REPORT 40

Market assessment report: Sydney Futures Exchange Limited

April 2005

Annual assessment (s794C) report

Sydney Futures Exchange Limited ACN 000 943 377

April 2005

Contents

Executive summary

Section 794C of the Corporations Act 2001 ("the Act") requires ASIC to assess at least once a year how well a market licensee is complying with certain of its obligations as a market licensee. That assessment must consider whether the licensee has adequate arrangements for supervising the market, including arrangements for handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market it operates is a fair, orderly and transparent market.

This assessment report is divided into three sections:

- The first provides some background to the SFE market, how we undertake our assessment role and areas of particular focus in this assessment;
- The second sets out our view of SFE's overall compliance with its supervisory obligations. It also identifies areas where we believe further work is required to ensure continued compliance; and
- The third sets out in greater detail our assessment of individual business units within SFE and contains some recommendations about non-critical issues.

Our Approach

A market licensee's obligations are ongoing, and whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance. We therefore use the assessment process to:

- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market, including the identification of specific aspects that require strengthening to ensure current or future compliance with its obligations under the Act at the time of the assessment; and
- identify matters that we believe may create risks to the licensee's ability to comply with its obligations in the future and which we will therefore continue to monitor and engage with the licensee directly.

Conclusions

In Section 2 of this report, we outline our overall view of SFE compliance and include some specific observations and recommendations from our assessment. We conclude that SFE has adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c) of the Act. Further, we conclude that in accordance with s792A(d), SFE has sufficient resources to operate the market properly and for the provision of the abovementioned supervisory arrangements.

Our key recommendations are that SFE:

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

Section 1: Background

1.1 The SFE market

Sydney Futures Exchange Limited ("SFE"), under its Australian market licence, offers trading in a range of products based upon interest rates, equities, currencies and commodities. Access to these products is made possible via a global electronic communications network providing 24 hour a day trading capability.

Products can be traded on the SFE's SYCOM system or via its Block Trade facility ("BTF") and Exchange For Physical ("EFP") facility. The BTF enables SFE participants to bilaterally arrange large volume transactions away from the central market. An EFP allows a futures position to be exchanged for a physical position in the underlying market at a price negotiated directly between counterparties.

SFE also offers a "listing and management" service whereby third parties with a requirement for exchange traded derivative products can outsource the development and on-going management of these products to the SFE. Examples of products offered on SFE that have developed under this model are the MLA/SFE cattle futures and d-cypha SFE electricity futures and options.

During 2003, on average more than 175,000 futures and options contracts were traded each day, an increase of over 24% on 2002 figures resulting in annual turnover exceeding 44.7 million contracts. The nominal value of this trading activity is greater than $A16.9 trillion annually.

1.2 The assessment process

ASIC's role

Section 794C of the Corporations Act 2001 ("the Act") requires ASIC to assess at least once a year how well a market licensee is complying with certain of its obligations as a market licensee. That assessment must consider whether the licensee has adequate arrangements for supervising the market, including arrangements for handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market it operates is a fair, orderly and transparent market. An assessment of the adequacy of arrangements, both supervisory and conflict handling, cannot be undertaken in isolation from the requirement that the market operates in a fair, orderly and transparent manner.

While section 794C is explicit about what must be considered, it allows for assessment by ASIC of any or all of a licensee's obligations within Chapter 7 of the Act and also enables ASIC to take account of any information and reports that it thinks appropriate. A key obligation that we will have regard to in undertaking our assessment is that a licensee must have sufficient resources to operate the market properly and for the required supervisory arrangements to be provided (s.792A(d)).

A market licensee's obligations are ongoing, and whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance. We therefore use the assessment process to:

- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market, including the identification of specific aspects that require strengthening to ensure current or future compliance with its obligations under the Act at the time of the assessment; and
- identify matters that we believe may create risks to the licensee's ability to comply with its obligations in the future and which we will therefore continue to monitor and engage with the licensee directly.

Conduct of assessment

In conducting our assessment of SFE, we:

- analysed information we received from SFE in the ordinary course of our dealings with SFE as a market licensee, including:
  - statutory notifications and referrals of suspected serious contraventions of the market's operating rules or the Act;
  - liaison meetings and other general correspondence; and
  - the annual regulatory report given to ASIC by SFE on 31 March 2004 under s792F of the Act. As our visit to the offices of SFE took place prior to receipt of their report, we also requested and were provided with a draft version of their report;
- reviewed policies and procedures for the conduct of SFE's market in general and their supervisory responsibilities in particular; and
- interviewed SFE staff.

We also considered:

- the operation of the market throughout the period and in particular any instances of disruption;
- extensive material provided to us by SFE under the *Australian Securities and Investments Commission Act 2001* (ASIC Act);
- information from external sources and media commentary; and
- internal SFE material produced as part of SFE inspections, investigations or disciplinary actions.

From 23 February 2004 to 27 February 2004, we spent time at the SFE offices in Sydney reviewing the work and work practices of a number of business units (see

Appendix). We discussed our initial observations at that time with the General Manager – Business Risk.

We subsequently obtained further information from SFE to progress our consideration of certain issues and engaged in discussion with relevant staff and the members of one of the SFE's two disciplinary committees. We have sought and received comments from SFE on the factual matters set out in this report as well as our conclusions and recommendations for future action. Where appropriate, their comments are reflected in our report.

Where SFE has identified ongoing actions to be implemented within certain timeframes we have obtained updates of the status but have not included any assessment of the practical effect of these changes.

1.3 Focus of this assessment report

In our first assessment of SFE, we focused primarily on the work undertaken by those units within the SFE group with responsibility for operation of the market and those carrying out monitoring, supervisory or enforcement activities.

The assessment covered by this report continued to examine the work done by those units. We paid particular attention to the extent to which SFE responded to the issues and recommendations made in our first assessment report.

In addition, in this assessment we considered in more detail the structural arrangements, supervision, reporting and decision-making responsibilities relied upon by SFE in meeting its obligations under the Act. In particular, we considered the handling of conflicts between SFE's commercial interests and the provision of a fair, orderly and transparent market.

Section 2: Observations and recommendations

2.1 Overall compliance

After making our assessment, ASIC concludes that SFE has adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c) of the Act. Further, we conclude that in accordance with s792A(d), SFE has sufficient resources to operate the market properly and for the provision of the abovementioned supervisory arrangements.

This conclusion is based on the following observations drawn from information considered during the assessment process, and the present market operating conditions (including system infrastructure, trading volumes and financial products traded):

1. SFE has delegated specific responsibilities to undertake rapid assessment and decision making in relation to matters that may impact on the provision of a fair, orderly or transparent market.
2. SFE devotes substantial staffing and technological resources to operating and supervising its market.
3. The infrastructure and operating system were upgraded during the period to improve levels of performance and redundancy of the SYCOM trading system.
4. The high degree of system availability and pro-active testing identified in our previous report continued.
5. The operating rules and guidance notes provide an adequate framework for a fair, orderly and transparent market.
6. Supervisory areas have adequate policies & procedures in place that deal with:
    - monitoring the conduct of participants and trading activity;
    - educating participants on their obligations;
    - investigating potential breaches of the operating rules or the Act; and
    - making supervisory decisions and/or recommending disciplinary action.
7. 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.

8 SFE actively shares information on supervisory matters with other market operators and ASIC.

2.2 Supervisory arrangements and accountability

Organisational structures, internal reporting and accountability and governance arrangements generally are important components of a licensee's ability to meet its obligations on a continuing basis. Similarly, comprehensive and effective arrangements for identifying and managing conflicts are essential where there is a continuing potential for conflict between commercial objectives and public supervisory responsibilities. However, neither organisational arrangements nor conflict management arrangements will be fully effective unless there is a systematic, whole-of-organisation approach to compliance with obligations. SFE's Board and senior management are ultimately responsible for its compliance with its obligations to supervise its market, including assessing how well it is delivering a fair, orderly and transparent market.

Audit Committee

The SFE Board has established an Audit Committee to assist in fulfilling its oversight responsibilities for the financial management and reporting processes in monitoring and demonstrating ongoing compliance with relevant laws and regulations.

The scope of responsibility of the Audit Committee, in relation to SFE’s obligations as a market operator, fall within the following categories:

- Corporate Control – have regard to the adequacy and integrity of SFE’s operational risk management framework and system of internal control, and the monitoring of the control process through internal and external auditing.
- Corporate Governance - consider whether SFE is in compliance with pertinent laws and regulations, is conducting its affairs ethically, and is maintaining effective controls against employee conflict of interest and fraud.

