



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 28

EUREX, HKFE and LME: Application for approval as exempt futures markets

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APPLICATIONS BY EUREX DEUTSCHLAND ("EUREX"), HONG KONG FUTURES EXCHANGE LIMITED ("HKFE") AND THE LONDON METAL EXCHANGE LIMITED ("LME") FOR APPROVAL PURSUANT TO SECTION 1127 OF THE CORPORATIONS ACT 2001.

APPLICATION BY EUREX FOR APPROVAL PURSUANT TO SECTION 771 OF THE CORPORATIONS ACT 2001.

CONSULTATION SUMMARY

This summary of the above applications has been prepared by the Australian Securities and Investments Commission ("ASIC") for the purpose of obtaining comments from interested persons about the applications.

This document focuses primarily on the operation of the Corporations Act 2001 in respect of the applications. In the event that the applications are approved, issues will arise in relation to the transition of the various exempt markets to the licensing regime to be introduced into the Corporations Act by the Financial Services Reform Act 2001 ("FSR Act"), the provisions of which will better facilitate proposals such as those under consideration. These issues will relate, for example, to compensation arrangements and supervision of market participants.

Although the FSR Act related issues will be considered in detail at a later stage, interested parties are also invited to comment at this time upon the implications of that Act for the proposed exempt markets which are the subject of the above applications.

1. Background

- 1.1. Each of Eurex, HKFE and LME ("the applicants") has independently made an application for its markets to operate in Australia on the basis that those markets be declared exempt futures markets pursuant to section 1127 of the Corporations Act 2001 ("the Act"). Eurex has also made an application for declaration of an exempt stock market on the basis that some of its options contracts may constitute securities for the purposes of the Act.
- 1.2. Each of Eurex, HKFE and LME has independently applied for the installation of its Automated Trading Systems or third party proprietary front-end systems in Australia, providing direct access for Australian participants or remote access users to each exchange's host system.

2. Regulation

Eurex

- 2.1. The legal structure of the German capital market involves the close interaction of Federal and State legislation and exchange rules and regulations. In general, the business activities of the trading participants (banks, investment firms and other financial companies) are covered by Federal law, with responsibility for regulatory oversight allocated between two Federal agencies, the Federal Banking Supervisory Office ("BAKred") and the German Federal Supervisory Office for Securities Trading ("BAWe").
- 2.2. At the State level, the German State of Hesse is responsible for exchange supervision as well as establishing and, in part enforcing, State regulations adopted under the purview of the Exchange Act (e.g. regulations concerning the election of an Exchange Council, and the establishment, composition and proceedings of an exchange disciplinary committee). The organisation, regulation and supervision of exchanges fall under the German Exchange Act. Although the German Exchange Act constitutes Federal law, the federalism principle provides for the supervision of an exchange through the Exchange Supervisory Authority of the respective Federal German State in which the particular exchange has its corporate domicile.

HKFE

- 2.3. Regulatory responsibility in Hong Kong is divided between the Hong Kong Securities and Futures Commission ("SFC"), as the primary regulator of the Hong Kong futures market, and HKFE, which is responsible for regulation of Participants in the market with respect to trading matters. The core legislation governing the futures industry in Hong Kong is the Commodities Trading Ordinance ("CTO"), pertaining to commodities trading and the business of advising on the purchase or sale of futures contracts.
- 2.4. The SFC has primary responsibility for conduct of routine inspections of Exchange Participants' businesses, monitoring of conduct rules and liquid capital requirements, and ensuring that Exchange Participants have proper systems of management and controls in place. SFC's role includes supervision of the market place, regulation of the futures industry, provision of investor protection, suppression of financial crime and market misconduct and co-operation with other securities and futures regulators. HKFE is the entity licensed, under the CTO, to establish and operate a commodity exchange and is permitted to provide and maintain a place for the trading of the futures contracts specified in the CTO.

LME

- 2.5. The LME is a Recognised Investment Exchange (RIE) under the Financial Services Act (1986) ("FSA 1986"). As such LME is the front-line regulator of its market, operating under the oversight of the Financial Services Authority (FSA), the UK's unified statutory financial regulator. The LME enters into a contract with each member and, therefore has contractual rights and

obligations in relation to each member. It also derives many of its responsibilities and duties from statute. The Recognition Criteria for RIEs, contained in Schedule 4 of the FSA 1986, establishes standards which RIEs must attain to be recognised by the FSA. The criteria cover both contract performance and regulatory standards.

