



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 13

ASIC call for public comment on ASX Futures Exchange

March 2001



ASIC

Australian Securities & Investments Commission

Application by ASX Futures Exchange Pty Limited ABN 18 006 599 364 (ASXF) for reactivation of its futures market in accordance with the rule amendment procedures in section 1136 of the Corporations Law

Application by Options Clearing House Pty Limited ABN 48 001 314 503 (OCH) for approval as a futures clearing house pursuant to section 1131 of the Corporations Law

Consultation summary

This summary of applications by ASXF and OCH has been prepared by the Australian Securities and Investments Commission (ASIC) for the purpose of obtaining comments from interested persons as part of the public consultation about these applications.

1. Background

Application

- 1.1 ASXF is proposing to reactivate its futures market by amending its business rules in accordance with the procedures set out in section 1136 of the Corporations Law (the Law). ASXF will have an agreement in place with OCH, for OCH to clear all market transactions traded on the market of ASXF. OCH has made an application for approval under section 1131 of the Law to become an approved clearing house of ASXF. These applications are being considered contemporaneously.
- 1.2 ASXF and OCH are located at Exchange Centre, 20 Bridge Street Sydney.
- 1.3 The Business Rules of ASXF and OCH will be supported by detailed procedures that will deal with administrative issues that give effect to the rules. ASXF's procedures are currently being drafted, however they are expected to be similar to those covering the application of Business Rules in the Exchange Traded Option (ETO) market. ASIC will review these procedures prior to making any final recommendation to the Minister about the applications.

Company Structure

- 1.4 ASXF and OCH are both wholly owned subsidiaries of Australian Stock Exchange Limited (ASX). ASXF was incorporated in 1986 under the name Australian Financial Futures Market Pty Ltd (AFFM), and in 1994 changed its name to ASX Futures Exchange Pty Limited.
- 1.5 AFFM was approved as a futures exchange in 1986 by the Attorney General of Victoria pursuant to section 15 of the Futures Industry Act 1986. AFFM became dormant after its clearing house, International Commodities Clearing House, ceased operating in Australia in 1991.
- 1.6 ASXF is now seeking to reactive its market. As ASXF is deemed under subsection 1126(3) of the Law to have been approved under subsection 1126(2) of the Law as a futures exchange, it is not necessary for ASXF to apply for such an approval. Rather, ASXF will amend its Business Rules in accordance with the procedures set out in section 1136 of the Law. Given the length of time for which ASXF has been dormant, ASXF's application is being treated as though it were a new approval.
- 1.7 OCH has operated as a derivatives clearing house for ASX markets in ETOs since 1976. OCH has also recently obtained approval as a futures clearing house to clear futures contracts traded on the market of the Australian Derivatives Exchange Limited (ADX).
- 1.8 ASXF's new draft constitution and new draft Business Rules permit the issue of a share known as a Redeemable Participant Share to participants of ASXF. These shares will be issued on the terms as set out in the draft constitution. In summary such a share:
 - (i) entitles the holder to transact business in ASXF's market;
 - (ii) may be redeemed by ASXF;
 - (iii) carries limited voting rights; and
 - (iv) carries limited rights to payment of capital, but no rights to receive dividends.

The rights of a participant to transfer such a share is subject to approval by ASXF.
- 1.9 The issue of Redeemable Participant Shares to ASXF participants is principally to ensure compliance with section 1148 of the Law, which requires licensed brokers to be members of a futures organisation.
- 1.10 ASXF is a proprietary company and under current law must have no more than 50 non-employee shareholders. However, the requirement for participants to be members of a futures organisation is to be removed under proposed Financial Services Reform legislation.

Regulatory implications of approval of multiple futures exchanges

- 1.11 There are currently two other established and active futures exchanges within Australia, namely the Sydney Futures Exchange Limited (SFE) and ADX. SFE is approved as a futures exchange and a futures association. ADX is approved as a futures exchange. ASXF will reactivate its futures market in accordance with the rule amendment procedures set out in section 1136 of the Law.
- 1.12 The fact that an ASXF participant may also be a participant of SFE and/or ADX, and deal for clients on each exchange raises issues about responsibility for supervision of broker activities and the arrangements that may need to be in place between SFE, ADX and ASXF in order to ensure market integrity is maintained.
- 1.13 OCH and Sydney Futures Exchange Clearing House Ltd (SFECH) have entered into an information sharing arrangement with regards to clearing participants common to the markets which are cleared by either OCH or SFECH.

Comments are sought on the implications of a person being a participant of SFE, ADX and ASXF in relation to supervision and position limits. In particular, ASIC seeks comments on the implications of no one exchange having an overview of all market positions at any given point in time.

Contracts

- 1.14 ASXF is proposing to recommence operation initially trading equity futures contracts. ASXF is intending to list:
- (i) exchange traded fund contracts (this contract will be over an underlying product which does not currently exist in the Australian market);
 - (ii) market leaders index contracts; and
 - (iii) deliverable share futures contracts.

Contract specifications are yet to be released. ASXF has advised that the specifications will be published during the consultation period.

- 1.15 Whilst ASXF is anticipating initially to trade equity futures, the draft Business Rules have been designed so that ASXF can trade other types of futures contracts. There is a likelihood that if the approval sought is granted that there will be three futures exchanges which, at least in part, trade similar contracts.

Comments are sought on any regulatory issues associated with the trading of similar products on three separate exchanges and in particular, on any implications for the integrity of those markets.

