



ASIC

Australian Securities & Investments Commission

REPORT 67

**Market assessment report:
SFE Clearing Corporation Pty
Limited / Austraclear Limited**

January 2006



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Annual assessment (s823C) report

**SFE Clearing Corporation Pty Ltd
ACN 050 615 864**

**Austraclear Limited
ACN 002 060 773**

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Executive summary

SFE Clearing Corporation Pty Ltd (SFECC) and Austraclear Limited (Austraclear) hold licenses to operate clearing and settlement facilities (CS facility licences). SFECC and Austraclear are both wholly owned subsidiaries of SFE Corporation Limited (SFE).

This report summarises ASIC's assessment under s823C of the *Corporations Act 2001 (Act)* of the compliance by SFECC and Austraclear with their obligations under s821A(c) of the Act.

How we conducted the assessment

In conducting this assessment, ASIC:

- interviewed SFE group personnel;
- reviewed policies and procedures relating to the conduct of SFECC's and Austraclear's CS facilities;
- reviewed extensive material provided to ASIC by SFE, SFECC and Austraclear under the *Australian Securities and Investments Commission Act 2001 (ASIC Act)*; and
- considered the annual regulatory report given to ASIC by Sydney Futures Exchange Limited (SFEL), SFECC and Austraclear pursuant to s792F and s821E of the Act.

Compliance by SFECC and Austraclear

In ASIC's view, SFECC and Austraclear each has adequate arrangements for supervising its respective clearing and settlement facility, including arrangements for:

- handling conflicts between the commercial interests of the licensee and the need to ensure that the clearing and settlement facility's services are provided in a fair and effective way; and
- enforcing compliance with the operating rules of the clearing and settlement facility.

Section 1: Background

1.1 The SFE group

SFE's wholly owned subsidiary, SFEL, currently holds an Australian Market License that permits it to operate a market in the financial products listed on its license. SFECC and Austraclear hold CS facility licences.

The infrastructure and services that support the operation of the SFECC and Austraclear clearing and settlement facilities are provided by SFE, which also provides human resources to SFECC and Austraclear.

1.2 Role of SFECC and Austraclear

SFECC

The primary function of SFECC is to act as a central counterparty clearing organisation. In fulfilling this role it also undertakes the following activities:

- trade registration, allocation and contract novation;
- position reporting and trade processing;
- guarantee and risk management; and
- collateral and treasury management.

Through the process of novation SFECC becomes the principal to all trades and liable to perform against all contracts to which it is a party and effectively 'guarantees' performance to other clearing participants. Performing this central counterparty function enhances the reliability of a clearing and settlement facility and also introduces exposures to credit or potential default risks that must be managed by SFECC. In doing so, SFECC undertakes a number of specific monitoring, analysis, pre-emptive and restorative activities to protect the interests of clearing participants and their clients and maintain the integrity of the facility.

Austraclear

Austraclear provides depository, clearing and settlement systems, and registry services to participants in Australian financial markets.

The functionality of the clearing and settlement systems is designed to minimise systemic risk in a number of ways, including:

- the system is a Model 1 DvP (Delivery versus Payment) settlement system whereby simultaneous exchange of cash and securities is achieved using Reserve Bank of Australia's (RBA) Information and Transfer System

(RITS)/Real Time Gross Settlement (RTGS) systems for settlement of interbank obligations;

- any securities transferred in the system must have been previously lodged with Austraclear;
- each participant must have an account held with a participating bank that effectively guarantees the cash element of each transaction undertaken by the participant;
- each participating bank is responsible for managing the credit exposure of the participants whose accounts it holds in relation to transactions in the system; and
- in the event of failure of a participating bank each other participating bank is responsible for sharing the burden of any losses arising as a result of that bank's failure to settle transactions.

In its simplest terms, each participant holds a securities account and a cash account in the Austraclear system. When a participant settles a trade using FINTRACS (the core application used by Austraclear to provide Central Securities Depository services), the system checks the balance in each account to ensure the buyer has available funds and the seller holds the securities the subject of the transaction. When the system receives confirmation that this is the case, it sends messages to initiate the interbank transfer of funds via RITS/RTGS. When this process is completed it immediately transfers the nominated securities from the seller's account to the buyer's account.

1.3 The assessment process

Section 823C

Under Section 823C ASIC may do an assessment of how well a CS facility licensee is complying with its obligations as a CS facility licensee under this Chapter (other than its obligations under paragraph 821A(aa)). In doing the assessment, ASIC may take account of any information and reports that it thinks appropriate, including information and reports from an overseas regulatory authority.