The Audit Committee is made up of at least three and no more than six members of the non-executive directors of SFE Group companies. Committee members will comprise a range of skills and experiences relevant to the operational, financial and strategic risk profile of the SFE group. At least one member must have specific expertise in accounting or financial management and reporting. The Audit Committee must meet four times a year, with additional meetings convened should circumstances warrant. SFE management or external auditors may be required to attend and provide detailed information on matters being considered by the Committee.

The Audit Committee mandate enables it to conduct or authorise investigations into any matters within its scope of responsibility. The Committee has identified and documented a series of specific actions it will undertake, and documents it will have regard to, in the exercise of its review function. Ultimately however, the authority of the Audit Committee is limited to referring matters and making recommendations to the Board for review or approval.

Enterprise-wide risk management

During 2003, SFE commenced implementation of an Enterprise-Wide Risk Management (EWRM) model in order to properly identify, quantify and manage the risks inherent in its business including:

- operational and process risks
- technology and vendor/outsourcing risks
- legal and regulatory risks
- personnel, premises and environmental risks
- financial and treasury management related risks
- market (credit and liquidity) risk.

The EWRM model was based upon the existing risk management and internal audit framework but introduced the following:

- an executive Risk Steering Committee – with a business wide risk co-ordination, prioritisation and monitoring mandate focusing on major entity wide risks such as business continuity planning, insurance, and regulatory liaison; and
- the Process Risk Oversight Group – tasked with undertaking systematic analysis and management of end-to-end process related risks to provide assurance regarding operational integrity standards and to produce risk and performance improvements.

Allocation of supervisory and commercial responsibilities

The International Organisation of Securities Commissions has noted that an exchange that is established "for-profit" and also has supervisory obligations faces the potential for conflict between its public interest responsibilities and its commercial incentive to maximize income. This could result in an unwillingness to commit sufficient resources to conduct market supervision or take enforcement action against market users.

As already noted, the Act requires a market licensee to balance the competing interests and ensure that it has adequate arrangements for handling conflicts. The process of handling conflict becomes particularly difficult where a business unit or individual has both supervisory and commercial responsibilities. ASIC supports the principle that, as far as possible, a market licensee should structure their business in order to separate supervisory and commercial roles. Further, a licensee should be systematic in assigning accountability and ensure that the internal reporting systems provide senior management and the Board with sufficient information to reliably assess overall compliance with its supervisory obligations.

In order to meet its obligations to provide a market that is fair, orderly and transparent and have adequate arrangements to supervise the conduct of market participants, SFE assigns responsibility and allocates resources mainly to its Compliance and Surveillance and Business Operations functions. Compliance and Surveillance undertake the bulk of the supervisory remit while Business Operations assists with real-time market and trading supervision and in maintaining processing integrity, availability and access to SFE's SYCOM trading platform.

The General Manager, Business Risk does not have a commercial role or responsibility within the SFE Group but rather has executive responsibility for key aspects of SFE's supervisory and corporate governance activities as follows:

- SFE's EWRM and reporting framework and SFE's group-wide compliance monitoring and reporting framework
- Oversight responsibility for SFE's internal audit function
- Chair of the executive risk steering committee (Corporate and Risk Management Committee) and member of the executive Default Management Team and Emergency (situation) Management Team
- Key liaison role with regulators, and key government and market bodies.

In addition, the General Manager, Business Risk has responsibility for directing and overseeing the activities of the Compliance and Surveillance business unit and also undertakes liaison with and monitoring of the effective discharge of responsibilities by SFE's supervisory committees. Where the potential arises for conflict between the General Manager's oversight of internal audit and an operational business unit upon which an audit is conducted, the audit results are reported directly to the CEO.

The General Manager, Business Risk reports directly to the CEO and Managing Director of SFE Group, but also has a direct reporting line to the Board Audit Committee in respect of corporate risk, audit and other corporate governance activities. The General Manager also attends Board meetings to provide direct update and input on compliance/surveillance and operational risk management activities, initiatives and issues.

2.3 Observations and recommendations for future action

SFE has undertaken substantial work in structuring and allocating responsibilities within its supervisory areas. Notwithstanding our conclusion of overall compliance with statutory obligations to adequately supervise the market, ASIC believes that in some areas, further work is required to ensure continued compliance. SFE should:

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

Imposition of administrative, financial and other disciplinary penalties

The SFE has two supervisory committees - the Business Conduct Committee (BCC) and the Market Practices Committee (MPC). A major role of both the BCC and MPC is, amongst other things, to consider alleged breaches of the SFE operating rules or the Act and to impose disciplinary action as appropriate. The imposition of a disciplinary penalty is scaled according to the relative seriousness of the breach - with less serious matters resulting in a Brought To Notice (BTN) determination. As the breach itself, or the conduct that led to it, becomes more serious the penalty imposition would progress to a reprimand or a financial penalty. The supervisory committees may also impose other non-financial penalties, such as engaging independent review of a participant's compliance structure, where it believes such an action is warranted.

We made the following observation in our previous assessment report in relation to the imposition of disciplinary penalties by SFE against participants:

- in the items that came before the MPC 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 also recommended that:

- SFE develop a process for escalation of penalties in circumstances of continued or subsequent breaches.

In this assessment we analysed the number and level of fines imposed and also reviewed the method of presentation to, and consideration by, the SFE supervisory committees in determining whether a breach of the rules had occurred and the appropriate level of penalty to be imposed in the circumstances.

Resources

ASIC notes that the number of matters referred to the MPC reduced by 29 per cent since 2001, while the number of matters referred to BCC reduced by 74 per cent for the same period. In its 2003 Regulatory Report SFE notes that the 2002-2003 reduction of referrals to supervisory committees can be primarily attributed to the cessation of the Associate Participant class and to a lesser extent staff turnover within the Compliance and Surveillance unit.

We note that Compliance and Surveillance did experience a high level of staff turnover in the preceding 12 months, with several senior staff moving to take up compliance roles at participants. In our interviews with the Compliance and Surveillance managers we were advised that they did not believe staff turnover had impacted adversely on the work undertaken by the department. The vacancies had been filled and the new appointees have substantial market experience. However, they did concede that the staff turnover and the "learning curve" effect of new staff had resulted in a smaller number of participant inspections being carried out than otherwise would have been expected.

We identified in our previous assessment that Compliance and Surveillance undertook fewer inspections than was detailed in its business plan. While this does not equate to a failing in SFE's supervisory arrangements, we recommend that SFE consider whether the current resourcing of the Compliance & Surveillance department is sufficient to maintain compliance with its supervisory obligations in the future. ASIC accepts that the allocation of resources to supervisory activities is an imprecise exercise, however given its importance to proper market operation it is an area that we will continue to monitor.

Penalty determination

ASIC notes that the previously identified reduction in the number of fines imposed by disciplinary committees reversed during the period under review. MPC imposed fines in 64 per cent of matters considered and BCC imposed fines in 25 per cent of matters.

However, ASIC is concerned that SFE should avoid any structural imbalance in the imposition of administrative rather than financial penalties when comparing the results of rule breaches designated as serious and significant with those that may be considered trivial, technical or administrative in nature. During our assessment we noted that SFE Trading Managers had imposed financial penalties for relatively minor breaches, however there were examples where the administrative penalties issued by a supervisory committee did not appear on their face to reflect the repeat nature or seriousness of the rule breached including:

- a participant that was noted as having previously breached a particular rule four times resulted in the BCC imposing a Brought To Notice penalty; and
- an instance where a breach was identified as a Category 1 rule breach, the most serious category, and the penalty imposed by the BCC was again Brought To Notice.

Discussion of the penalty determination process with BCC members included the individual circumstances of these matters and why, on balance, they regarded an administrative penalty as appropriate. BCC members also noted that imposing a financial penalty is not always the most appropriate result and that the BCC has on occasion imposed additional penalties such as compliance undertakings and compliance reviews. These additional penalties are however, imposed rarely and in limited circumstances.

ASIC recommends that the SFE undertake a review to ensure that disciplinary action continues to act as a sufficient deterrent to enforce compliance with SFE operating rules. The review should specifically consider the:

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

New product development

During the period under review, SFE undertook development of several new futures contracts. The development of new products contains an inherent conflict of interest for any licensee. That is, the temptation to have less regard for the protection of retail investors or the principles of maintaining a fair orderly and transparent market when seeking to increase turnover and profitability through the release of new market products. The conflict issue is further complicated by SFE's listing and management service, which directly involves a third party in the product development process. SFE also develops products internally where particular information, such as an index calculation, is obtained from a third party supplier to be used in determining the settlement price.