3. Contracts

Eurex

- 3.1. Eurex proposes to make available capital market, money market, index and equity products through its automated trading system.

HKFE

- 3.2. There are four types of derivative products offered by HKFE; namely, equity index, equity, interest rate and foreign currency derivative products.

LME

- 3.3. LME is a metals exchange. LME will make aluminium, aluminium alloy, copper, nickel, lead, silver, tin, zinc and the LMEX Base Metals Index Contract available via its automated trading system.
- 3.4. Although there are some similarities between futures products of various exchanges in terms of generic risk management characteristics, the applicants have informed ASIC that they currently have no intentions to introduce or list any products which are substantially the same as, or identical to, products that are presently offered by Australian exchanges.

4. Participants

- 4.1. Each of the applicants has categories of "Participants" (as defined in its Business Rules*), who will be entitled to conduct business on their market. The Participants can mainly be described as:

- (a) Participants who can only execute and/or clear business for their own account; and
- (b) Participants who can execute and/or clear business for their own accounts, other Participant accounts and customer accounts.

* HKFE's categories of "Participants" excludes Australian remote access users.

- 4.2. Each of the applicants has minimum capital requirements that must be satisfied prior to admitting a Participant.

Eurex

- 4.3. Eurex proposes to install its electronic trading terminals in the offices of Eurex members located in Australia. Reference to members of Eurex includes "affiliates"* of such members to the extent that such affiliates are granted access by the member to the Eurex trading system. The Eurex Rules and

Regulations require that the affiliate will be required to comply with all of Eurex's rules relating to trading on the Eurex trading system, and that the member shall remain responsible to Eurex for ensuring its affiliate's compliance with such rules.

- * An "affiliate" of a Eurex member means any person that;
 - (a) owns 50 % or more of the member;
 - (b) is owned 50% or more by the member; or
 - (c) is owned 50% or more by a third person that also owns 50% or more of the member.

- 4.4. A requirement for participation in Eurex will be that the Australian members hold either a futures brokers licence or a securities dealers licence, as applicable.

HKFE

- 4.5. HKFE proposes that access to its market through HKATS be by way of proprietary front-end systems in Australia, with direct access to HKATS. Access would be made available to Australian authorised remote access users ("Aust.ARAUs"), that is, Australian firms who are clients of an Exchange/Hong Kong Clearing Corporation ("HKCC") Participant or "affiliates"* of Exchange/HKCC Participants. Aust.ARAUs must not breach any of the HKFE Business Rules relating to HKATS, and the Exchange/HKCC Participant is responsible to HKFE for ensuring its client or affiliate is in compliance with such rules. An Aust.ARAU can only trade for its own account unless it is an affiliate of an Exchange/HKCC Participant. Under current HKFE Rules an Australian firm cannot be admitted as an Exchange Participant, and only Hong Kong incorporated companies can become Exchange Participants.

- 4.6. Aust.ARAUs operating in Australia would be required to be regulated entities in Australia.

- * For the abovementioned purpose, affiliates would be defined as subsidiaries, fellow subsidiaries or holding companies under Hong Kong law of the relevant HKFE Participant.

LME

- 4.7. LME wish to make its electronic trading and order matching system, known as LME Select, available to LME members in Australia. All trading on LME Select is subject to the full LME Rules and Regulations.
- 4.8. All LME member firms trading on LME Select from Australia would have to be appropriately authorised and licensed (i.e. hold a futures brokers licence) in Australia to conduct their business on LME Select.

Participants on Australian Exchanges

- 4.9. The fact that participants of the applicants may also be participants of SFE Corporation Limited ("SFE"), ASX Limited ("ASX") and potentially, ASX Futures Exchange Pty Limited ("ASXF"), and may deal for clients on each exchange, raises issues about supervision of the participant's activities and the

arrangements that may need to be in place between the applicants and the Australian exchanges.

- 4.10. Prior to the implementation of the Financial Services Reform Act, SFE is both a futures association and futures exchange and accordingly has responsibility for both the conduct of its participants on its market, as well as markets of Recognised Futures Exchanges.
- 4.11. ASXF as a futures exchange will have responsibility for the conduct of its participants on its market.
- 4.12. However, it should be noted that pursuant to section 792A(c)(ii) of the Financial Services Reform Act 2001, holders of Australian Market Licences are required to monitor the conduct of participants only on or in relation to their own market.

