was considered due to its coordination of budgeting and expenditure reporting.

On-site visit

We interviewed the following to gain a better understanding of the unit's role in the supervisory functions of SFE:

- Chief Financial Officer; and
- Group Financial Controller.

Observations

SFE has undertaken a substantial amount of strategic planning to assess the business and revenue implications should the Commonwealth Government decide to completely retire public debt. Planning has included strategies to maintain sufficient supervisory resources in the event of a wind-down of SFE markets.

Recommendations

We recommend:

- The Finance unit should develop some form of methodology to identify those staff with supervisory roles and the percentage of their work devoted to supervision, particularly those employed in the Technology unit.
- Guidelines should be settled on the methods used to determine staff allocations between supervisory and operational functions in order to maintain a consistent approach.

A8 Strategy & Business Development (S&BD)

Role of unit

The S&BD unit is not regarded as a supervisory section within SFE; however as this area drives the development of new products it was felt appropriate that we discuss with them the involvement of supervisory areas with their business.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- project plan for new product introduction;
- monthly project progress reports;
- minutes of project team minutes;
- sponsored product sponsorship agreements; and
- market maker agreements.

On-site visit

We interviewed the following to gain a better understanding of the unit's role in the supervisory functions of SFE:

- Senior Manager, New Business;
- Senior Manager, Interest Rate & Currency Products; and
- Manager, Equity Products.

Observations

We observed:

- Comprehensive documentation is maintained on the development of new products. However files are not maintained or housed on a project basis, which means that record-keeping standards may vary between products. Files are maintained by the relevant manager rather than on a centralised product or project file, which meant the ASIC review needed to bring together information from various sources.
- Units that have supervisory responsibilities are integrated in the project development.
- S&BD actively follow opportunities to develop a deeper market in illiquid stocks through recognising/establishing market makers.

- S&BD have a process for undertaking due-diligence assessment of potential markets, particularly for price discovery.
- Contract specifications for new products including sponsored products are investigated and sign-off is required.

Recommendations

ASIC has no particular recommendations for S&BD.