



**ASIC**

Australian Securities & Investments Commission

**REPORT 33**

**Market assessment report:  
ASX Settlement and Transfer  
Corporation Pty Limited /  
Australian Clearing House Pty  
Limited**

November 2004



**ASIC**

Australian Securities & Investments Commission

# **Annual assessment (s823C) report**

**ASX Settlement and Transfer  
Corporation Pty Limited  
ACN 008 504 532**

**Australian Clearing House Pty  
Limited  
ACN 001 314 503**

(formerly known as Options Clearing House Pty Limited)

**November 2004**

## Contents

---

<b>Executive summary .....</b>	<b>3</b>
How we conducted the assessment.....	3
Compliance by ASTC and OCH.....	3
<b>Section 1: Background .....</b>	<b>4</b>
1.1 The ASX Group.....	4
1.2 ASX CS facilities restructure .....	4
1.3 The National Guarantee Fund Proposal.....	5
1.4 Section 823C .....	6
1.5 The assessment framework.....	6
1.6 The assessment process .....	8
<b>Section 2: Observations and recommendations</b>	<b>10</b>
2.1 Overall compliance .....	10
2.2 Recommendations.....	10
<b>Appendix: Additional information on individual business units .....</b>	<b>13</b>
A1 Clearing and Settlement Operations .....	14
A2 Risk Management Unit .....	17
A3 Compliance Services Unit.....	21
A4 Investigations and Enforcement.....	24
A5 Audit of control objectives.....	25

# Executive summary

This report summarises ASIC's assessment of compliance by the -ASX Settlement and Transfer Corporation Pty Limited and Options Clearing House Pty Limited with their obligations under s823C of the *Corporation Act 2001* (Act).

ASX operates two clearing and settlement facilities (CS facilities) through its wholly owned subsidiaries, both of which hold CS facility licenses under the Act:

- ASX Settlement and Transfer Corporation Pty Limited (ASTC); and
- Options Clearing House Pty Limited (OCH) (OCH changed its name to Australian Clearing House Pty Limited (ACH) in February 2004). Throughout this report we refer to OCH as the assessment was substantively undertaken prior to the change.

## How we conducted the assessment

In conducting our assessment, we:

- interviewed ASX Group personnel;
- reviewed policies and procedures for the conduct of ASTC and OCH CS facilities in general and their supervisory responsibilities in particular;
- reviewed extensive material provided under the *Australian Securities and Investments Commission Act 2001* (ASIC Act); and
- considered the annual regulatory report given to ASIC by ASTC and OCH on 30 September 2003 (as required under s821E of the Act).

We also considered how well ASTC and OCH might comply with their obligations in the future. For more details about the assessment process, see Section 1.

## Compliance by ASTC and OCH

In ASIC's view, ASTC and OCH each has adequate arrangements for the supervision of its respective CS facility, including arrangements for:

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

# Section 1: Background

## 1.1 The ASX Group

The ASX Group held at the time of our assessment two Australian clearing and settlement (CS) facility licences granted under s824B of the Act. The CS facility licences are held by the wholly owned ASX Group subsidiaries, ASTC and OCH (the latter changed its name in February 2004 to Australian Clearing House Pty Limited):

- At the time of our assessment ASTC provided the clearing and settlement services to trades executed on the ASX SEATS based markets for equities and warrants. The Clearing House Electronic Subregister System (CHES) is the primary infrastructure supporting the operations of ASTC. CHES enables clearing and settlement interaction between participants, payment providers and the ASX's Derivatives Clearing System (DCS).
- At the time of our assessment OCH cleared and settled trades in exchange traded options (ETOs) that were executed on the ASX Options Market as well as ASX futures contracts that were executed on the ASX Futures Exchange Pty Limited (ASXF). Its primary infrastructure for this service was DCS. OCH was also the central counterparty for all products traded on ASX's markets.

The infrastructure and services that support the operation of ASTC and OCH are largely provided through the ASX wholly owned subsidiary ASX Operations Pty Limited (ASXO). ASXO provides supervisory and operational resources to both CS facilities using common staff and infrastructure.