Management of this conflict of interest should include a process to determine the appropriate balance of resources devoted to developing new products from a business perspective and consideration of the supervisory or market integrity aspects. Further, the development of new products may in some circumstances involve additional, ongoing supervisory obligations.

In our assessment we reviewed the process for development of new products and the interaction between business development and other business units in this process.

In particular we considered the steps taken by SFE to:

- establish the ability of third parties to provide data or other inputs that form the basis of the settlement price for the product
- negotiatiate contractual arrangements establishing obligations and service standards between SFE and third parties
- interact with ASIC where the arrangements with a third party were relevant to our consideration of Operating Rule amendments required to introduce the product.

The Business Development unit within SFE plays a lead role in both the development and implementation stages for new products and this involves substantial interaction with other business units through delivery group meetings. Our assessment identified a lack of policies or procedures, which detail the requirements for developing new products after the initial proof of concept stage.

We believe policies that clearly identify the:

- terms of reference;
- level of market analysis and testing;
- obligations/capacity of third parties;
- management of conflicts;
- legal and regulatory issues; and
- level of consultation and sign-off

are necessary to ensure that the product development process deals adequately with both market and regulatory requirements.

While we found no evidence that suggested the introduction of the new products during the period under review necessitated additional supervisory activity or created a need to expend additional financial allocations to SFE's supervisory work, we recommend that SFE give priority to the introduction of policies and procedures dealing with product development.

SFE have since implemented a checklist for Business Development that more formally sets out all the necessary tasks to be undertaken (and any associated documentation required) prior to the implementation of a new product or initiative.

Section 3: 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.

The business units we reviewed were:

- Business Operations
- Compliance and Surveillance
- Supervisory Committees
- Technology
- Participant and Client Services
- Internal Audit
- Finance
- Business Development (Exchange Trading).

3.1 Business Operations

Role of unit

The Business Operations unit (previously known as Trading Operations) covers activities in relation to market operation, market data and access. This business unit has specific responsibility for the "proper market operation" regulatory obligations to the extent that they cover access, availability and market integrity.

The unit is divided into two sub-units, Business Operations – Derivatives, and Access & Distribution. Since our last visit, restructuring of the unit has taken place and Business Operations – Derivatives now includes clearing operations, while the scope of the Manager, Access and Distribution has been extended to include management of infrastructure/software used by all participants. The unit is at the very core of the operation of the market, and is essentially the 'interface' between SFE and the market place. Some of its key functions include:

- Front-line live monitoring of orders and trades;
- Clearing responsibilities (i.e. collection and payment of Margins);
- Referrals to Compliance and Surveillance;
- Processing objections and cancellation of trades;
- Assist with the management of system outages;

- Access to SYCOM and the SFE market – both technical and business development (including training);
- General SYCOM maintenance issues and identification of SYCOM improvements;
- Help desk.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- Trading Operations Procedures;
- Business Operations Monthly Reports (Operational Version) submitted to the General Manager, Business Operations;
- SYCOM Incident Reports and Failure Logs for four major outages;
- SECUR Incident Report;
- one complaint received by the unit;
- various registers and spreadsheets detailing trade cancellations, block trades and trader infringements;
- HEAT records in relation to trade cancellations;
- HEAT records in relation to fines issued by the Manager, Business Operations – Derivatives;
- HEAT records in relation to referrals from Business Operations to Compliance and Surveillance;
- Trading Operations Market Management, Fair, Orderly and Transparent Principles, Version 2; and
- agendas and minutes of various SFE working groups.

On-site visit

We interviewed the following staff to test our understanding of the unit's role in performing supervisory functions of SFE:

- General Manager, Business Operations
- Manager, Business Operations – Derivatives
- Manager, Access and Distribution – SFE Markets.

We also requested and were provided with a tour of the unit (its "Operations Room"), an overview of market and clearing systems utilised and a demonstration of systems used to monitor the market.

Observations

Progress on recommendations from ASIC's previous assessment

- 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.

The unit continues to refer matters to the Compliance and Surveillance unit. Referrals are made via email, the SFE website (trade investigation requests) and direct conversations where Business Operations staff suspect rule breaches may have occurred.

HEAT records are also kept of referrals to Compliance and Surveillance. We were informed that these might not constitute a complete record of referrals made. The referrals figures detailed in the Business Operations Monthly Report are sourced from HEAT records; therefore an accurate number of referrals from the unit to Compliance and Surveillance may not be reflected in the monthly reports.

From our review of the HEAT referral records for the period 1 January 2003 to 31 December 2003, the majority of referrals made relate to crosses by participants.

Programmed interaction between the unit and Compliance and Surveillance has increased, with a different staff member from Compliance and Surveillance working in the Operations Room every morning four days a week to gain a better understanding of the business unit and its interactions with participants. Appropriate arrangements have been put in place to manage potential conflicts of interest.

- There should be more detailed procedures for sign-off of amendments to system alert parameters.

Team leaders within the unit have the authority to adjust system alert parameters in response to market activity. Our initial concern in allowing active system alert amendment without a detailed sign-off was a perception that it introduced a risk that human intervention could be used to undermine the integrity of the alert process. However further analysis indicated that adjustments are made within the boundaries of the "Specified Tick Range" as contained in the schedules to the business rules. The limitation this places on the amendments to system alert parameters reduces the need for more detailed approval procedures.

Subsequent to our assessment the specified tick range is now contained in the Operating Rules determinations.

- 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.

A guidance document had not yet been produced at the time of our assessment.

The reasons given for not implementing ASIC's recommendations in this area were that the Trading Manager exercises only minimal discretion and some decisions also involve input from either or both of the Fair Orderly Transparent ("FOT") response Group and the Legal business unit.

While we acknowledge the limitations of the Trading Manager discretion, the lack of a central file of all previous decisions, in our opinion, creates a key-person risk for the business unit.

Resourcing and Restructure

Following the restructure of the unit and the amalgamation of clearing operations, 3 full-time staff were no longer required as some data entry processes were automated.

Business Operations staff members are currently being cross-trained in the derivatives and clearing systems, and staff showed a clear understanding of the various systems and their role in SFE's supervisory framework.

Participant Training

During the year, the unit provided system and software training to participants. Educational forums are also held by SFE, with various business units in attendance, including Business Operations, Legal, Business Development and Compliance and Surveillance.

Complaints received by Business Operations

Business Operations received one formal complaint in the period. We reviewed the related documentation and have no concerns with the decision of the Contract Committee, which upheld the decision of the Trading Manager to cancel a series of error trades.

We were further advised that since October 2003, SFE introduced new procedures for the making of trading and clearing related complaints. Business Operations are no longer involved in receiving complaints and instead they advise complainants to make their complaint in writing or direct them to make the complaint via the SFE website.

Trading Operations Procedures/SFE Clearing Operation Manual

Documented policies and procedures are extensive and provide clear explanations of the unit's processes and procedures.

Notification of participant/trader infringements

During the course of our assessment it was noted that fines issued by the Trading Manager were not being advised to ASIC. We advised SFE that we consider fines issued by the Trading Manager to be disciplinary action taken by the market licensee and therefore required to be advised to ASIC pursuant to paragraph 792B(2)(b) of the Act.

Trade Cancellations and Objections

Trade cancellation and objection records are kept electronically. The summary table of cancellations (excluding EFP transactions) contains the reason for approval or rejection - the relevant Trading Rule or brief comment is detailed. However, the summary table for EFP cancellations did not provide reasons for cancellation. We were informed that it was highly likely small details of the transaction were incorrect and the transaction was subsequently cancelled.

In a sample of individual cancellation/objection sheets reviewed, we were able to observe further details and/or reasons for the approval or rejection, this also generally applied to EFP transactions. SFE have subsequently updated the form of the summary table so that it now includes reasons for EFP cancellations. SFE also provided participants with clarification on EFP cancellations by way of a bulletin on 30 November 2004. The bulletin also highlighted that *"consistent with the policy of facilitating legitimate EFP activity without allowing activity which could easily be effected on-market to be transacted as an EFP, the Exchange considers that all roll trading, especially at expiry, should be performed transparently on the trading platform so as to maintain the integrity of available open interest."*

Approximately 288 deals were cancelled in the year ended 31 December 2003 and the majority related to participant or trader reported error trades within 5 minutes of the trade being effected (Trading Rule 24.1). Under Trading Rule 24.15, the Trading Manager can use his/her sole discretion to cancel a trade – this rule was only provided as a basis for the cancellation of approximately 6 deals or about 2% of total deals cancelled.