Paragraph 821A(c) states that a CS facility licensee must have adequate arrangements (whether they involve a self-regulatory structure or the appointment of an independent person or related entity) for supervising the facility, including arrangements for:

- (i) *handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the facility's services are provided in a fair and effective way; and*
- (ii) *enforcing compliance with the facility's operating rules.*

Pursuant to section 823C of the Act, the RBA must assess whether a CS facility licensee is complying with its obligations under section 821A(aa) of the Act. The annual assessments by ASIC and the RBA are completed independently.

Conduct of ASIC assessment

The SFE group is structured so that some of the same business units perform functions relating to the operation and supervision of the markets operated by SFEL and the clearing and settlement facilities operated by SFECC and Austraclear.

This report only covers the activities of these business units in so far as they relate to the operation of the clearing and settlement facilities.

ASIC has reviewed the work practices of the relevant business units to assess the level of compliance by SFECC and Austraclear with their obligations under section 821A(c) of the Act. Our inquiries focused on operations, risk management and supervisory practices and also relied upon information obtained during our assessment of SFEL as a market licensee.

The following individual business units were reviewed:

- Business Operations Derivatives ;
- Risk Operations (SFE Clearing);
- Compliance and Surveillance ; and
- Clearing, Settlements and Depository Services.

ASIC also:

- analysed information we received from and about SFECC and Austraclear in the ordinary course of our dealings with each of them as CS facility licensees, including information received as part of the Austraclear application for its CS facility licence, granted on 10 March 2004;
- interviewed key staff with operational and supervisory responsibilities;
- reviewed extensive material provided to us by SFECC and Austraclear under the *Australian Securities and Investments Commission Act 2001* (ASIC Act); and
- noted the report prepared by RBA on its assessment under section 823CA(1) of the Act.

ASIC has discussed the results of this review with SFECC and Austraclear and has sought their comments on the factual matters and conclusions set out in this report.

Section 2: Observations and recommendations

2.1 Overall compliance

It is ASIC's assessment that, based on the information collected during the review and given the present operating conditions, SFECC and Austraclear each has adequate arrangements for the supervision of its clearing and settlement facility in accordance with its obligations under s821A(c) of the Act.

ASIC's conclusion is based on the following observations:

- key management and staff responsible for the operation and supervision of the clearing and settlement facilities demonstrate a high level of operational expertise. This view is supported among other things by:
 - the competence, knowledge and expertise of personnel involved in operating the clearing and settlement facilities;
 - the very high operational reliability of the facilities; and
 - the absence of any significant supervisory issues during the period;
- SFECC and Austraclear have good and reliable technology in place that enables them to provide a fair and effective clearing and settlement facility. There were no serious CS facility failures or disruptions that had an adverse impact on market trading during the period covered by this assessment;
- SFECC and Austraclear are active and vigilant in financial risk management. Operational personnel and management involved in risk management are knowledgeable and experienced and demonstrate a commitment to sound risk management practices;
- SFECC and Austraclear operating rules provide an adequate framework for the operation of a fair and effective facility;
- satisfactory procedures are in place for the key supervisory areas; and
- operational files on supervisory decisions that we reviewed demonstrated that decision-making on supervisory matters generally follows sound procedures, and that SFECC and Austraclear actively pursue breaches of their operating rules and conduct ongoing supervision of their participants.

2.2 Observations

Management of risk

Both SFECC and Austraclear maintain comprehensive risk management arrangements that have been designed to ensure that the interests of relevant parties are protected and the integrity and financial stability of the market place is maintained.

For SFECC the arrangements extend to:

- daily mark-to-market and calling of margins (initial, variation, intra-day and extra margins);
- the imposition of limits to highlight and manage risk, including capital based position limits, stress testing limits and concentration limits;
- formal admission criteria for clearing participants, which include a net tangible asset minimum requirement;
- a structured regime of surveillance of clearing participants and market activity, including liaison between SFE's surveillance function and SFECC's Risk Operations unit to consider and co-ordinate action with respect to large position exposure; and
- maintenance of a clearing guarantee fund, which involves a risk spreading model in which the fund is made up of a component of financial commitment by clearing participants, a component of SFECC's capital and an insurance component.

For Austraclear the arrangements extend to:

- utilisation of control functionality and integrity developed within the FINTRACS application;
- formal admission criteria for Participants;
- operations with the RITS/RTGS as an approved feeder system approved by the Payments System Board; and
- half yearly external third party review of FINTRACS IT control environment.

Austraclear operates via a RTGS DvP Model 1, which was designed to mitigate financial and systemic risks and facilitates the gross simultaneous settlement of securities and funds transfer.