We therefore conducted our assessment of both CS facilities at the same time, and summarise our assessment of both CS facility licensees in this report.

We also used information obtained during our assessment of ASX as a market operator in our assessment of ASTC and OCH as CS facility licensees.

## 1.2 ASX CS facilities restructure

Throughout 2002, 2003 and to be completed in 2004, ASX restructured its clearing and settlement facilities, with its major objective being that clearing and settlement services are to be provided by different entities. This will see ACH providing clearing services and ASTC providing settlement services.

Stage 1 of the restructure was completed on 1 December 2002 with the result that:

- OCH's CS facility licence was varied to allow OCH to provide clearing and settlement services for non-transferable derivatives in respect of the licensed markets operated by ASXF and the ASX; and
- OCH became the central counterparty for all products traded on ASX's market and was granted an exemption under section 820C of the Act from the requirement to hold a CS facility licence in respect of certain aspects of this role until the earlier of 11 March 2004, or the day on which OCH was granted a CS facility licence to carry out this role.

Stage 2 of the restructure was largely completed on 11 March 2004, with the grant of variations of OCH's and ASTC's Australian clearing and settlement facility licences.

Post-variation, OCH, now known as the Australian Clearing House Pty Limited (ACH), is providing clearing services and continuing to be the central counterparty for ASX market trades novated to a central counterparty. In providing clearing services, ACH is matching, confirming, registering and novating trades. As well, ACH is calculating the obligations to be settled and informing ASTC and participants of their settlement obligations.

Post-variation, ASTC is providing only settlement services. ASTC is ensuring the completion of transactions where the seller transfers securities or financial instruments to the buyer and the buyer transfers money to the seller. ASTC is offering settlement on a delivery versus payment basis or a real time gross settlement basis. ASTC is also offering registry services. It should be noted that although the final goal of the restructure is for ASTC to provide settlement for a range of financial products including derivatives, in the short term, ACH is providing settlement for derivatives, as ASTC is currently unable to provide this service. In order to be able to fulfil this role ASTC is currently undertaking changes to CHESS (the IT system used by ASTC to provide settlement services) and plans to have the capacity to settle derivatives by May 2004.

At the same time as the ASX Group clearing and settlement restructure occurred, a restructure of the market licensing arrangements of the ASX Group was also undertaken. On the 11 March 2004 ASX's market licence was varied to allow it to provide a market in all derivatives. ASXF has ceased to operate a market.

The restructure will have been completed by the next assessment and the impact of the restructure on the provision of clearing and settlement services will be a focus of our review.

### **1.3 The National Guarantee Fund Proposal**

As part of the restructure ASX has applied for the payment of funds to ACH from the National Guarantee Fund ("NGF") under section 891A of the Act.

The NGF is a fund maintained by the Securities Exchanges Guarantee Corporation Limited to meet a range of claims that may arise out of conduct by participants on the securities market operated by ASX. In brief, the NGF currently fulfils two functions - investor protection and clearing support. ASX proposes that the investor protection and clearing support functions be separated. Splitting the fund would clarify responsibility and roles; be consistent with the Reserve Bank of Australia's financial stability standards; bring the clearing support into line with international practice and expectations; and provide the ASX with greater flexibility in relation to new services and products in the future.

Sufficient funds would need to be kept in the NGF to provide for the payment of claims under the continuing heads of claim. Funds in excess of this amount would be paid to the ACH so it can provide support for the clearing function.

## 1.4 Section 823C

The Act requires ASIC to conduct an annual assessment of each Australian CS facility licensee.

Section 823C of the Act says:

- (1) 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.*
- (2) In respect of the obligation in paragraph 821A(c), ASIC must do such an assessment at least once a year for each CS facility licensee.*
- (3) As soon as practicable after doing an assessment under this section, ASIC must give a written report on the assessment to the Minister and a copy of the written report to the RBA.*

Paragraph 821A(c) states that a CS facility licensee must:

- (c) 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.**

## 1.5 The assessment framework

In developing a framework for the assessment of securities settlement systems we have had regard to relevant international standards.