Participant/Trader Infringements

Records in relation to participant/trader infringements are kept electronically. Nine (minor) fines of $500 each were issued in the calendar year, the majority relating to making a trade in error that leads to cancellation. We queried under what circumstances error trades would lead to the imposition of a fine and were advised that the Trading Manager will consider imposing a fine on the participant/trader if the cancelled trade has an impact on other trades, which must also be cancelled as a result of the original error. Details of fines issued by the Trading Manager are provided to Compliance and Surveillance periodically.

The Trading Manager can also impose fines on clearing participants, however none were issued in the period.

Block Trades

We reviewed the register of block trades approved for the relevant period and no concerns arise.

Working Groups

Six working groups were established in the course of 2003, all report to an appropriate steering committee composed of relevant Executive Management. Each working group was established to ensure "process integrity" and contributes to the review of processes and procedures to reduce costs or avoid duplication of activity. Each working group is composed of staff from various business units (depending on the mandate of each group) and all groups meet monthly, with chair responsibilities rotating.

Fair, Orderly and Transparent Working Group (FOT)

This group was introduced at the time of our last assessment visit in March 2003 and meetings have generally been held on a regular basis to discuss market events, undertake scenario analysis and identify issues that are directed to the working groups outlined above for consideration and resolution. The FOT group comprised 5 members (from Business Operations, Compliance and Surveillance and Legal) and reports to the Risk Steering Committee.

Default Management Working Group (DMWG)

DMWG is responsible for monitoring, escalation and resolution of defaults (as defined in SFECC By-Law 71.3). The working group meets every three weeks and reports to the Risk Steering Committee. The DMWG is currently comprised of 4 members (from Business Operations, Legal, Risk and Compliance and Surveillance).

The working group has completed various tasks associated with its areas of responsibility.

System integrity and performance

SFE considers major system halts to be halts lasting for a period greater than 15 minutes. Four such halts occurred during 2003 and in accordance with arrangements between SFE and ASIC, we were notified of all major SYCOM halts.

The SFE website provides real time information on the availability of the SYCOM and SECUR systems. We observed that information had historically been provided to the market via the SFE screen dealing bulletins outlining the reasons for system outages and the resolution of any problems. This information was no longer provided.

During our previous assessment we were advised that SFE was considering a system that can act as a temporary back up in the event of system outages at a critical time. The functionality of SFEIN, a secure internet based registration and information platform, was extended in April 2004 to accommodate the electronic registration of telephone trades in the event of a SYCOM emergency disaster recovery situation. One SECUR outage/halt was experienced in the period and no system integrity concerns arose following our review of the incident report.

Monthly Business Operations Reports

The two sub-units contribute to a monthly report prepared for the General Manager, Business Operations. We note the report is detailed and provides statistical information on items such as trade cancellations, (human) resource management, and system integrity and performance.

Internal Audit Report findings and recommendations

In March 2003, SFE's Internal Audit unit released its operational audit report of the business unit conducted in the first quarter of 2003. A total of 5 issues were raised (includes new issues identified and re-opened issues), varying from medium to very low risk. We were able to confirm that action to address the medium risk item, to establish escalation procedures for unavailability of externally provided cash settlement prices, was in progress.

Recommendations

Notification of participant/trader infringements

ASIC recommends SFE establish procedures to notify ASIC of fines issued by the Trading Manager.

SFE accepted our view that the imposition of a fine by a Trading Manager was a disciplinary action requiring notification to ASIC. SFE took immediate steps to rectify the failure in their reporting systems and effective March 2004 implemented a process where all fines issued by Business Operations are immediately forwarded to Compliance and Surveillance for distribution to ASIC in the standard mechanism for notification of disciplinary action.

Manager discretion in relation to trade cancellation and fines

We repeat our recommendations from our previous assessment that:

- 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.

SFE have advised that a database in which all Operating Rules allowing Trading Manager discretion has now been introduced and will be maintained. In addition all scenarios where discretion has or has not been used will be captured in the database to ensure consistency in decision making by Trading Managers.

System integrity and performance

We recommend that SFE provide details of outages/halts on a historical basis (for example, by reintroducing the applicable Screen Dealing Bulletin or through the SFE Monthly Markets report) to provide greater transparency on system integrity and performance. SFE have undertaken to make information on all market halts publicly available.

Referrals

We recommend Business Operations maintain a central register or formal log of referrals sent to Compliance and Surveillance as it is impossible to assess whether all matters referred are appropriately dealt with.

SFE have advised that a template has been developed that deals with the main areas of trading surveillance conducted by Business Operations and stipulates the information required to be included in referrals.

3.2 Compliance & Surveillance (C&S)

Role of unit

C&S is the primary supervisory unit of SFE charged with monitoring trading and clearing participant conduct, investigating possible breaches and generally enforcing compliance with SFE Operating Rules.

The C&S unit:

- 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 ultimately result in a referral to a SFE disciplinary committee or to ASIC;
- conducts 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

Our previous assessment of C&S was primarily concerned with gaining a better understanding of the extent of its supervisory functions and the tools and methods used to monitor the ongoing compliance of participants. The methodology used in undertaking our assessment this year was designed to follow-up on issues that were highlighted in our previous report and also to undertake a more focussed review of compliance inspections, investigations and related file management to test the effectiveness of the processes that C&S have in place.

In our previous assessment report, we made several recommendations relating to inspection methodology, file management and document control procedures. The relevant recommendations were:

- introduction of some form of risk assessment methodology to assist in the planning of inspections from both a timing and scope perspective (including analysis of previous complaints data);
- review of file management processes and document control procedures (including summary of recommendations and outcomes); and
- introduction of project management principles for large scale inspections.

In addition, the key areas of interest that we wanted to target in this assessment were the:

- use of risk targeting in prioritising and preparing for participant inspections;
- consideration given to any previous breaches or other information held by SFE in relation to participants; and
- level of documentation of decision points and ongoing supervisory review.

In order to test the effectiveness and consistent application of C&S policies and procedures we reviewed operational files selected at random to provide a cross-sectional view of different market participants.

Documents and information reviewed

We reviewed the following files and documents during our assessment:

- 31 participant files (ranging from inspections, investigations, complaints, self reported breaches and exemption applications);
- C&S procedures manual including standard inspection documents;
- Current "Agenda" database maintained by C&S detailing the status of all current matters.

On-site visit

We interviewed the following staff to test our observations and obtain clarification on specific areas of review:

- Managers, Compliance & Surveillance (two separate individuals)
- Market Analyst, Compliance & Surveillance
- Financial Analyst, Compliance & Surveillance.

Observations

Progress on recommendations from ASIC's previous assessment

Document control

In our previous assessment, we outlined the importance of file management processes and document control procedures. In particular, we recommended that the finalisation of inspections should include a summary of the recommendations made and outcomes achieved. This was considered important given the reliance of C&S officers on review of previous inspection files to gain an understanding of any issues specific to a particular participant. As a result of our recommendation, it was apparent that C&S had introduced a more formalised file management and document control procedure.

Notwithstanding the more formalised procedures, our on-site file review continued to show some inconsistencies in file maintenance and document control procedures. The variation in files was most apparent when a comparison was made between matters that had taken some time to investigate and resolve. While some files, where a preliminary review resulted in no further action, contained a detailed "Memo to file" providing a complete summary of the matter, findings and basis for conclusions, others did not contain sufficient documentation to demonstrate the analysis undertaken in the specific matter.

Some of the more common issues identified in relation to operational files include:

- lack of documentation of follow-up actions taken or to be taken;
- no signatures or initials on copies of letters indicating that they were actually sent to external parties;
- files indicated that a C&S officer had held a discussion with a participant however there was no formal record of conversation or file note indicating the nature of the issues discussed or advice given; and
- inconsistent approach to preparation for a C&S inspection activity. While some files contained comprehensive information including printed extracts of participants' historical information detailing past complaints and breaches, others did not.