Comments are sought as to:

- (a) the implications of a person being a participant of the SFE and/or ASXF as well as being a participant or direct user of Eurex, HKFE and LME; and*
- (b) any implications for the role that may need to be performed by SFE as a futures association and a futures exchange, and the ASXF as a futures exchange in regards to such persons, both before and after the implementation of the Financial Services Reform Act.*

5. Clearing

Eurex

- 5.1. Eurex Clearing AG clears all Eurex trades and functions as counterparty for all options and futures transactions that take place on Eurex. Every Eurex participant is required to participate in the clearing process of Eurex Clearing AG. Every clearing member is required to maintain sufficient margin to cover all of its contractual obligations. Under German law, Exchange Participants are required to segregate customer funds from their own funds.
- 5.2. Eurex Clearing AG maintains a Clearing Guarantee fund made up of contributions from Eurex Clearing Members and funds from its annual surplus. As at 31 December 2000 the fund stood at approximately EUR250 million (equivalent to approximately A\$430 million, based on A\$1 = EUR0.58).

HKFE

- 5.3. HKCC, a wholly-owned subsidiary of HKFE, clears and is the counterparty to all trades through its facilities and sets minimum margin levels for HKFE's products. An Exchange Participant must be a Clearing Participant of HKCC or have procured the clearing of its trades through a General Clearing Participant of HKCC. The SFC requires that customer monies be separately accounted for and segregated from securities and other property of an Exchange Participant. The customer's assets, monies, securities and other

property do not form part of the assets of the Exchange Participant for insolvency or winding up purposes.

- 5.4. HKCC has established a Reserve Fund to support it in fulfilling its counterparty obligations in the event that one or more HKCC Participant fails to meet its obligations to HKCC. Currently, the aggregate size of the Reserve Fund exceeds HK\$590 million (equivalent to A\$147.5 million based on A\$1 = HK\$4.0). This is made up of Participants' cash deposits, interest income, insurance and bank facilities.
- 5.5. As noted in paragraph 4.5, Aust.ARAUs cannot be admitted as Exchange Participants and would therefore not be involved in the clearing process as a HKCC Clearing Participant.

LME

- 5.6. Contracts traded on LME are matched and cleared by The London Clearing House ("LCH"). As with other Clearing Houses, contracts are novated and the LCH becomes the counterparty to each side of every trade. Members who are permitted to trade on LME Select must also be members of LCH.
- 5.7. The LCH clearing guarantee fund is referred to as the default fund. The default fund's authorised amount is £400 million. The fund is held in cash and fund contributions amount to about £300 million. Fund contributions are calculated on a member by member basis, with reference to activity measured by volume and initial margin requirements. For each cleared market, members are required to make a minimum contribution to the default fund.
- 5.8. Members that only clear LME contracts are required to make a minimum contribution to the default fund of £100,000. The contribution increases as the member's cleared volume increases. The contribution to the fund is made in cash, which is held by the LCH.

6. Fidelity Fund

Eurex

- 6.1. Eurex itself does not maintain a Fidelity Fund, although if a customer deposits funds or securities directly or indirectly with German credit institutions or financial services institutions they are entitled to the benefits of several insurance and compensation schemes. The statutory compensation schemes are funded by required contributions from member institutions, which are set at levels overseen by BAKred and the German Federal Finance Ministry. The compensation Schemes themselves are subject to supervision and audit by the BAKred.

HKFE

- 6.2. The CTO requires HKFE to make a contribution in respect of every holder of Trading Rights towards the Compensation Fund established under the CTO

for the benefit of the investing public. The fund is in place to compensate any person who sustains pecuniary loss because of a default committed by an Exchange Participant. The HKFE is required to keep deposited with the SFC HK\$100,000 for each holder of a Trading Right.

- 6.3. An Australian end-user would have a claim against the Compensation Fund (all other factors being satisfied) where the claim arose from default by an Exchange Participant. An Australian end-user, however, would not have a claim against the Compensation Fund where that claim arose from a default by an Aust.ARAU, because it is not an Exchange Participant.
- 6.4. HKFE contends that an Australian end-user would have a claim under the SFE Fidelity Fund (all other factors being satisfied). This is said to be on the basis that Aust.ARAU's are required to be licensed futures brokers in Australia and would therefore be covered by the Fidelity Fund presently established under Chapter 8 of the Corporations Act 2001. (Note that this issue also arises in relation to the exempt futures market applications made by Eurex and LME.)
- 6.5. Under the Financial Services Reform Act 2001, access to compensation arrangements for investors will change. At the end of the transitional period for SFE, access to the SFE Fidelity Fund, will cease in relation to trading which takes place otherwise than on SFE. Australian investors will instead be reliant on compensation from individual Aust.ARAU's with whom they are dealing. This raises an issue in relation to the two year transition period. It may be that for example an Aust.ARAU chooses not to obtain an Australian Financial Services Licence until the end of the two year transition period. In this case, the individual compensation arrangements applicable to each Aust.ARAU may not be equivalent to the SFE Fidelity Fund.