### *CPSS–IOSCO task force*

We have in particular considered the work done by the Joint Task on Securities Settlement Systems of the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO), including its November 2001 publication “Recommendations for securities settlement systems”.

The CPSS–IOSCO task force comprised 28 central bankers and securities regulators from 18 countries and regions and from the European Union. We have not assumed that all of the risks and recommendations raised are directly applicable in the context of our assessment. In particular, the recommendations are broader in scope than our assessment under s823C of the Act. Nonetheless, they provided a useful framework for our assessment process.

### *Pre-settlement risks*

Among other pre-settlement risks, the CPSS–IOSCO paper identifies:

- the procedure for and the timeliness of the confirmation of a trade between a buyer and a seller;
- the length of the settlement cycle (T+3); and
- the establishment and operation of a central counter party in the clearing and settlement process.

Each of these elements are adequately covered by the ASTC and where relevant, the OCH facilities.

### *Central securities depository*

The CPSS–IOSCO paper recommends the use of a central securities depository (CSD) where securities are held in a dematerialised form and are capable of transfer by book entry. In the ASTC context, this is provided by CHESS. The paper says that the CSD system should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment. In addition, it recommends that final settlement should occur no later than the end of the settlement day. These are well known operating features of CHESS.

The paper also recommends that the CSD have in place risk controls to address the possibility that a participant is unable to settle. It suggests that the most reliable set of controls is a combination of collateral requirements and position limits. ASX undertakes prudential and risk control measures through its rules and through monitoring by its Risk Management Unit (RMU). RMU undertakes these supervisory services on behalf of both ASTC and OCH.

### *Operational risk*

Operational risk is another potential major risk category. On operational risk, the CPSS–IOSCO paper says:

*systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.*

A significant part of ASIC’s focus during the on-site phase of our assessment was spent gaining an understanding of the operating procedures and practices of ASTC and OCH.

### *Custody risk*

The final major risk category identified by the CPSS–IOSCO task force was custody risk. It characterised this risk as the risk of loss on securities due to the insolvency, negligence, misuse, fraud, poor administration or poor record keeping by the custodian. In the ASX context, these risk recommendations are reflected in the security measures associated with CHESS holdings, their protection and their use as collateral for derivative positions.

## **1.6 The assessment process**

In conducting our assessment under s823C, we:

- analysed information available from external sources, including information from international regulatory bodies and reports published by ASX;
- had regard to the recommendations made by the Joint Task on Securities Settlement Systems of the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO);
- analysed information we received from and about ASTC and OCH in the ordinary course of our dealings with each of them as CS facility licensees, including:
  - information received as part of the OCH and ASTC restructure process;
  - ASX’s most recent annual report; and
  - ASX’s most recent annual regulatory report;
- interviewed key ASX staff with operational and supervisory responsibilities;
- interviewed KPMG personnel involved in the annual audit of CHESS and DCS control procedures;

- reviewed internal ASTC and OCH material, including disciplinary and investigation files, internal reports and information collected by ASTC and OCH on a continuous basis;
- analysed the information gathered during our assessment of ASX and ASXF.

We also visited the Sydney offices of ASTC and OCH and spoke to a number of business units and personnel during the period from 19 January 2004 to 28 January 2004. Our on-site inquiries focused on operations, risk management and the supervisory practices associated with ASX's CS facilities.

(For more information about our assessment procedures for individual business units, see the Appendices to this report. In some instances more detail will be contained in the ASIC annual assessment report on ASX as a market operator dated August 2004)

We have discussed the results of this review with ASX and have sought their comments on both the factual matters set out in this report and on our conclusions.

# Section 2: Observations and recommendations

## 2.1 Overall compliance

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

Our conclusion is based on the following observations:

- key management and staff responsible for the operation and supervision of the CS facilities demonstrate a high level of operational expertise. This view is supported among other things by:
  - the competence, knowledge and expertise of ASX personnel involved in operating the CS facilities;
  - the very high operational reliability of the facilities; and
  - the absence of any significant supervisory issues from 1 July 2002 to 30 June 2003;
- ASX has good and reliable technology in place to support the outcomes of a fair and effective CS facility. This is reflected in the absence of any serious facility failures or disruptions from 1 July 2002 to 30 June 2003;
- ASX is active and vigilant in financial risk management. Operational personnel and management involved in risk management were knowledgeable and experienced and demonstrated a commitment to sound risk management practices;
- ASTC and OCH 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 ASTC and OCH actively pursue breaches of their operating rules and conduct ongoing supervision of their participants.