ASXF Technology

- 1.16 ASXF has selected CLICK for its trading system. CLICK was developed by OM Gruppen AB in 1991 and is used across 16 securities and derivatives exchanges

including Stockholm Stock Exchange – Derivatives, OM London Exchange, Hong Kong Futures Exchange, London Metal Exchange and American Stock Exchange. ASX currently uses CLICK to match orders in respect of Low Exercised Price Options (LEPOs) and ETOs.

- 1.17 In the existing structure, CLICK has two separate order books; the Central Orderbook and the Bulletin Board. CLICK is currently undergoing modifications to allow all orders to be matched in the Central Orderbook. ASXF draft Business Rules provide that the Central Orderbook is a facility for trading Contract Series and Standard Combinations and the Bulletin Board is a facility for advertising interests and trading Non-Standard Combinations and component Contract Series of Cross Combinations. The ASX Communication Structure will provide the secure communications network which will link participants in the ASXF market.
- 1.18 ASXF will provide three levels of service to participants trading on its markets. These levels are:
- (i) Full Broadcast Service - will provide full market depth information and will have a line speed which is designed to permit larger quantities of orders to be routed through to the Central Orderbook at the same time. ASXF considers that this service is suitable for those participants who undertake market making activities;
 - (ii) Standard Service - will show best five bid and offer prices rather than full market depth and is considered by ASXF to be adequate for most participants; and
 - (iii) Dial up Service - is intended by ASXF for those participants who do not require the feed of all information, and only require selected information of their choice. Participants will request information which will be shown in summary format.
- 1.19 OCH will use its existing Derivatives Clearing System (DCS) and Theoretical Intra-day Margin System (TIMS) margining and risk management systems to manage ASXF's clearing requirements.
- 1.20 DCS is designed so that each participant in each market can be segregated according to which market (either ASXF or ETO) the transaction is dealt on. DCS can separately process and report trading and allocation activity, position activity, exercise / assignment / delivery / cash settlement activity, and the daily settlement amounts (both segregated and unsegregated). Initially DCS will be configured so that there will be no cross netting between ETO and ASXF markets. Any amendment to cross netting will require systematic changes along with any necessary business rule amendments.

Regulatory Arrangements

- 1.21 It is envisaged that there will be a Memorandum of Understanding (MOU) or other arrangements between ASXF and ASIC and OCH and ASIC to ensure that there is an effective co-regulatory arrangement. It is also likely that there will be MOUs or other arrangements with other exchanges with which ASXF will have relationships.

- 1.22 ASIC proposes that ASXF and ASIC will enter into a deed incorporating the obligations contained under section 769A of the Law, adapted to reflect matters being proposed in the Financial Services Reform legislation in relation to market operators. These obligations would include provision of financial, technical and human resources for proper market operation and carrying out its supervisory arrangements. This deed will be similar to the deeds entered into by ASIC and SFE and ASIC and ADX.
- 1.23 ASIC expects that ASXF's constitution will contain clauses dealing with corporate governance requirements such as fit and proper tests, good fame and character, and integrity of directors and senior executives of ASXF.

2. ASXF participants

- 2.1 ASXF's draft Business Rules deal with classes of participant which are entitled to conduct business on the ASXF market. They are:
- (i) Broker Participants;
 - (ii) Local Participants; and
 - (iii) Non-Trading Clearing Participants.

These classes will be referred to collectively as 'Participants'.

Broker and Local Participants

- 2.2 Part 2 of ASXF's draft Business Rules deals with the rights of Broker Participants, which are outlined as follows:
- (i) the right to trade in any contract on the exchange on its own behalf;
 - (ii) the right to trade in any contract on the exchange on behalf of another person;
 - (iii) Trading Permission (as defined in ASXF's draft Business Rules) with respect to the trading system; and
 - (iv) the right to hold one Redeemable Participant Share in ASXF.
- 2.3 Local Participants will have the same rights as outlined above; save that they will not have the right to trade on behalf of another person except as provided under the Law.
- 2.4 Non-Trading Clearing Participants will not have the right to enter into any Market Transactions (as defined in ASXF's draft Business Rules), and are only permitted to clear Market Transactions as defined under ASXF Rule 2.1.1.
- 2.5 Participants who are admitted as either Broker or Local Participants have trading permission and are referred to as Trading Participants. ASXF's draft Business Rules maintain that the Trading Participant must comply with relevant organisational and technical resources, trading management arrangements and security arrangements (ASXF Rules 9.2.4 to 9.2.7).
- 2.6 An applicant for Broker or Local Participant admission (ASXF Rule 3.1) must:

- (i) hold the relevant licence under the Law which authorises the applicant to carry on business as a Participant;
- (ii) in the case of an individual making an application, reside in Australia, be of good fame and character and high business integrity and have completed the relevant qualifications and training;
- (iii) in the case of a body corporation, be incorporated under the Law or recognised as a foreign company under the Law;
- (iv) satisfy ASXF that it has the facilities, procedures, personnel and financial resources in place that are adequate to perform its obligations as a Participant under the Business Rules;
- (v) in the case of a Trading Participant, comply with operational requirements set out in ASXF's draft Business Rules;
- (vi) be admitted as a Clearing Participant or have entered into a Clearing Agreement with a Clearing Participant;
- (vii) comply with relevant ownership requirements (ASXF Rule 3.4); and
- (viii) have insurance arrangements in place.

2.7 ASXF Rule 17.3.4 provides that ASXF has the right to suspend or terminate the Participant's admission if the Participant's actions result in default under ASXF Rule 17.3.2 or another significant event under ASXF Rule 17.3.3. The event of default or other significant events which may result in suspension or termination of a Participant's admission is dealt with in greater depth in paragraph 9.7 of this document. ASXF's Rule 17.5.2 provides for an appeal process. ASXF Rule 2.5 deals with the resignation of a Participant's accreditation.