SFE have advised that documentation of any follow-up action resulting from consideration of a matter by a supervisory committee is noted in the "Schedule of Matters Outstanding" paper that is presented back to the supervisory committee at each meeting and is only deleted once the action is completed or otherwise resolved by the committee. Our observation however is directed to situations that do not necessarily involve, or indeed warrant, consideration by a supervisory committee but still generate some level of follow-up action by C&S staff.

Supervisory control

The documentation of managerial oversight of supervisory procedures across the range of C&S files inspected was inconsistent. While some of the files demonstrated management review and consultation on progress, others were unclear as to the approval mechanism for actions, findings and subsequent resolution or recommendations. The Compliance & Surveillance manual expressly requires approval and/or consultation with the Manager.

It was possible to confirm that management consultation had occurred for some of the files that did not note it by making reference to the "Agenda". However as that document is primarily designed to record current matters it is not appropriate as a record of managerial approval for C&S activity.

Inspections

In our previous assessment, we noted that C&S uses a standard inspection template for all inspections undertaken without modification to reflect the size or different business models of the various participants in the market. We recommended the introduction of some form of risk assessment methodology to assist in the planning of inspections, which should include specific analysis of previous complaints data to target potential problem areas.

C&S introduced a documented risk assessment procedure in November 2003 to better target inspections. During discussion with C&S Managers, we were advised that a risk-based approach had traditionally been used in planning for participant inspections, but following our recommendation, the process was formally documented. The procedure involves the collection of information, sourced internally and externally, to identify key risk factors and derive an overall risk ranking. Participants are then selected for inspection based on comparative risk rankings and specific areas of focus in an inspection are determined based on risk assessment.

Our on-site review covered only 1 inspection that had been initiated and was in the process of being finalized using the, now documented, risk-based approach. We are of the view that there was substantial delay in implementation of the new risk-based approach in view of the recommendations made last year. Hence, we are unable to get a clear indication of the benefits derived from the use of the new approach. Further we are unable to comment on its effectiveness, until additional reviews are undertaken following this process to allow comparison. We noted however, that the main difference of the new approach is in the final scope of the inspection, which may result in the testing of specific areas of identified risk, rather than all areas of the participants' market related activities. Notwithstanding our inability to undertake a proper review of SFE risk-targeting methodologies at this point we believe that the use of such a tool should enable SFE to undertake a greater number of inspections than would otherwise be the case.

Our review of inspection files prepared under the "old" procedure showed that the level of information gathering undertaken prior to an inspection has improved, but still varies between files. Some files contained printed logs of historical information relating to the participant but this is not applied consistently across all inspections. SFE believe that the same process for inspection preparation is followed by all staff and involves a detailed review of the previous inspection file and the previous 12 months correspondence between the participant and SFE thereby highlighting instances of repeat non-compliance or other events for specific focus. SFE will reiterate with staff the need to formally document completion of this stage.

We further noted that the preliminary information gathering and indeed the inspections undertaken are very quantitatively focused. While an inspection activity clearly must be able to be supported by tangible data, a narrow approach may not always identify cultural deficiencies in a participant’s compliance structure.

Referrals from Business Operations & Complaint Handling Procedures

C&S receive complaints/referrals from several sources:

- Complaints can come to C&S from the SFE website. The completion of a standard "Trade Investigation Request" form generates an email to C&S.
- Participants contact C&S by telephone with their complaint. A file note is made of the conversation but complainants are asked to put their concerns in writing before the matter is taken further (this can be either in the form of a letter or by completing the "Trade Investigation Request" form on the SFE website).
- Referrals are received from Business Operations as a result of their monitoring of market activity. (On occasions a participant may contact Business Operations rather than C&S to discuss aspects of market behaviour or make a complaint). Referrals/complaints from Business Operations are notified to C&S either by email or phone. Alternatively, BO may complete the "Trade Investigation Request" form on the SFE website.
- Complaints can also come from members of the public. These complaints were traditionally from retail clients of Associate

Participants. With the removal of the Associate Participant status these complaints have effectively ceased.

C&S do not distinguish between referrals made to them by Business Operations and complaints received direct from participants. We were advised that the reasoning for this approach is that the source of the information is not relevant in assessing the merits of an individual matter and each is equally likely to result in an investigation being commenced by C&S.

Regardless of the source of a complaint being made to C&S the procedure to be followed is the same. The C&S manager will allocate the matter to an officer to undertake an initial evaluation. Once the initial evaluation is completed the matter will be discussed with the Manager to determine whether it is appropriate to initiate an investigation. Subsequent to initiating an investigation, C&S may require further information from BO and/or the participant concerned to progress the analysis. There are specific conflict management arrangements in place to ensure that the status or likely outcome of any particular matter is not divulged to BO staff.

Other C&S interaction with the Business Operations department

C&S has implemented a process whereby on a rotating basis, a C&S officer sits in the SYCOM room 4 mornings a week to gain a better understanding of the work undertaken by BO and identify any trends in the types of queries received from participants. There are documented policies to manage the potential conflict situation that this process introduces. C&S officers do not work on sensitive C&S matters while in the SYCOM room and do not discuss the details of any current investigation activity with BO staff.

C&S management and staff displayed a clear understanding of the conflict management procedures and the reason for their existence. We believe that the knowledge gained by C&S staff observing real time market activity and interactions between participants and BO staff will assist them in undertaking their core supervisory activities.

Resourcing

While our previous report did not make any specific recommendations in regards to the level of staffing of C&S, we did recommend cross-training of staff.

C&S have introduced a more formal process of cross training of staff, particularly to alleviate the key person risk, identified by Internal Audit, associated with the technical nature of the work undertaken by the market analyst.

Recommendations

Document control

We recommend the inclusion of file notes and/or record of conversations of initial and any subsequent meetings and other interactions between participants and C&S staff to promote transparency of procedures and decision making (in part to assist our assessment process but also to provide C&S officers with a complete and reliable picture of changes in participants' business or control environment).

We also recommend further monitoring of work practices to ensure a copy of final documents are retained on file and that managerial approval is obtained where required. SFE have indicated that while they believe that the requirement to consult with management is strictly adhered to by staff they will implement a file checklist review to ensure appropriate notation is retained on file.

Inspections

As discussed above it is difficult at this time to evaluate the impact of process amendments introduced as a result of our previous recommendations in the area of risk-targeting. However we recommend that the pre-inspection work carried out by C&S be modified to include a level of qualitative analysis to support the quantitative analysis already undertaken. We believe that such an approach would assist in undertaking peer entity comparisons and may identify cultural or other deficiencies that indicate the potential for compliance issues to develop at a participant.

3.3 SFE Supervisory Committees

Role of unit

The SFE has two supervisory committees - the Business Conduct Committee (BCC) and the Market Practices Committee (MPC). A major role of both the BCC and MPC is, amongst other things, to consider alleged breaches of the SFE operating rules or the Corporations Act and to impose disciplinary action as appropriate.

Disciplinary action can also be taken by BCC delegates and SFE Trading Managers who are authorised to impose reprimands and fines in limited circumstances.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- SFE Supervisory Committees Policies and Procedures;

- SFE Bulletin's advising of Disciplinary Action taken by the BCC and MPC;
- Disciplinary action framework, including categorisation of breaches;
- Minutes of BCC and MPC meetings for period of 1 January 2003 to 23 February 2004;
- decisions of BCC delegates for period of 1 January 2003 to 23 February 2004;
- MPC files for period of 1 January 2003 to 23 February 2004;
- BCC files for period of 1 January 2003 to 23 February 2004; and
- a random sample of Compliance and Surveillance operational files that related to matters considered by either the MPC or BCC.

On-site visit

We interviewed the following staff:

- General Manager, Business Risk
- BCC Chairman.

We also met with the members of the BCC prior to one of their meetings which provided us with the opportunity to enhance our understanding of their approach to considering matters brought before them. The discussion left us with a greater insight into the committee process, the application of policies and afforded a contextual framework within which to make our assessment.

Observations

Progress on recommendations from ASIC's previous assessment

- ASIC to follow up on SFE review of policy on publication of results of BCC and MPC disciplinary committees, particularly the decision to remove anonymity of participants in market disclosures of disciplinary results.

Publication and removal of anonymity in disciplinary actions

The SFE released a Bulletin in early January 2004 (SFE Bulletin Number 02/04) advising participants of new arrangements for notification of disciplinary actions. The SFE will now, in circumstances where the relevant Board or Supervisory Committee considers rule breaches or penalties to be serious in nature, publish the name of the participant involved.

ASIC is not in a position to comment on the impact of the new arrangements, as, at the time of our assessment, the SFE had not published the names of any participants as a result of disciplinary action.