## 2.2 Recommendations

Based on the material available to ASIC at the time of our assessment ASIC makes the following recommendations.

### *Conflict Handling arrangements*

We note that in its Annual Regulatory Report, and in a number of internal ASX documents cited by ASIC during the assessment there are statements made by ASX that an informal agreement has been reached with ASIC in relation to conflict handling arrangements for the ASX wholly owned non broker participant, CHESSE Depository Nominees ("CDN"). In ASIC's view, it is important that formal arrangements be put in place within ASX to manage this conflict and that, to the extent that a role is proposed for ASIC, those arrangements should also be formalised.

CDN is a non-broker participant that provides services in support of particular products for which ASX has established markets. These include CHESSE Depository Interests ("CDIs") that trade instead of their underlying foreign issued securities. CDN holds the underlying foreign securities on behalf of the holders of the relevant CDI. CDN also holds securities that are traded through the ASX Worldlink facility.

As a non-broker participant CDN is required to comply with the operating rules of ASTC. However as CDN is wholly owned by ASX there is a conflict of interest in ASX supervising compliance with and enforcing those rules.

As noted in the ASX Annual Regulatory Report dated 30 September 2003 ASX gave ASIC a copy of an inspection report prepared by the ASX business unit, Compliance Services in relation to CDN. However no arrangements have been agreed between ASX and ASIC in relation to the review or follow-up of issues raised in that report.

Subsequent to our assessment ASX has advised ASIC of the grant of a waiver of ASTC Settlement Rule 4.9.1 to CDN. This waiver highlighted the absence of any formal conflict handling arrangement in relation to CDN.

ASIC was also notified of a grant of a waiver to ACH from ASTC Settlement Rule 4.9.1. This waiver also illustrated the absence of conflict handling arrangements in relation to ACH.

We recommend that ASX reviews its conflict handling arrangements in relation to clearing and settlement, in particular in relation to CDN and ACH, and establish appropriate formal arrangements.

ASX and ASIC have commenced detailed discussions in relation to proposed arrangements, which are likely to involve ASIC undertaking some supervisory tasks in relation to CDN and ACH. ASIC is presently considering ASX's proposals to this effect.

### *Documentation of clearing risk management policy*

We are concerned that ASX documentation does not fully set out its policy approach to clearing risk management.

We recommend that ASX expand the OCH risk management policy and procedure documentation so as to fully articulate its current practices and supervisory policies in this area. ASIC is not concerned about current practices in this area however we are of the view that ASX needs to document all its key supervisory policies to ensure consistency of supervisory operations.

ASX have subsequently advised the need for extended policy and procedure documentation has been identified as part of the Risk Management review currently being undertaken by the Risk Management Unit.

## **Appendix: Additional information on individual business units**

In this Appendix, we provide a more detailed explanation of the process we undertook in our review of some individual ASX business units, and summarise specific observations for these units.

As part of our assessment we undertook on-site inspections of the following individual business units:

- Clearing and Settlement Operations;
- Risk Management Unit;
- Compliance Services;
- Investigations and Enforcement; and
- Business Development;

Many of these business units undertake functions relating to the supervision of markets conducted by the ASX Group. This report does not cover activities by these business units arising from ASX's obligations as a market operator. As the Business Development Unit is not an integral part of the CS facility operation or supervision a specific report has not been included.

In addition we reviewed the annual audit undertaken by an external audit firm of the control procedures and objectives that ASX has in place for the operation of its CS facilities. The audit of the CHES control objectives leads to an audit report that is provided to CHES clearing participants. A summary of this review is at Appendix 5.