2.8 Part 5 of ASXF's draft Business Rules provides that Participants will be able to comply with either NTA requirements or an equivalent to the ASX Rule 1A Risk Based Capital Requirement (as set out in ASX Business Rules) during a two year transitional period. After the transitional period, Participants must comply with the Risk Based Capital Requirement. ASXF Rule 5.2.1 requires ASX Participating Organisations to comply with requirements which apply to Participants under ASX Business Rules; other Participants of ASXF can elect to comply with the NTA requirements.

2.9 Trading Participants must maintain financial records which correctly record and explain the transactions and financial position of the business of dealing in futures contracts and must continue to comply with section 1213 of the Law (ASXF Rule 4.2.2). ASXF's draft Business Rules also require an auditor to be appointed to conduct an audit of internal procedures, and any other matters which are specified by ASXF.

2.10 A Trading Participant that is not a Clearing Participant must enter into a Clearing Agreement with only one Clearing Participant. The Trading Participant's nominated Clearing Participant will be responsible for the clearing obligations in respect of the Trading Participant's transactions, immediately after the Trading Participant enters into the trade. The agreement between the Trading Participant and the Clearing Participant

must meet the minimum terms set out under ASXF Rule 6.2.1. Termination of any such arrangement is dealt with under ASXF Rule 6.4.

- 2.11 ASXF Rule 3.3.3 provides that where an applicant for admission resides outside Australia or is a body corporate incorporated outside Australia, the applicant must satisfy ASXF that it is regulated by a foreign derivatives and securities exchange or foreign regulatory authority. ASXF may require additional undertakings or undertakings governed by Australian law in respect of any matter which ASXF considers reasonable or in the interest of the public or the exchange. These undertakings include:
- (i) amount of and number of personnel to be located in Australia;
 - (ii) access by ASXF to records required to be kept by the Participant under ASXF draft Business Rules or the Law;
 - (iii) foreign taxes that might be payable;
 - (iv) whether the law of the body corporate's place of incorporation would recognise protections afforded by Australian law to clients' money and property in winding up of the body corporate; and
 - (v) ranking of creditors on a winding up of the body corporate.

ASIC seeks comments on the appropriateness of foreign applicants being approved as participants of ASXF.

Market Makers

- 2.12 ASXF's draft Business Rules make provision for market making activities by Trading Participants. The draft Business Rules provide that at least one Class (all Contract Series with the same underlying physical asset) will be assigned to a Market Maker. It is currently proposed that the Trading Participant's market making activities must be separated from all other trading activities (ASXF Rule 12.2.1).
- 2.13 The obligations of a Market Maker are dealt with in ASXF Rule 12.3 and include provisions dealing with making markets during the relevant period (as determined by ASXF), the minimum quantities and maximum spreads (ASXF Rules 12.3.1 to 12.3.3). It is intended that there will be two categories of obligations:
- (i) Continuous basis - making the market for at least a percentage of the Relevant Period (as determined by ASXF); and
 - (ii) Quote Request basis - must make markets on receipt of a request.
- 2.14 ASXF is intending to offer fee discounts to Market Makers based upon meeting continuous and/or quote request obligations.
- 2.15 ASXF's draft Business Rules deal with suspension and withdrawal of registration as a Market Maker and the appeal mechanism available to Market Makers (ASXF Rule 12.8).

Accredited Advisers

2.16 Employees of a Trading Participant who advise or make a recommendation (including recommendations in a research report) to a client in relation to a product on ASXF must be Accredited Advisers. The criteria for approval is set out in Part 8 of the ASXF's draft Business Rules and includes:

- (i) a Proper Authority from the Trading Participant;
- (ii) a pass level (as prescribed in the procedures) for the accreditation examination; and
- (iii) the relevant prerequisite skills, knowledge and integrity.

2.17 ASXF will have the ability to automatically withdraw an Accredited Adviser's registration if he/she ceases to hold a Proper Authority or ceases to be employed by the relevant Participant (ASXF Rule 8.5.1) or fails to comply with ASXF draft Business Rules or the prerequisites for skill and integrity (ASXF Rule 8.5.5). There is an appeal process available for Accredited Advisers relating to decisions in connection with the application or suspension or termination (ASXF Rule 8.8).

Designated Trading Representative

2.18 ASXF Rule 9.3.1 provides that only Designated Trading Representatives (DTR) may submit trading messages into the Derivatives Trading Facility, unless the trading message is conducted in accordance with Automated Order Processing requirements which is dealt with in greater depth in paragraph 3.8 of this document. Persons accredited as DTRs must:

- (i) hold a Proper Authority if required by the Law; and
- (ii) demonstrate knowledge of the Business Rules and Procedures and any other relevant practices, directions, decisions and requirements by passing an examination determined by the ASXF (ASXF Rule 9.3.4).

2.19 ASXF's draft Business Rules provide for suspension and withdrawal of registration as a DTR and an appeal mechanism (ASXF Rules 9.3.8 to 9.3.13).

Clearing Participants

2.20 The criteria for admission as a Futures Clearing Participant are set out in Rule 2.3 of OCH's draft Business Rules. Only bodies corporate can be Futures Clearing Participants. In addition, under OCH Rule 2.3.2 the general admission requirements with respect to eligibility provide that an applicant must:

- (i) be a participant of an Approved Exchange;
- (ii) meet the capital requirements imposed by the relevant Approved Exchange;
- (iii) agree to comply with the rules, procedures, practices, directions and decisions of the relevant Approved Exchange;

- (iv) satisfy OCH that it has facilities, procedures and personnel and financial resources adequate for the performance of the obligations of a Futures Clearing Participant under the Rules and for expeditious and orderly dealings with the Approved Exchange, OCH, other Futures Clearing Participants and participants of the relevant Approved Exchange;
- (v) if required by the Law, hold a licence which authorises the applicant to carry on the business which it will carry on (OCH Rule 2.3.2(e)); and
- (vi) be a member of OCH in the true corporate sense in accordance with sections 1121 and 1131 of the Law. OCH draft Business Rule 2.2 provides, therefore, that all Futures Clearing Participants must hold a share in OCH. These shares will be non-voting redeemable shares which carry no real economic interest in OCH itself.