Bond and Repo Clearing Service

The Bond and Repurchase Agreement Clearing (BRC) service was offered by SFECC to over-the-counter market participants to take advantage of capital and liquidity effectiveness by novating bilateral securities trades and becoming the central counterparty clearer for these trades. SFECC netted off settlement obligations between itself and each BRC participant with daily cash and physical settlements. The service was meant to be operated on a DvP Model 1 basis, meaning cash and securities were to be transferred simultaneously.

Stock circles

In the OTC market, a situation can occur where the same stock is bought and sold by a number of traders. A consequence of this is that occasionally each trader cannot settle their trade relating to the particular stock until they receive that stock via the settlement relating to another trade in the OTC market. In other words, settlement of one trade is dependent on the settlement of another trade and so on forming a circle of dependent settlements. This is known as a "stock circle" and traders only become aware of their existence at settlement.

The formation of stock circles is not predictable. As a result, it is common practice in the OTC market to transfer cash but not securities at settlement between market participants. In effect, delivery versus payment does not occur in this situation. The risk with this practice is that market participants who receive cash without providing securities may utilise these funds in a manner other than market convention and leave their counterparty and the market without required funds or securities. The end result could see some parties being in default of their transactional obligations.

When the BRC service was introduced the issues arising out of the formation of stock circles was not considered a problem for SFECC as it believed the BRC service was an extension of the prevailing OTC conventions and practices. As a result, there were times when SFECC was unwittingly participating in stock circles.

During April 2004, a settlement failure occurred due to a transaction circle within SFECC's BRC clearing system. The transaction was ultimately settled without loss to SFECC or any of its participants. As a result of this incident and subsequent investigation, SFE immediately notified the RBA that it considered such transactions were not compliant with DvP requirements of the Financial Stability Standards for central counterparties and sought confirmation regarding this position from the RBA. The RBA confirmed that SFECC could not remain compliant with the Financial Stability Standards and participate in the settlement of circle transactions. Based on the position confirmation from the RBA and other concerns of SFECC, the BRC service was suspended from 31 July 2004.

Systems integrity and availability

During 2004, SFECC's and Austraclear's core systems continued to be housed, operated and supported by SFE's outsourcing technology partner, OM Technology (OM) in Sydney. Both SECUR and FINTRAC systems maintained high levels of reliability and robustness throughout 2004. To support these operations, SFE has detailed underpinning agreements in place with OM that define the required levels of service and support for both systems.

Only one incident occurred during 2004 that impacted SECUR's otherwise 100% reliability. The incident resulted in an interruption to one day's deal transfer process for 11 hours and 15 minutes. However, whilst this incident impacted and delayed clearing processes, it had no adverse impact on market trading. Moreover, the predominant use of straight through processing by clearing participants enabled effective and fast processing of the buffered deals after SECUR became available.

SFECC response to previous report recommendations

In our last report ASIC made the following recommendations.

System integrity and performance

We recommended that SFECC implement a procedure to ensure ASIC is advised of halts and outages of the clearing system similar to procedures for halts and outages to SFE's trading platform (SYCOM).

SFECC has updated its procedures to ensure clearing system outages are reported to ASIC in a timely manner. SFECC has further included clearing platform outages within the scope of public notification process of core system and platform outages.

SFE Clearing Operation Manual

We recommended that SFECC's Business Operations Derivatives business unit update this document to reflect any changes and additional responsibilities associated with the amalgamation of trading and clearing operations.

SFECC has constructed an SFE Clearing Operations Manual for use by Business Operations supervisors. The manual has been designed to complement the existing Clearing Operations documentation.

2.3 Recommendations

Delegation of powers under the Austraclear operating rules

Despite the segregation of Clearing Business Development from the operational and supervisory areas of Austraclear, we note that a number of powers of the

Committee (being the board, a committee of the board or a delegate of the board) under the operating rules have been delegated to the General Manager Business Development Clearing and Settlement and to the General Manager Business Operations.

The powers delegated include:

- approval or refusal of applications for admission;
- determining whether a breach of the operating rules should be regarded as a disciplinary matter;
- providing consent on whether an Associate Participant can lodge securities or transact with another Associate Participant (neither of which is permitted unless such consent is given); and
- approving other types of transactions.

While we believe that there are minimal conflict issues in the provision of a fair and effective CS facility by Austraclear, we do not believe it is appropriate for business development areas of the business to be determining supervisory matters. This is particularly so given that SFE's segregation of commercial and supervisory areas is the mainstay of its arrangements to handle conflicts of interest.

We recommend that Austraclear revoke the delegation to the General Manager Business Development Clearing and Settlement of Committee powers under the operating rules in relation to supervisory matters.

SFE has advised that during the interim period since ASIC's on-site component of the assessment it has reviewed its delegations and revoked the relevant supervisory related delegations from the General Manager Business Development Clearing and Settlement.