We discussed with the BCC their approach to the naming of participants in disciplinary actions and floated the idea that naming might be extended to all disciplinary actions in the interest of transparency. Members of the BCC advised that the naming of participants required careful consideration on a case-by-case basis and rejected the concept of compulsory naming that did not take account of the seriousness of the breach. Their view is that such an approach was unlikely to serve a constructive purpose and would almost certainly undermine the proper functioning of the supervisory committees. They advised that participants regard public naming as a very serious consequence with substantial, ongoing, commercial impact and the prospect of compulsory naming would see participants respond to the disciplinary process in a more litigious manner.

The BCC approach to naming firstly determines whether the matter indicated a deliberate intent to breach, or, a complete disregard for, the rules. Further there is consideration of the extent to which the breach might identify a systemic compliance breakdown at the participant.

The key principles underpinning a decision as to the appropriateness of naming are whether the matter:

- by its nature raised a legitimate public interest issue; or
- ought be made available to ensure the public were able to make an informed choice in selecting a broker/adviser or clearer.

ASIC agrees with the SFE view that the statutory obligation to enforce its rules, as part of maintaining a fair, orderly and transparent market, requires ongoing consideration of public interest issues. The process of disciplining participants for operating rule breaches is a key component of enforcing compliance and we will review SFE's approach to naming in this context in our next assessment.

Recording and Notification of disciplinary actions

ASIC reviewed the decisions of BCC delegates, minutes of the BCC and MPC committees and the paper presented to the SFE Board. The following table, based on the information available at the time of our assessment, represents the number of matters dealt with where a disciplinary finding was made and the level of penalty imposed.

	SFE Trading Managers	**MPC***	**BCC delegate**	**BCC^**	**SFE Board+**
Number of Matters	9	17	13	39	1
Brought to notice	N/A	3	5	12	

Reprimand	N/A	2	8	14	
Other penalty	N/A	N/A	N/A	3	
Number of fines	9	11	N/A	9	
Fines	$4,500	$19,000	N/A	$19,500	

* 1 matter before the MPC was yet to be finalised

^ 1 matter heard by the BCC was appealed to the Board

\+ the matter before the Board was yet to be finalised

ASIC notes that the figures contained in the SFE Annual Regulatory Report differ from those presented above. This is due to the fact that the figures reported by SFE contain only the most serious penalty imposed by the Supervisory Committees in relation to each matter considered.

MPC and BCC Minutes

We reviewed all files and minutes of the MPC and BCC for the period 1 January 2003 to 23 February 2004. The minutes of both committees essentially contain a statement to the effect that the committee resolved that based on the material before it a participant failed to comply with a particular rule and the committee resolved to impose a particular penalty.

Neither the MPC nor the BCC minutes include any form of summary of the issues considered by committee members, or the relative importance placed on information or circumstances presented, in determining whether a breach had occurred. Further, they do not always set out reasons for the imposition of a particular penalty or document whether consideration was given to naming of the participant where the breach is of a serious nature.

Our file review identified the following examples where the level of penalty reduced substantially during the process of consideration by the relevant committees. We were unable to ascertain the level and significance of additional information presented to, or, particular circumstances considered by, the committee in making its final determination:

- a senior Compliance and Surveillance analyst recommended that the MPC determine a breach had occurred and impose a fine of $15,000 on the participant. The MPC initially imposed a fine of $1,000 during an "expedited" hearing; however the participant exercised their right to a full hearing. At that hearing the penalty was further reduced to a reprimand. The Compliance and Surveillance file did not contain any notes, contemporaneous or otherwise, to indicate why the final determination was made. There was no information in the MPC minutes or the MPC file detailing information considered by the committee relevant to the decision to impose a disciplinary penalty that was substantially different from that recommended by the investigating analyst.

- the BCC determined a breach occurred and imposed a $20,000 fine during an expedited hearing. Again the participant involved exercised their right to a full hearing and the penalty was subsequently reduced to "brought to notice" during that hearing. The BCC file and minutes do not reflect the information presented during the course of the hearing to warrant such a significant reduction in penalty.

SFE noted that the supervisory committees are completely independent of management. Further they advised that while both the information presented and the penalty proposed by C&S are always considered by a supervisory committee, the final determination by the committee may result in a disciplinary sanction that is higher or lower than that contained in the recommendation.

In commenting on the impact on the level of penalty imposed as a result of conducting a hearing, SFE advised that participants may not always respond comprehensively during the course of an investigation or inspection. Rather they tend to undertake more thorough preparation in formulating a hearing or appeal submission. It is often the case that the participant will provide additional information or greater clarity on the particular circumstances or events involved than was apparent during the initial investigation or inspection. The supervisory committee will give due consideration to all the information presented in reaching a final decision on whether a breach occurred and the appropriate penalty to impose. ASIC is aware that in some circumstances a transcript of a hearing is made and becomes an annexure to the committee minutes. However, it is ASIC's view that the transcript is generally of the submissions presented by a participant during a hearing and does not include the subsequent consideration of matters by the committee members.

ASIC accepts and supports both the importance of the independent consideration of matters by committee members and the right of participants to present detailed information or contextual submissions at a hearing. Our concern is that the minuting of these processes does not sufficiently evidence either the level or content of deliberations. Particularly in circumstances where a disciplinary penalty is substantially different, whether higher or lower, than that proposed by C&S, ASIC expects to be able to engage with the supporting documents as evidence of the relative importance placed on individual factors in making a determination. Further, we expect that there would be specific reference to the circumstances or evidence that make penalty variance appropriate.

Escalation/Mitigation of penalties

The SFE has developed a Disciplinary Action Framework ("the Framework") for use by Compliance and Surveillance staff and the Supervisory Committees. The Framework consists of:

- a document that lists breaches in four numbered categories according to the seriousness of the rule; and
- a table that is completed by Compliance and Surveillance staff which lists the factors that are to be considered in determining the penalty to be imposed.

On the basis of the files reviewed, the Framework is being completed and used by Compliance and Surveillance staff consistently.

ASIC believes it is reasonable to expect that the table of factors or circumstances to be used in determining the level of penalty to be imposed in a specific matter before a Supervisory Committee would be considered in the order in which they are presented. We are concerned that the factors appearing at the top of the list could be regarded as having greater priority or influence than those appearing towards the bottom of the list. In particular, factors such as the participant's track record in regard to a specific issue, whether the breach suggests a systemic issue and the level of impact/risk to the market are found in the bottom part of the list. It is ASIC's view that repeated breaches of a rule by a participant and the issue of the level of impact/risk to the market should be considered highly important factors in determining the level of penalty.

ASIC is also concerned that factors that are not listed in the table as being relevant in formulating the appropriate penalty level are being relied on by Supervisory Committees as a basis for penalty mitigation. For example:

- we identified an instance where Compliance and Surveillance recommended that breaches which involved "medium risk" to the market, by a participant with "previous breaches of this particular rule" and with a "poor compliance track record" should result in a Brought To Notice penalty. However, at MPC the view was that *"although such actions would normally warrant the imposition of disciplinary action, due to mitigating circumstances regarding the proximity to expiry and associated liquidity issues faced by the Participant and its client,…the Committee resolved to take no further action with regard to these matters."* Neither the issue of proximity to expiry or associated liquidity are listed as factors that are to be considered in determining an appropriate penalty.

In our discussion with members of the BCC we were advised that Supervisory Committees, in deciding upon the level of penalty for a particular breach, have regard to each of the factors presented by Compliance and Surveillance both individually and cumulatively. Further, members felt that it is entirely appropriate and congruent with their independent standing to take account of any matter specific circumstances that they believe has a bearing on the appropriate penalty to be assigned to a breach.

ASIC notes that the Framework was designed to be, and has been, an evolving document to support the SFE disciplinary process and as such is constantly under review by SFE. We therefore recommend that consideration be given to the order in which factors influencing the level of penalty are presented to ensure that factors such as risk to the market are given appropriate priority. Further, the Framework should clearly articulate that the particular circumstances of a breach might influence the level of penalty imposed. Where matter specific factors not identified by Compliance & Surveillance result in penalty escalation or mitigation, appropriate notation should be included on file.

Oversight of Supervisory Committees

Responsibility for oversight of the supervisory committees is split between the relevant Committee Chair, the General Manager – Business Risk, the CEO and the Board of Directors.