2.21 To satisfy itself that an applicant has adequate personnel, OCH may, prior to admitting the Futures Clearing Participant have regard to the character and business integrity of directors and officers as well as persons involved in the business of the applicant in connection with OCH (OCH Rule 2.3.4).

Comments are sought as to the adequacy of the admission criteria for persons seeking to be a participant of ASXF and a futures clearing participant of OCH.

3. Market Structure and Operation

- 3.1 A Trading Participant will be required, before accepting an order to enter into a Market Transaction for a client for the first time, to enter into a client agreement (ASXF Rule 7.1.1). The Trading Participant is not required to obtain a written client agreement referred to in ASXF's Rule 7.1.1 if the Trading Participant has satisfied itself that the client has executed and lodged with ASXF a Professional Investor Client Agreement (ASXF Rule 7.1.4). ASXF's draft Business Rules will require a Trading Participant to provide clients with contract notes, monthly statements and any other information relating to its dealing for a client, as required by Chapter 8 of the Law (ASXF Rules 7.5 and 7.6).
- 3.2 It is currently proposed that the market will operate between 10.00am and 4.00pm, Mondays through Fridays. A pre-opening phase will operate where orders can be entered into the trading system, but no matching will take place until the market has opened.
- 3.3 ASXF is also proposing to offer Late Trading to Trading Participants during the period 4.15pm to 5.00pm. ASXF Rule 11.10.2 provides that if a Trading Participant intends to enter into a Market Transaction during Late Trading the Trading Participant must use its best endeavours to contact all Market Makers in the Class it intends to deal in, or other recorded sellers or recorded buyers (as defined under ASXF Rule 11.10.3).
- 3.4 ASXF Rule 11.11 provides that a Trading Participant may enter into a Market Transaction between 5.01pm to 7.00am if the Trading Participant is acting on behalf of a client who does not reside in Australia and the instructions are transmitted from outside Australia and received by the Trading Participant outside Trading Hours. ASXF expects that transactions executed during this period will primarily involve Market Makers and represent a very low proportion of the overall market trades.
- 3.5 The order types to be traded on ASXF are limit orders, market orders and contingent orders. Contingent orders are multiple orders which are to be executed simultaneously in the ratios specified. The contingent orders include:
 - (i) Standard Combinations – which are designed by ASXF and represent commonly traded derivatives strategies; and
 - (ii) Non-Standard Combinations – which consist of combinations of two to four derivative legs relating to the same underlying security and Buy & Write Combinations with one derivatives leg and one underlying security leg which is the underlying of the derivatives leg.
- 3.6 Provisions for priority of orders are found under ASXF Rule 11.3.6. Trading Participants must maintain a complete audit trail of orders received (ASXF Rules 4.6.1 and 4.6.2). Client orders are to have priority over principal (house) orders (ASXF Rule 7.4.2).

- 3.7 Provisions relating to error trades and trade disputes are dealt with under Part 15 of ASXF's draft Business Rules. ASXF may appoint Trading Governors for the purpose of resolving trade disputes. The Trading Governors will have the power to make any decision necessary to enforce the Dealing Rules (as defined in ASXF's draft Business Rules) or ensure a fair and orderly market.
- 3.8 ASXF Rule 9.4 permits Automated Order Processing with the responsibility for these orders remaining with the Trading Participant. Trading Participants must ensure compliance with Operational Requirements under ASXF Rule 9.2.4 to ensure that the Automated Order Processing does not interfere with the efficiency and integrity of ASXF or the proper functioning of the Derivatives Trading Facility (as defined in ASXF's draft Business Rules). Any orders to be routed using the Automated Order Processing facility must satisfy any filtering obligations.
- 3.9 ASXF Rule 7.5.4 provides for accumulation and price averaging where two or more Market Transactions have been entered on behalf of a client. The Trading Participant must have prior authorisation from a client to accumulate or price average. The Trading Participant must also issue a contract note with the requirements specified under ASXF draft Business Rule 7.5.4(c).
- 3.10 ASXF's draft Business Rules do not contain specific prohibitions on conduct such as pre-arranging, dual trading and post allocation. ASXF has indicated that action will be taken against Participants who engage in such conduct and other inappropriate conduct under its draft rules relating to "Unprofessional Conduct" (ASXF Rule 21.1).

ASIC seeks comments on whether the general regulation on inappropriate conduct in ASXF's draft Business Rules is adequate to prohibit conduct such as pre-arranging, dual trading and post allocation, and whether ASXF will be able to take effective disciplinary action in respect of such conduct.

4. Clearing

- 4.1 As a clearing house for a futures exchange under Chapter 8 of the Law, OCH must have its own separate Business Rules. OCH's draft Business Rules are substantially equivalent to the rules approved by the Minister to permit OCH to clear ADX markets.
- 4.2 OCH does not currently propose to require its Futures Clearing Participants to make capital commitments to meet potential market defaults. OCH will use \$5 million in shareholder funds and \$20 million in subordinated debt borrowed from ASX pursuant to a loan agreement dated 22 November 1999. The total financial backing will therefore be \$25 million. OCH will rely on a margin ratio of 28% to determine the adequacy of its clearing guarantee. The 28% margin ratio is also relied on by OCH when clearing ADX markets. SFE does not rely on a margin ratio, rather SFE's clearing guarantee fund is fixed at \$150 million, which on present financial information is approximately 35% of initial margins. OCH has not indicated how it will provide further

funding if the financial backing needs to be greater than \$25 million to maintain the 28% margin ratio.