## A1 Clearing and Settlement Operations

### Role of unit

At the time of our last assessment, Clearing and Settlement Operations (C&S) was split into two areas, ASTC Operations and OCH Operations. A restructure has occurred since then and the groups have been merged. Therefore, unlike our last report we have not separated our observations and recommendations for ASTC and OCH.

The ASX Group operates two separate CS facilities. ASTC clears and settles trades in securities or warrants made on the ASX SEATS based equity and warrants markets. OCH is responsible for the clearing and settlement of trades in exchange traded options and futures made on the ASX Derivatives Trading Facility (referred to as CLICK), as well during the period OCH was the central counterparty for trades in securities made on the ASX SEATS based equity market.

C&S operates primarily as a help desk for the operational personnel of clearing participants. It provides assistance to those personnel using the CS facilities and amongst other things enables the smooth operation of the process. Because of their direct and immediate involvement in the day-to-day operation of the facilities, C&S are also able to effectively monitor compliance by participants with SCH Business Rules and the OCH Derivatives Clearing Rules. The unit also works closely with the Risk Management Unit, which monitors the ability of OCH's clearing participants to meet and maintain margins and collateral.

### Assessment process

#### *On-site visit*

We interviewed:

- the National Manager, Clearing and Settlement Operations, and
- the Manager, Clearing and Settlement Operations.

The focus of the interview was to gain a further understanding of the responsibilities of the unit and its role in the supervision of clearing participants.

### Documents and information reviewed

As part of the assessment process, we reviewed the following documents:

- Clearing and Settlement Operations monthly reports, compiled by the Manager, Clearing and Settlement Operations (from June 2002 to July 2003);

- CHES Participants Procedures Guidelines (provided to participants of ASTC);
- CHES policies and procedures Volume 1;
- Issuers and Registries procedure Guidelines;
- OCH procedures;
- Option Clearing House Pty Limited – Derivative Clearing Procedures (provided to participants of OCH);
- “Independent audit report ASTC’s CHES Control Objectives and Procedures” for the period 1 July 2001 to 30 June 2002 by KPMG;
- Terms of engagement with KPMG in relation to the audit of ASTC control objectives and procedures in relation to the CHES system;
- ASTC Participants Audit, Issues List for December 2002 and June 2003;
- Complaints Registry file;
- Late Payment Correspondence file; and
- 6 Participant files (including correspondence and fail fee waivers).

## Observations

### *Restructure of unit*

ASX advised the management restructure started in November 2001 and the recent merger of ASTC Operations and OCH Operations will result in many synergies, including enhanced sharing of information with respect to participants' profiles (equities and derivatives positions), reduced paperwork and costs.

### *Procedures manuals*

The CHES Participants Procedure Guidelines, which is provided to participants of ASTC, was updated and released on 11 March 2004.

### *Defaults*

Default by a participant is one of the major risks in clearing and settlement and so one of the key daily processes for C&S is to ensure the banks (payment providers) are willing and able to make or receive payment for the trades to be settled that day. If a bank refuses to make a payment on behalf of a participant, then the participant is in default. There has never been a significant default, but staff have detailed procedures to ensure that the correct action is taken if a default occurs.

The procedures outlined above were tested when C&S were required to manage an accidental participant payment failure during the settlement process in March 2003. The payment failure resulted from a combination of errors being made by the operator at the payment provider that was then followed by an error being

made by the ASX operator. The default procedures were then automatically set in motion. The event was a mistake and no credit risk was attributable to the nominally defaulting participant. ASIC notes C&S has completed a review of the event and updated procedures.

*Failed trades and fail fee waivers*

Failed trades are a result of clearing participants not providing securities at the time of settlement. If this occurs, the trade is removed from settlement and re-scheduled to the next day. C&S analyses failed trades on a monthly basis and clearing participants are sent a monthly letter notifying them of their ranking in the failed trade report. The Manager will query a participant if there has been a significant movement in the percentage of failed trades and if necessary, request a letter documenting the reasons. For the period 1 July 2002 to 30 June 2003, the average daily settlement failure rate was 0.88% of the value of transactions of the participants.