The General Manager – Business Risk has responsibility for:

- managing the membership and succession planning for the committees;
- ongoing operation of the committee process and responding to specific informational or procedural issues raised by committee members; and
- advising the CEO and Exchange Board of significant disciplinary matters.

The Chairman of the BCC meets quarterly with the CEO/MD to discuss market, participant or procedural issues

The BCC and the Exchange Board meet annually to discuss the market impact of major matters over the period, emerging trends or risks identified from their consideration of matters.

Policies and Procedures

The policies and procedures of the SFE supervisory committees deal in detail with the appointment and resignation of committee members and the conduct of ordinary committee meetings. In outlining the policies and procedures in respect of hearings and appeals there are references made to information contained in the Compliance and Surveillance policies and procedures.

Recommendations

We recommend that the SFE Annual Regulatory Report contain all penalties imposed by the SFE Supervisory Committees and those individuals with the delegated authority to impose disciplinary sanctions rather than just the most serious penalties imposed. SFE have confirmed that in future they will provide a full list of all disciplinary penalties imposed.

ASIC recommends that the SFE introduce procedures that ensure the minutes, or related files, of MPC and BCC meetings reflect the discussion that took place during the course of the meeting and indicate the importance of, or reliance upon, specific information in reaching a determination. Further we recommend that minutes indicate in greater detail the committee reasoning in assigning a particular disciplinary penalty, in particular, where this varies substantially from the recommendation made by C&S. We also recommend documentation of the consideration by the committee in deciding whether or not to publish the name of a participant as part of a disciplinary action. We note that BCC members contend that they are satisfied that the minutes, as currently prepared, provide an acceptable summary of considerations and determinations. However SFE has undertaken to include further details where appropriate to assist in ASIC's ability to review specific matters or outcomes. As part of our next assessment we will review the extent to which changes to the preparation of minutes allows us to better understand the process followed in reaching a determination.

ASIC recommends that consideration be given to codifying the extent of formal oversight of the Supervisory Committees. The role should, amongst other things, include the conduct of periodic reviews of supervisory decisions to ensure their functions are carried out in an effective manner and their determinations continue to be appropriate in the circumstances. Such oversight should also ensure that the minutes of committee meetings reflect an objective summary of the matters considered and decisions made including sufficient detail to provide transparency as to the reasoning employed by the committee.

ASIC considers it appropriate to consolidate the policies and procedures relating to supervisory committees into one document. SFE have agreed to import into the supervisory committee practices and procedures information that is currently documented elsewhere that relates to Committee members' actions and conduct.

3.4 Technology

Role of unit

The unit, (together with Business Operations), directly and through outsourcing, is responsible for maintaining the ongoing availability of SFE's trading, clearing and related systems which include:

- SYCOM and Downstream systems;
- SECUR Derivatives Clearing system;
- FINTRACS Debt Depository & Registry system;
- Wide Area Networks;

- Participant infrastructure and connectivity;
- Infrastructure monitoring, batch processing;
- Provision and dissemination of Market Data; and
- Facilities Management Services.

The ongoing successful interconnectivity of these components enables SFE to provide trading and clearing capabilities to more than 200 SYCOM workstations and 150 SYCOM interfaces (located in Australia, US, Hong Kong, UK and New Zealand) and over 100 SECUR APIs (located in Australia).

During the year the unit also upgraded the SYCOM Host infrastructure.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- Technology unit policies and procedures
- Files on SYCOM and SECUR outages and stoppages
- Contingency planning and system testing.

On-site visit

During our on-site visit we both interviewed and put written questions to the unit's senior managers.

We noted that SFE had held ongoing discussions with the RBA in relation to the SFE Business Continuity Plan (BCP) testing strategy and that ultimately the RBA considered the methodology to be in compliance with the Financial Stability Standards for Central Counterparties and Securities Settlement Facilities, and advised the Minister accordingly.

Observations

The unit, in the year passed, undertook substantial improvements to support the provision of a fair, orderly and transparent market. In particular:

- SYCOM outages due to "runaway gateways" have now been rectified with the late 2003 transition to a new operating system
- Network Intrusion Detection (NID) is no longer a task with a key man dependency, with cross-skilling and deployment of the NID system completed at the end of 2003

Other projects to promote a fairer, more orderly and more transparent market, are scheduled. These projects include:

- SYCOM upgrades to permit anonymous trading
- SFEIN Enhancements Phase 2 will provide functionality that will enable the effective continuation of trading in the event of a complete SYCOM system failure via enhancements within the SFEIN application
- FINTRACS is to be replaced with the EXIGO system, also adding to system functionality.

Recommendations

ASIC has no specific recommendations for Technology.

3.5 Participant & Client Services (P&CS)

Role of unit

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

Assessment process

Our previous assessment of P&CS was primarily concerned with gaining a better understanding of the scale of activities undertaken by P&CS and its role in the supervisory functions of SFE. In that assessment we observed that P&CS performed essentially an information gathering and coordination function rather than making admission decisions. We noted that there were established lines of communication with supervisory business units and requirements for sign-off of various kinds by them. In particular, we noted a high degree of involvement by Compliance & Surveillance in each application.

In our assessment this year, we adopted a more focused review of participant applications and related file management to test the effectiveness of the P&CS processes.

Documents and information reviewed

We reviewed the following documents during the assessment:

- P & CS policies and procedures;
- Participant applications for 2003; and
- Responses from the Manager, P&CS to our written queries.

Observations

We did not have any specific recommendations for P&CS from our previous assessment. Observations from this year's review include:

Document control

- The policies and procedures for assessing applications for admission or maintenance continue to be well documented and updated.
- 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. However, we noted that there was often a gap in documentation where a specific section of the process is undertaken by another department e.g. considerations, potential concerns, scoring system (to assist with risk-classification for subsequent inspection activities).
- Other correspondence contained in the file e.g. letters pertaining to compliance & surveillance matters, were not properly referenced to the files likely to contain further relevant information.

Approach

- The assessment of applications was structured and often accompanied by a memo providing a good summary of the key actions taken, or to be taken, the officer-in-charge and a deadline for each of these actions. Where actions involved a supervisory issue or a decision to be made, an individual from the appropriate business unit would undertake the task.
- There was pro-active interaction with participants and potential participants and this included the provision of specific instruction relating to the issues that needed to be addressed for a particular application.

Recommendations

P&CS should liaise with the other departments involved to ensure proper record keeping of the entire application process. This could involve either incorporation of further information into the existing participant file maintained by P&CS or by reference to other files maintained by the respective departments.

3.6 Internal Audit (IA)

Role of unit

IA's responsibilities within the SFE group can be divided into four functional areas:

- Project review work;
- Participant Operational Reviews;
- Operational audits; and
- Special investigations.

Project review work

IA is involved in major SFE group projects and performs both a compliance role and provides consultative services to the project sponsor. IA initially assesses projects against a risk matrix to establish overall business impact and sign off levels. IA continues to provide updates to the Board Audit Committee (BAC) of the progress of projects with audit involvement, including the results of project audit reviews.

Participant Operational Reviews

Under the direction of the General Manager – Business Risk, IA is responsible for the planning, coordination and execution of the Participant Operational Reviews (PORs). Initial planning for the PORs took place in the latter half of 2003 and commenced in 2004. Staff from other business units assisted IA in specific areas of the review especially where technical expertise was required, such as risk management and business continuity plans.

The initial information component is provided by C&S with the other main inputs from Business Operations and Risk Operations. The primary focus of the PORs is not to identify non-compliance with the SFE Rules but rather to identify any areas of systemic weakness or operational risk. The result of PORs will also be reported to the Risk Steering Committee and if relevant, to the SFE Clearing Board.

Operational audits

The overall audit plan for each year is prepared by IA and ratified by the General Manager - Business Risk. It is a risk based assessment process and the plan is generally reassessed after 6 months to take into account any relevant changes in the Group structure and the risk profile of the business units.

IA undertakes a process of ranking each business unit according to a risk matrix (i.e. high, medium, low) in order to establish the critical nature of the work undertaken. The frequency and priority of the business unit operational audits would depend on the ranking on the risk matrix. Operational audits for supervisory business units appear to be conducted once a year.

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 focuses on the risk measurement and control methods implemented within the individual business units.

Special Investigations

The CEO, BAC, or a General Manager 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 as part of the assessment:

- Internal Audit Group policies and procedures;
- Failure to deliver review (June 2003);
- Participant operational review - high level approach (November 2003);
- Operational audit reports;
- Facilities & Administration Penetration Test Actions List (January 2004); and
- Security Action Items (external security specialist's report on Vulnerability Assessment of the Internal Production Network).