ASIC seeks comments on the adequacy of ASXF's clearing guarantee fund and appropriateness of the 28% margin ratio used to calculate the amount of financial support for the proposed clearing arrangements.

- 4.3 OCH Rules are consistent with other Clearing Houses with respect to the legal relationship created upon registration of contracts. In particular, OCH has an obligation with respect to an Open Contract registered in the name of a Futures Clearing Participant to perform, as principal, its obligations (whether as Buyer or Seller) under the Open Contract. This obligation acts as a guarantee of performance of contracts as OCH becomes the buyer to every seller and the seller to every buyer upon registration.
- 4.4 OCH is the operator of the clearing system and is a principal to all market transactions with brokers after registration of market transactions. OCH Rules in section 6 provide for OCH to disregard agency relationships and interests other than those of Futures Clearing Participants. OCH therefore assumes substantial liability to perform contracts.

5. Market Intervention Powers

- 5.1 ASXF reserves the power under ASXF Rule 13.1.1 to suspend trading in a Contract Series, a Class, or a Market generally if it considers that the suspension is appropriate in the interest of maintaining a fair and orderly market or underlying market. ASXF Rule 13.2 gives ASXF the power to suspend trading in a market if access to the Derivatives Trading Facility is generally affected because of systems and communications failures.
- 5.2 Provisions will be in place under ASXF Rule 13.6 to deal with a state of emergency, where ASXF may take any action or direct a Participant to take action or request the Clearing House to exercise its powers if it considers necessary to alleviate the state of emergency.
- 5.3 ASXF Rule 13.5 permits ASXF, where it determines an undesirable situation or practice is developing which is contrary to the maintenance of a fair and orderly market, to take the following action:
 - (i) suspend one or all of the Markets;
 - (ii) cancel or amend any Market Transactions;
 - (iii) direct Participants to take action; or
 - (iv) request the Clearing House to exercise its powers to terminate a registered contract.
- 5.4 ASXF Rule 13.4.3 provides the power to reduce Throughput Capacity (as defined in ASXF's draft Business Rules), disable the Quote Request function or suspend Trading Permission for a particular Trading Participant or all Trading Participants generally to ensure the efficiency, integrity and proper functioning of the Derivatives Trading Facility.

Comments are sought on ASXF's ability to cancel market transactions. In particular, ASIC seeks comments in relation to the impact on a market user who has entered into a contract in good faith.

6. Registration of Contracts

- 6.1 All Market Transactions will be cleared by OCH, subject to the draft Business Rules and procedures of ASXF and OCH. OCH Rule 5.4.1 provides that OCH will only register Market Transactions in a Contract Series agreed with the relevant Approved Exchange.
- 6.2 The rules governing registration of Market Transactions are set out in section 5 of OCH's draft Business Rules. The draft Business Rules feature the following points:
- (i) on registration of a Market Transaction with OCH, the Market Transaction will be novated to OCH through the standard novation process;
 - (ii) the OCH draft Business Rules contain provisions which allow OCH to refuse to register Market Transactions entered into on ASXF, in certain circumstances. These circumstances are limited to those set out in OCH Rule 5.4.6 (Clearing House may refuse or impose conditions on registration) and OCH Rule 8.5.2 (positions in excess of initial margin limits) and OCH Rule 12.2 (Powers of Clearing House on default); and
 - (iii) OCH Rule 5.5 (Daily Settlement) will require contracts to be "settled to market" on a daily basis. The settlement to market approach is consistent with the approach adopted by SFECH under its Business Rules.

7. Termination of Contracts

- 7.1 OCH draft Business Rules give OCH the power to terminate open contracts in certain circumstances. These include:
- (i) where an undesirable situation or practice develops, performance becomes impossible or impracticable or where there is a state of emergency (OCH Rule 13);
 - (ii) where an event affects a contract in a way that calls for an adjustment but where the adjustment is not practicable under the exchange rules; and
 - (iii) where an event of default occurs under OCH Rule 12.1.
- 7.2 The mechanisms for terminating contracts under the OCH Rules are set out in section 14 of OCH's draft Business Rules. In some circumstances, where there is no available market, the process of termination will involve OCH exercising its discretion to select a corresponding opposite contract to terminate, similar to the way in which SFECH effects compulsory settlement under its rules. This action is necessary to preserve an equal number of bought and sold contracts in the clearing system. The party or parties whose contracts have been terminated will be entitled to receive a termination amount equal to the market value of the contract and, where there is no market available, an amount which OCH considers fair and reasonable in the circumstances. This

mechanism exists to protect the viability of the market by seeking to underpin the clearing function that guarantees performance of contracts.

Comments are sought in relation to consumer protection issues raised by these powers given that under these proposed rules, in certain circumstances, a contract can be terminated without a party's consent.