LME

- 6.6. The FSA has established a single compensation fund, creating a single entry point for compensation claims in the event of an authorised firm's default. The compensation scheme is confined to defaults. Compensation claims against on-going firms are covered by dispute resolution mechanisms such as LME arbitration or ombudsman schemes. The single compensation scheme operated by the FSA is established by statute in the Financial Services and Markets Act 2000, Part XV. As with the other compensation schemes, access to compensation is aimed at private individuals and small businesses.

Comments are sought on the adequacy of arrangements for fidelity/compensation funds in respect of Australian participants and Australian customers of participants.

Comments are also sought as to the appropriateness of access to Australian exchange fidelity funds in relation to activity, which occurs on markets operated by non-Australian exchanges.

7. Supervision

Eurex

- 7.1. Australian participants in the Eurex market will be subject to the same supervision imposed on current members of the Eurex market. As a fully automated exchange, Eurex believes it is in a position to monitor and examine compliance of each exchange member with the laws, regulations, terms and conditions and other rules governing trading on Eurex. The Eurex system has the capacity to produce a detailed audit trail for every transaction.
- 7.2. The Eurex Rules and Regulations do not impose requirements on participants in their dealings with their customers. The focus of the Rules and Regulations are the dealings of the participants themselves. Eurex contends that it is the responsibility of the home regulator and futures organisation to monitor the behaviour of their participants in dealing with customers.

HKFE

- 7.3. Market surveillance functions are currently performed by the Listing, Regulations and Risk Management Unit ("LRRM") of Hong Kong Exchanges and Clearing Limited. The LRRM has established "Market Supervision" and "Market Surveillance" teams. The monitoring process extends to trades initiated by Aust.ARAU's, as these trades must be cleared and settled by, and in the name of, HKCC Participants.
- 7.4. HKFE Business Rules provides that an Exchange/HKCC Participant is liable for all orders arising from remote access clients including Aust.ARAU's, and shall implement adequate measures to monitor the trading on HKATS by its Aust.ARAU and to ensure compliance with its risk management policy. Where an Aust.ARAU has breached any of the HKFE Business Rules relating to HKATS, the relevant Exchange Participant will be responsible and fully liable for such a breach and if the LRRM determines that there are grounds for disciplinary action to be taken, it will give notice to the relevant Exchange Participant.

LME

- 7.5. Full monitoring of trading on LME Select is carried out by the LME's Regulation and Compliance Department, which is overseen by the FSA. Monitoring of LME Select is conducted via a number of electronic surveillance tools and automated audit trails. The LME Regulation and Compliance Department can view every trade in real time transacted on LME Select, and also the timing of every order entered, withdrawn or otherwise amended. In addition, all historic data on LME Select is stored on the database.
- 7.6. All trading on LME Select is subject to the full LME Rules and Regulations, including the investigation, enforcement and disciplinary regime. The LME operates under contract law, with each of its members entering into a contract with the LME. The LME's rulings, disciplinary actions (including fines) and regulatory actions are enforceable in the UK courts.

Comments are sought as to the adequacy of the supervision and compliance to be undertaken by the applicants.

8. Request For Comments

- 8.1. Comments are sought on what conditions, if any, you think ASIC should recommend to the Minister to ensure the protection of Australian users of Eurex, HKFE and LME, the integrity of Australian markets and the stability of the Australian financial system.
- 8.2. ASIC seeks comments on the applications of Eurex, HKFE and LME, particularly on the matters identified in the discussion above as well as any other issues you would like to raise.
- 8.3. Submissions may be sent by email to tracey.lyons@asic.gov.au
or sent to

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- 8.4. All submissions will be treated as public by ASIC and will be provided to Eurex, HKFE and LME unless otherwise marked.
- 8.5. ASIC will accept comments until the close of business on **Friday, 16 November 2001.**