Observations

Methodology

In undertaking its various functions, IA creates a degree of focus on the adequacy of procedures and systems used to deliver the business and regulatory outcomes of the SFE group. IA acts in a consultative capacity by recommending improvements to the system of internal controls.

IA also plays an indirect role in assessing the adequacy of arrangements for supervising the market, including arrangements for enforcing compliance with the market's operating rules. In particular it assesses the level of compliance with the various SFE Business Rules and established internal company policies and procedures. IA is responsible for:

- Recommending improvements in policies, procedures and systems to detect and/or prevent instances of non-compliance or control weaknesses and refer to management for corrective action;
- Determining and assessing risk related components of business units under review and projects in which IA is involved; and
- Reviewing, testing and appraising the operation and adequacy of the internal control environment across SFE.

Identifying areas of risk

IA completed 10 operational audits during 2003 and a further 2 were in the process of finalisation at the time of our assessment.

The operational audits were in our view thorough and robust. The reports produced were comprehensive and contained detailed findings with specified risk ratings as well as suggested business improvement opportunities. The reports also outlined recommendations, which importantly included the proposed timeframe for implementation and the person responsible. Where the report included repeat recommendations these were highlighted.

A total of 6 ad hoc audits and reviews were undertaken and reported to BAC in 2003. These included an Austraclear Depository Risk Review and a review of the appropriateness and integrity of the failure to deliver processes in place for physically deliverable SFE contracts/products.

Supervisory functions

While IA does not perform any direct supervisory function of participants at SFE, through the PORs, IA plays an indirect role in monitoring the conduct of participants on or in relation to the market. By identifying areas of systemic weakness or operational risk amongst participants SFE is better able to target their supervisory actions.

Further, the operational audits performed by IA of supervisory business units involve some consideration of the adequacy of resources (both human and technological). With regards to technological resources, we note that in addition to the operational audits relating to IT related business units, IA also conducted several IT related projects during 2003 including a vulnerability assessment of the SFE internal production network. As to assessment of the adequacy of human resources, IA does not consider the level of human resources in an absolute sense, however they identified key person risk/dependencies in C&S and Technology Services. IA also identified a reliance on key people for the completion of specific tasks in the Participant Support Group.

Conflict

SFE has identified the potential for conflict where IA undertakes an operational audit of supervisory business units reporting to the General Manager - Business Risk. In such instances, the stated policy is that while the findings are communicated to the General Manager to be actioned, the report is also provided directly to the CEO.

Recommendations

ASIC has no specific recommendations for IA.

3.7 Finance

Role of unit

The Finance unit does not have direct supervisory functions. We considered its operations in the context of its role in determining the amount of funds expended on supervisory functions. SFE is obliged, due the effect of subsection 792A(d), to have sufficient resources (financial, technological and human) to run a fair, orderly and transparent market.

In our previous report we recommended that SFE 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. We recommended that guidelines should be settled on the methods used to determine staff allocations between supervisory and operational functions in order to establish a consistent framework for making comparisons from one year to the next on the amount SFE expends on its supervisory obligations.

On-site visit

We reviewed documents produced by the Finance unit relating to the methodology on supervisory costs, and worksheets used by the unit to determine costings.

Observations

During the on-site visit we interviewed the General Manager - Business Risk, and put a number of questions in writing regarding the work of the Finance unit in determining the methodology and quantum of money expended on supervision.

Progress made on previous assessment issues/recommendations

SFE has gone some way to establishing a methodology to split costs between "proper operations" and "supervisory activities". It has done this through a system of "departmental recharges", which is based on units allocating a portion of their expenditure to market operations and clearing and settlement. Some of the figures are very even, suggesting that "ball-park" estimates were used. Other figures were more scientifically determined. For instance, we were advised that rental of premises costs attributed to supervision were calculated by reference to floor space usage.

The key responsibility areas (KRA) of each member of staff do not explicitly set out or reflect the split of each employee's duties between supervision and business development responsibilities. In addition to making more difficult the identification from one year to the next of which staff members have supervisory duties, and the percentage of their duties devoted to one or other of these two roles, this lack of formal attribution in KRAs has implications for management of the conflicts of interest inherent in staff having both supervisory and business development roles.

SFE expended substantially the same dollar amount in 2003 as it did in 2002 in undertaking its supervisory obligations. This suggests that SFE determined that increased turnover on its market did not necessitate the expenditure of additional resources for supervision.

Recommendations

We recommend that SFE, when determining the level of resources required for ongoing supervision, consider the incremental increases in supervisory obligations that may occur from new product development or increased turnover in traditional products and record the results of that consideration.

3.8 Business Development (Exchange Trading)

Role of unit

The primary responsibility of the Business Development unit ("BD") continues to be the introduction of new products, enhancement of existing products and interaction with participants and customers in relation to existing and proposed products. BD is not regarded as a supervisory business unit within SFE.

We took the view that it would be appropriate to undertake a review of this business unit in order to better understand the process of product development and in particular how this translates to changes to operating rules.

Assessment process

Documents and information reviewed

We reviewed the following documents during the assessment:

- Register of project management files Jan 2003 – Jan 2004;

- Policy and Procedures – 2003;
- Monthly project progress reports;
- Minutes of project team minutes;
- Various documents relating to a proposed new futures contract (Draft Agreement, general correspondence);
- Agenda and actions of Operations Delivery Group meetings (10 Nov 03 – 16 Feb 04);
- Agenda and actions of Legal and Finance Deliver Group meetings (25 Nov 03 – 17 Feb 04)
- Agenda and actions Legal Delivery Group (11 Nov 03 & 27 Nov 03);
- Agenda and actions of Marketing Delivery Group (4 Feb 04 & 18 Feb 04)

On-site visit

We interviewed the following staff to enhance our understanding of the unit's role in product development and related rule amendments:

- General Manager, Strategy & Business Operations
- Senior Manager, Equity Products.

Observations

Progress on recommendations from ASIC's previous assessment

ASIC made no particular recommendations for BD in the previous assessment report.

Policies and Procedures

The policy and procedures deal mainly with ongoing maintenance for existing products and ongoing agreements with third party service providers. The policy and procedures do not deal in any way with initiation and/or establishment of new products.

Records/Files

Some information is filed within BD but in relation to product development a significant amount of information appears to be contained in the files of other SFE Business Units as well as the relevant Project File. From our review it appears that there is no central file that captures all the information generated in developing a new product.

Interaction with other business units

Apart from the interaction relating to new product development outlined in section 2 of this report, BD also interacts with other business units as a consequence of their ongoing liaison with participants. This may involve potential rule amendments, changes to contract specifications, suggested changes to functionality of trading platform, changes to margin parameters etc. Interaction is between BD and Legal, Business Operations, Clearing, Technology etc.

Market Makers

There are currently 8 Market Makers who quote some of the following products; AUD/USD futures, Swap futures, Individual Share futures, Interbank futures and Options over the SPI200 futures.

BD has a new piece of software which is capable of monitoring compliance by Market Makers with their contractual obligations. This will enable BD to ascertain the level of compliance by the Market Makers with their obligations and a process of active review by BD may deliver improved market making thereby adding liquidity to the market.

Block Trading Facility

The introduction of the Block Trading Facility ("BTF") included an undertaking that SFE would provide a report to ASIC on several issues including the impact, if any, on the central market as a result of the introduction and ongoing availability of the BTF. BD is not involved with the day-to-day validation and registration of Block Trades, this is the responsibility of Business Operations. BD was however responsible for the preparation of the report to ASIC.

The report was due to be provided to ASIC by the end of August 2003 but was not provided until 27 February 2004. The report included a comparative analysis undertaken by an independent expert of large transactions in the central market and through the use of the BTF. The analysis indicated that large transactions executed on the central market have significant price impact, whereas in contrast, there is no discernable central market movement around the time that trades are executed on the BTF or at the time they are reported to the market.

While the report was late it was accepted as compliance by SFE with their undertaking based upon the detailed analysis of price impacts it contained and the absence of complaints to ASIC claiming a negative impact on liquidity or volatility on the central market as a result of the introduction of the BTF.

Recommendations

As BD does not have a specific supervisory role within the SFE structure we do not make any recommendations for them in relation to supervisory functions. At section 2 of this report we have made some recommendations in relation to the process of product development generally within SFE.