8. Risk Management by OCH

8.1 OCH Draft Rules 4 and 11 deal with accounts and risk management. An example of the requirements is as follows:

- (i) OCH Rules provide for daily margining and, where appropriate, intra-day margining (OCH Rule 11.1.1);
- (ii) OCH will maintain separate house and client accounts. Futures Clearing Participants will have the option to elect to have omnibus client accounts (as on SFECH) or individual client accounts (as for ETOs), or both. OCH will record the positions, cash and collateral in respect of each particular account;
- (iii) OCH will initially settle all Market Contracts to market on a daily basis, which is consistent with the SFECH approach;
- (iv) OCH will calculate two daily net settlement amounts owing to or from each Futures Clearing Participant for ASXF - one for house positions and one for client positions (OCH Rules 4.3.2 and 4.3.3);
- (v) to satisfy margin calls, Futures Clearing Participants must lodge cash or collateral as Cover (OCH Rule 11.2.1). The form of cover is determined by OCH;
- (vi) Futures Clearing Participants will be able to deposit with OCH cash which is excess to any Cash Cover required as a result of the margining process (OCH Rule 11.2.2). Where OCH owes a Futures Clearing Participant a net amount as a result of daily or intra-day netting under OCH Rule 4.3, the Futures Clearing Participant can direct OCH to retain some or all of this amount as Excess Cash (OCH Rule 4.3.5);
- (vii) OCH cannot use any amount of Cash Cover recorded in respect of a Futures Clearing Participant's Client Account towards satisfaction of that Futures Clearing Participant's obligations relating to any House Account (OCH Rule 4.2.3).
- (viii) OCH Rules provide for the potential situation where OCH clears for more than one approved futures exchange. Where a Futures Clearing Participant clears for more than one market, clients on ASXF's market are, generally speaking, protected from exposure to another market. OCH cannot use any amount of Cash Cover recorded in respect of a Futures Clearing Participant's Client Account established for a particular Approved Exchange towards satisfaction of that Futures Clearing Participant's Client Accounts established for any other Approved Exchanges (OCH Rule 4.2.2). This is considered appropriate, given that the margining process will occur separately for ASXF and ADX markets and given that OCH will have a separate source of funds to "back-up" its obligations in relation to ASXF and ADX markets;

- (ix) where a Futures Clearing Participant gives OCH Cash Cover for Client Accounts relating to the ASXF market, Cash Cover in respect of one Client Account can be used to discharge that Participant's liabilities relating to Open Contracts registered in other Client Accounts. This is consistent with the omnibus account environment; and
- (x) Cash Cover and Excess Cash deposited with OCH becomes the absolute legal and beneficial property of OCH and represents a debt equal to the credit balance owing to the Futures Clearing Participant. OCH Rule 4.2.1 makes this legal characterisation clear to Futures Clearing Participants and to the market (including clients of Futures Clearing Participants).

8.2 OCH Rule 4.2.4 provides that Excess Cash and Cash Cover attributable to client accounts cannot be applied against liabilities attributable to house accounts in the event of broker insolvency provided that the liquidator agrees to deposit these funds into the client segregated account and will either pay those funds to clients or use them to discharge client liabilities to the Clearing Participant.

8.3 Potentially conflicting policy considerations exist with respect to use of client segregated funds in the event of insolvency. It is arguable that if funds lodged with OCH in relation to margining of the client positions are set off against debts in relation to house positions in the event of broker insolvency, there may be a conflict with the policy of section 1209 of the Law which requires segregation of client moneys (see also proposed ss 941D, 941E Financial Services Reform Bill). The competing policy concern is the ability of OCH to clear on a daily basis.

Comments are sought from market participants about the approach taken in OCH's Rules in relation to protection of client funds.

9. Disciplinary Rules and Proceedings

9.1 Under ASXF Rule 17.1.1, ASXF may require a Participant to provide information or permit inspection of any records in its custody or control in connection with performance of the Participant's obligations. ASXF may instigate disciplinary action under ASXF Rule 17.2 if it considers that the Participant has breached ASXF's Rules and/or Procedures, acted in a manner which constitutes Unprofessional Conduct (as defined by ASXF's draft Business Rules), or contravened the Law.

9.2 Market Control at ASX will also be responsible for the monitoring of the activities and all Participants on the ASXF market. Market Control will be assisted in its surveillance functions by the electronic Surveillance Of Market Activity (SOMA) facility. The facility works by comparing electronic signals (such as price and volume) produced by CLICK against a series of parameters. ASXF will also have access to the Derivatives Trading System Replay program which has the ability to replay the CLICK market either in a Contract Series or for a particular contract.

- 9.3 Market Control will be responsible for:
- (i) investigating any circumstances which may involve a breach of the Business Rules;
 - (ii) assisting Participants and entering transactions on a Participant's behalf in the event of technical difficulties; and
 - (iii) assisting in resolution of disputes.
- 9.4 Market Control will have the power to enter, amend or alter orders, cancel trading privileges, set parameters for supervision of market activity and suspend the market in the event of system problems.
- 9.5 ASXF may expedite disciplinary proceedings against a Participant under ASXF Rule 17.2.2 which may result in censure, payment of commission or profit resulting from the transaction or imposition of a fine which does not exceed \$20,000. The Participant has the right to elect to have the matter heard by the Disciplinary Tribunal under ASXF Rule 17.2.3.
- 9.6 The Disciplinary Tribunal has the following powers (ASXF Rule 17.2.8):
- (i) to censure the Participant;
 - (ii) to impose a fine which does not exceed \$250,000;
 - (iii) to suspend the Participant from any or all privileges;
 - (iv) to prohibit a Participant from transacting any business on ASXF or through any Participant for a period not exceeding three months;
 - (v) to upgrade the Participant's education and compliance program;
 - (vi) to require payment of commission or any profits from any transaction which is the subject of the proceedings to be remitted to ASXF;
 - (vii) to require a Participant to meet all reasonable costs of ASXF in the investigation or disciplining of the Participant; and
 - (viii) to terminate the admission of the Participant.
- 9.7 ASXF Rule 17.3.2 lists events which ASXF will classify as an event of default. These include the Clearing Participant ceasing to be a Clearing Participant under the Clearing Rules, indication by a Participant that it is insolvent or that it may cease to carry on business, the participant no longer satisfies the criteria of admission or the Participant is suspended or expelled from an Australian or overseas derivatives, securities or commodities exchange. ASXF Rule 17.3.3 provides a list of Other Significant Events in relation to which it may take action which includes failing to comply with the Rules or procedures of ASXF and/or the Clearing House. In the event of a default under ASXF Rules 17.3.2 and 17.3.3, ASXF may cancel the transaction, suspend or terminate the Participant's admission or impose restrictions on the Participant's rights or privileges or take any action or direct a Participant to take or not to take action which the ASXF considers appropriate for the protection of the Exchange.
- 9.8 ASXF must not terminate a Participant's admission unless ASXF gives the Participant an opportunity to appear in person or be represented before ASXF or lodge a written submission for consideration by ASXF (ASXF Rule 17.4.2). The Participant has the