CHESS automatically applies failed fee levies to participants with failed trades. Fail fees are calculated on an ad valorem basis (subject to a minimum fee and maximum cap) as outlined in Section 18 of the CHESS Participants Procedure Guidelines. Participants can request waivers from fail fees. The Manager has authority to approve waivers, however a structured index of situations in which waivers are granted is maintained.

*Annual audit certificate*

In accordance with SCH Business Rules 17.8.1 and 17.8.2, KPMG has completed and signed off on an annual independent audit report on ASTC's control objectives and procedures for CHESS. The report noted that in KPMG's opinion, ASTC maintained suitably designed and effective control procedures for the period 1 July 2002 to 30 June 2003.

## A2 Risk Management Unit

### Role of unit

The Risk Management Unit (RMU) has two teams:

- Prudential Risk Management (PRM); and
- Clearing Risk Management (CRM).

PRM ensures that participants who assume market or counterparty risk meet risk-based capital liquidity requirements. In effect, all participants except those that are simply ASTC settlement participants are subject to prudential capital requirements and oversight by RMU. ASTC Settlement Participants that are not also ASX or OCH participants are required to lodge performance bonds. Compliance Services monitors Settlement Participants' compliance with the bond requirements.

ASTC participants that are also ASX participants must meet the capital requirements of ASX Operating Rules as set out in Rule 1A (a risk based capital requirement) and are thus monitored in their capacity as ASX participants by RMU.

ASX participants may also be OCH participants. Non-ASX participants that are OCH participants must meet the capital requirements of the OCH Derivatives Clearing Rules and these participants are also monitored by RMU.

CRM manages the counterparty risk that OCH accepts as central counterparty to the transactions that it clears. OCH's counterparties are participants that clear trades and therefore its risk management activities only cover OCH Clearing Participants.

#### *Prudential Risk Management (PRM)*

PRM is concerned with the financial strength of OCH participants and thus is responsible for monitoring the capital requirements of OCH participants, as well as the participants of the ASX markets. OCH participants are required under OCH Derivatives Clearing Rules to comply with either the risk based capital requirements, net tangible asset (NTA) requirements or "other" capital requirements.

However, OCH's operating rules state that if an OCH participant is also an ASX participant, the participant has to comply with the risk based capital requirement of ASX business rule 1A.

Similarly, if the OCH participant is also an ASXF participant, then the participant can either comply with the risk based capital requirements, or with the NTA requirements. The operating rules allow a participant to comply with an "other"

capital adequacy requirement if OCH is satisfied that the participant is subject to an appropriate level of prudential supervision.

The consequence is that in practice, PRM will apply different prudential rules to different participants depending on the circumstances of that participant. While technically a different prudential test may be applied, the objectives of prudential supervision remains unchanged.

#### *Clearing Risk Management (CRM)*

CRM focuses on monitoring the risk profiles of OCH participants, monitoring the ability of the participants to meet margin payments, and calculating daily margins for every client of a participant.

### **Assessment process**

#### *Documents and information reviewed*

We reviewed the following documents:

- Copies of the minutes of meetings of the board of directors of ASTC and OCH held during the period 1 July 2002 and 30 June 2003;
- Copies of the monthly ASTC and OCH board reports that relate to the period 1 July 2002 to 30 June 2003;
- RBA Financial Stability Standards for Central Counterparties (report on stress test results and risk control measures);
- Copies of the monthly management reports of RMU; and
- Copies of the current risk management procedures;

#### *On-site visit*

As part of the CS facility assessment process, we interviewed:

- the National Manager, Risk Management, Market Services; and
- the Manager, Clearing Risk.

The key focus of these interviews was to develop further understanding of the role of RMU in monitoring ASTC and OCH participants and the changes that have occurred since our last assessment.

### **Observations: CRM**

#### *Changes since our last assessment*

At the time of our assessment RMU was in the process of developing its policies and procedures in response to the Reserve Bank of Australia's Financial Stability Standards, the FSR Reforms, the ASTC and OCH restructure, and the split of the

National Guarantee Fund (NGF). In respect to OCH's role as a central counterparty and the anticipated inflow of funds as a result of the NGF split, RMU was in the process of improving the model and methodology and developing systems to improve efficiency. RMU was also gearing up for the risk management function of the Australian Clearing House.