right to appeal the Disciplinary Tribunal's decision to the Appeal Tribunal (ASXF Rule 17.5.1).

9.9 OCH Business Rules governing compliance and access by OCH to information are set out in section 16. These provisions ensure that OCH will have access to the information required to assess whether Futures Clearing Participants are complying with OCH's Rules.

9.10 The OCH audit trail is designed to save all actions on the clearing system including any transfers, deletions or amendments. There is a hard copy and an electronic version of all information. On a monthly basis an electronic disk is created archiving data using an archive system. This data is capable of being stored for an indefinite period of time.

9.11 In managing and monitoring the risk to OCH, OCH may focus its attention on the following details:

- (i) the adjusted liquid capital or the Net Tangible Assets of the Participant;
- (ii) the management and structure of the organisation;
- (iii) the amount of adjusted liquid capital or Net Tangible Assets compared to risk margin;
- (iv) the number of active client accounts;
- (v) any house trading;
- (vi) whether positions are mostly cash covered or collateral covered;
- (vii) the type of collateral cover lodged;
- (viii) daily cash movements including settlement to market;
- (ix) the breakdown of cash covered accounts compared to collateral covered accounts;
- (x) the daily volume of business transacted;
- (xi) the type of transactions that are executed, eg futures, options;
- (xii) whether the spread of risk is across many accounts or whether it is concentrated in a few accounts;
- (xiii) the contracts being traded;
- (xiv) the open position size and the inherent risk in the house and client portfolios; and
- (xv) the effect of a market rise or fall, as detailed in weekly stress tests, on the positions held.

Comments are sought regarding the adequacy of ASXF's disciplinary rules and procedures and OCH's compliance rules.

10. OCH's default processes

10.1 The provisions governing default are set out in section 12 of the OCH Business Rules. Some features of these provisions set out in paragraphs 10.2 to 10.4.

10.2 Paragraph (n) of OCH Rule 12.1 means that action taken by ASX or OCH against a Futures Clearing Participant in relation to its ETO activity would constitute an event of default under the OCH futures clearing rules. If OCH clears for an exchange other than

ASX, ASXF and ADX, this principle will also apply so that a default in one market is a default in all markets.

- 10.3 Paragraph (i) of OCH Rule 12.1 states that a default event has occurred where, among other things, an investigation under the Law or other legislation into those affairs material to a Clearing Participant's capacity to meet its obligations to OCH has commenced.
- 10.4 OCH Rule 12.2 deals with powers of OCH on default. These include powers with respect to collateral secured in favour of OCH, (paragraph (h)) and the ability to apply cash cover in respect of satisfaction of any amount due (paragraph 2.2 (j)). Each of these measures is intended to assist OCH in meeting its primary obligation of ensuring that contracts registered with OCH will be effectively guaranteed in terms of performance.

11. Supervision, expulsion, suspension and disciplining of Futures Clearing Participants

- 11.1 The supervision, expulsion, suspension and disciplining of Futures Clearing Participants is governed by section 16 of OCH's draft Business Rules which includes:
- (i) power to access to specific client information;
 - (ii) the ability to compel attendance by employees of a Futures Clearing Participant at a hearing of OCH, the Disciplinary Tribunal, the Appeals Tribunal or OCH's delegates;
 - (iii) provisions concerning accountant investigations and reports; and
 - (iv) disciplinary proceedings involving a breach of OCH's Rules, Procedures or Chapter 8 of the Corporations Law.
- 11.2 OCH Rule 16.3 ensures that the powers concerning suspension and termination tie in clearly with the events of default which appear in OCH Rule 12. From another perspective, it is important that OCH powers under OCH Rule 12 concerning suspension and termination also tie in with the suspension and termination powers under OCH Rule 16.
- 11.3 OCH Rule 12.2.1 enables OCH to suspend or terminate the admission of a Futures Clearing Participant, but that power is made subject to OCH Rule 16.4.
- 11.4 OCH Rule 16.3.1 provides that OCH can take action to suspend or terminate under OCH Rule 12.2.1 without the need for disciplinary proceedings.
- 11.5 Termination pursuant to an event of default is not automatic, but requires a decision on the part of OCH.
- 11.6 Any proceedings undertaken by virtue of the above OCH Rules by the Disciplinary Tribunal must be conducted in accordance with the rules as set out in OCH Rule 17. Any findings by this Tribunal may be appealed and will be taken to a separate panel for consideration.

Comments are sought regarding the adequacy of the expulsion, suspension and disciplinary powers with regards to Futures Clearing Participants.

12. Dispute Resolution Rules

- 12.1 A dispute for the purposes of ASXF's Rules is a dispute arising in respect of a Market, which is either between Participants or between one or more Participants and one or more clients. A dispute does not include a Trade Dispute unless the Trading Governors' Committee decides it is more appropriately dealt with as a dispute under ASXF Rule 16. A Trade Dispute is defined as a dispute between Trading Participants that arises from an order entered in error or involves a breach of the Dealing Rules or the related Procedures.
- 12.2 Parties to a dispute may select to:
- (i) hold a conciliation conference (ASXF Rule 16.4); and/or
 - (ii) arbitrate the dispute (ASXF Rule 16.5).
- 12.3 OCH Rule 15 deals with disputes and complaints. Any disputes between Futures Clearing Participants or between Futures Clearing Participants and their clients are dealt with in accordance with the rules of the Approved Exchange to which the dispute relates which are described above.
- 12.4 In the event of a complaint against a Futures Clearing Participant in relation to facilities provided by OCH or with respect to compliance with OCH's Rules, OCH will, under Rule 15.2 be able to take appropriate action including the inspection of records, the taking of disciplinary action or reference of the matter to the relevant Approved Exchange, or the appropriate regulatory authority.

13. Fidelity Fund

- 13.1 Part 8.6 of the Law, requires the Board of ASXF to establish and manage a Fidelity Fund for the exchange. The Fidelity Fund Rules deal with the content and status of the Fidelity Fund, how money is paid into and out of the Fidelity Fund and claims against the Fidelity Fund.
- 13.2 Each applicant for accreditation as a Participant of the Exchange must pay its initial contribution to the Fidelity Fund, the amount being not less than \$500. Payment of contribution is a prerequisite to obtaining admission as a Participant. ASXF Rule 19.2.1 requires a Participant to pay a yearly contribution to the Fidelity Fund (on or before 31 March each year) being an not less than \$100. At inception the ASXF Fidelity Fund will consist of:
- (i) \$1,984,000 being funds which were accumulated during the operation of AFFM together with interest thereon; and
 - (ii) initial contributions received from participants.

ASXF has advised that it may consider obtaining top up insurance if the market grows to a sufficient size.

- 13.3 The Board may require Participants to pay a transaction levy to supplement the Fidelity Fund if there are insufficient funds to make payments as may be required.

Comments are sought on the adequacy of arrangements for the proposed fidelity fund.

14. Waiver power and exercise of discretion within the Rules

- 14.1 ASXF Rule 20.8 provides for ASXF to have a general power to waive any of the requirements in Rules 3, 4, 7, 8, 9, 11 and 12 (and any Procedure relevant thereto). The proposed power would permit a waiver in relation to a particular applicant, participant or group of participants.

- 14.2 There are other proposed Business Rules where the ASXF may exercise its discretion and these include, but are not limited to:

- (i) a power to extend the time for lodgement of financial statements (ASXF Rule 4.2.6);
- (ii) a power to withdraw approval as underlying instruments (ASXF Rule 10.1.2);
- (iii) a power to make adjustments to a Contract Series and direct the Clearing House to make corresponding adjustments to an Open Series (ASXF Rule 10.3.1);
- (iv) a power to suspend trading (ASXF Rule 13.1.1); and
- (v) a general fair and orderly markets power, which includes a power to suspend one or more Markets and/or cancel or amend any Market Transaction in specified circumstances (ASXF Rule 13.5);

- 14.3 The exercise of ASXF's waiver and discretionary powers, particularly a class waiver under ASXF Rule 20.8, has the potential to impact on the overall integrity of the market.

Comments are sought on whether ASXF's waiver powers and discretions in relation to the application of rules are appropriate.

15. Financial Resources

15.1 ASXF is proposing that the financial obligations of ASXF will be guaranteed by way of a deed of cross-guarantee by its parent, ASX. Therefore, any financial resources available to ASXF will be dependent on the available resources of ASX. Potentially this could give rise to issues in the event that one or more entities guaranteed under this arrangement failed, resulting in potentially significant demands on the assets of ASX. The level of any such risk to ASX as the parent entity depends on the extent of any potential financial exposure, financial resources and operating costs of the subsidiary. ASIC considers that the guarantee arrangement is novel in that ASX is itself an authorised exchange operator.

15.2 ASXF has not prepared separate financial statements for the financial year ended 30 June 2000. ASXF is a small proprietary company and its accounts have been consolidated into the group accounts of ASX.

ASIC seeks comments on any issues raised by reliance on a deed of cross-guarantee or other form of guarantee, rather than on financial resources in the entity that will operate as a futures market, particularly in circumstances where the guarantor is itself an authorised exchange operator and other entities within the group may also have the benefit of a similar guarantees.

ASIC also seeks comments on the implications, if any, which may arise from the absence of separate public financial information in relation to ASXF.

16. Request For Comments

16.1 ASIC seeks public comments on the applications of ASXF and OCH, particularly on the matters identified in the discussion above.

16.2 Copies of the draft Business Rules to which the consultation summary refers are also available on request to ASIC. If you would like to request any additional information, including copies of the draft Business Rules please call Nikki Swinson, Analyst, Markets Regulation on 02 9911 2466 or email to nikki.swinson@asic.gov.au.

16.3 Submissions may be sent by email to tracey.lyons@asic.gov.au

or sent to

Ms Tracey Lyons
Manager, Markets Regulation
Australian Securities and Investments Commission
Level 18
No. 1 Martin Place
Sydney NSW 2001

or

GPO Box 9827
Sydney NSW 2001

or

DX 653 Sydney

16.4 All submissions will be treated as public by ASIC and will be provided to ASXF and OCH unless otherwise marked.

16.5 ASIC will accept comments until the close of business on **20 April 2001**.

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