RMU has been reviewing its three capital adequacy frameworks. Apart from rationalisation and clarification, a key objective of the review is to facilitate the direct participation of larger, better capitalised organisations such as Banks, and in so doing recognise the increasingly globalised, multi-market activities of major clearers. ASX is also part of CCP-12 (an association of the world's central counterparties) and is involved in developing risk management benchmarks for the industry.

#### *The role of the Manager, Clearing Risk*

To assess the participant's ability to meet margin calls and changes in the market, the Manager, Derivatives Risk Management every morning reviews each participant's risk margin ratio (ie the ratio of the participant's liquid capital to its risk margin position). General information about the ratio's trigger points and maximum is in the internal OCH policies and procedures folder. However, the Manager, Derivatives Risk Management may change the ratio's trigger points and maximum, depending on the size or the risk profile of the individual participant. Participants are informed of the ratio limits verbally.

The Manager, Derivatives Risk Management personally manages any breaches of the participant's risk margin ratio. He holds discussions with and makes recommendations to the participant about how they could reduce their ratio to an acceptable level. The recommendations include that the participant increase their liquid capital or lodge securities as collateral. The Manager, Derivatives Risk Management indicated that if a participant breaches risk margin ratio as determined by ASX it was not necessarily a breach of OCH Derivatives Clearing Rules. Those rules do not mandate that a specific ratio should not be exceeded. Rather ASX practice is that the Manager, Derivatives Risk Management formulates a ratio for a participant that is then used for supervisory purposes within ASX. However the Manager will make a judgement about a participant's exposure in the context of the given circumstances. A variety of factors will be considered including the size of the participant and the composition of their exposure.

In discussion ASX have said that although the rules do not prescribe a specific risk margin ratio, if the ASX are not comfortable with a participant's exposure then they are able, if necessary, to use the powers within OCH Derivatives Clearing Rules.

The Manager, Derivatives Risk Management appears to retain a lot of information and knowledge about each participant that is not documented, including the ability of the participant to handle risk.

During our assessment ASIC was not able to identify any ASX documentation that fully articulated the processes and policy used to manage the risk exposures of participants. We recommend that ASX document this area of its operations.

*Interaction with other ASX business units*

CRM has a close relationship with the Clearing and Settlement Operations unit. The manager of this unit is located near the manager of Clearing and Settlement Operations, and supplies Clearing and Settlement Operations with reports on its clearing participants.

The Manager, Clearing Risk interacts with Compliance Services and makes them aware of any issues concerning OCH participants. There is no formal process for this and it is done either via the phone or email.

CRM only interacts with Investigations and Enforcement if there are breaches of the rules.

*Involvement of the OCH board*

The OCH board is actively involved in risk management. The Board receives detailed board papers before each meeting which outlines any issues that management believes should be considered by the Board. A Risk Management Sub-Committee meets one week before the scheduled board meetings. Issues raised in the Sub Committee are reported to the OCH Board in the Boards' Risk Management Report.

Our observation is that any significant operational matters that appear in the monthly reports of CS Operations find their way into the monthly board reports. Minutes of these meetings are sufficient to reflect that individual matters are raised and discussed.

*Documentation and files*

Files are created when participants have any issues. Only items that are deemed important, such as a letter to the participant or file notes about the participant, are placed on the file.

## A3 Compliance Services Unit

### Role of unit

The Compliance Services Unit (CS) is responsible for monitoring and promoting compliance with the SCH Business Rules, the OCH Derivatives Clearing Rules, ASX business rules, ASXF business rules, and the Act by persons bound by those rules.

Consequently, CS performs a key supervisory role for ASTC and OCH, including:

- providing compliance approval for the recognition and admission of participants;
- withdrawing or suspending participation rights;
- monitoring ongoing compliance with the SCH Business Rules and the OCH Derivatives Clearing Rules;
- granting or refusing waivers from business rules;
- referring potential rule breaches to Investigations and Enforcement;
- conducting self-assessment and inspection programs; and
- providing various education activities.

CS seeks to foster a compliance culture among CS facility participants and to develop lines of communication with other ASX units to allow for prevention, or early identification and rectification, of any problems.

Where a potential breach of the operating rules or the Act is identified, a referral is made to Investigations and Enforcement.

### Assessment process

In our assessment of this unit we have relied in part on the work undertaken during our assessment of ASX and ASXF.

#### *Documents and information reviewed*

We reviewed the following documents and files:

- CS policies and procedures including template documents;
- 14 files from the clearing and settlement section of CS, including files on ASTC and OCH participants. We also used information from files reviewed as part of our assessment of ASX, because some of these files covered broker participants. The file sample included entities that could pose specific conflict issues;
- self-assessment related material;

- information on the Direct HIN review project;
- National Inspection Register (from 1 July 2002 to 30 June 2003); and
- correspondence with ASIC about waivers of the SCH Business Rules (from 1 July 2002 to 30 June 2003).

#### *On-site visit*

We interviewed the Manager, Compliance Services and a Compliance Adviser, Clearing House Compliance to gain an understanding of the internal systems and operations of the unit.

### **Observations**

#### *Structure, Resources and Planning*

CS has undergone a restructure since our last assessment, centralising all operations in Sydney. The restructure was designed to ensure consistency of process and decision-making.

As was the case last year, Compliance Advisers are assigned as the primary contact for a number of participants. The restructure involved a significant reallocation of participants amongst the Client Advisers and we observed that they each had considerable knowledge of the participants for which they were responsible.

Clearing and settlement is considered a specialist activity within CS. Since the restructure advisers do not work exclusively on clearing and settlement matters, as had been the case previously however a larger number of advisers have been assigned to deal with clearing and settlement issues. Ongoing advice and education of participants remains a key tool of CS to facilitate compliance by participants.

In order to highlight the need for minimum educational standards it is planned that each ASX Compliance Adviser will obtain accreditation from the Compliance Institute.

Another structural change in CS has been to create a manager position to monitor the day-to-day operations allowing the National Manager to focus greater attention on systemic issues and strategic planning. This was a relatively recent development and therefore we were unable to measure the impact of this initiative on the performance of the business unit. However we note that CS plans to incorporate improved delivery mechanisms, particularly web-based, to support its ongoing supervisory work. CS also plans to pilot a new self-assessment methodology that will allow participants to undertake an operational risk and control analysis against the CS database of industry best practice.

The weekly meeting of all CS staff remains a significant forum for discussion of participant specific and general compliance issues. We note that the meeting we attended also included an active discussion of business planning and Compliance Advisers were encouraged to provide input to improve risk targeting.

### *Complaints*

Due to the specialist nature of the issues, CS plays an important role in handling complaints about clearing and settlement facilities. CS appeared to be involved in a greater proportion of complaints about clearing and settlement facilities than complaints about trading by ASX or ASXF participants. CS's assistance in resolving such complaints is generally sought at an early stage. The compliance adviser responsible for a broker participant will also be involved in resolving complaints about that broker participant.

Complaints may be sourced from Clearing and Settlement Operations and other ASX business units who receive calls from shareholders and brokers and external sources such as ASIC, FICS or matter that arise out of professional indemnity insurance claims.

### *Waivers*

CS receives waiver applications in relation to what were known as the SCH rules at the time of our assessment in January 2004. These rules are now known as ASTC Settlement Rules. These waiver applications are assessed by the legal division and approved by the ASTC board.

## **A4 Investigations and Enforcement**

### **Role of unit**

Investigations and Enforcement (I&E) investigates suspected breaches of the SCH Business Rules and the OCH Derivatives Clearing Rules by participating organisations. I&E is also responsible for initiating formal disciplinary action for such breaches by referring matters to the SCH Disciplinary Tribunal (SDT) or the OCH Disciplinary Tribunal (ODT). The SDT or the ODT determine matters referred to them by I&E and have the power to impose a variety of penalties.

I&E plays a similar role in relation to designated trading representatives and breaches of the ASX and ASXF business rules.

Generally I&E does not play an active role in initially identifying breaches of the SCH Business Rules and OCH Derivatives Clearing Rules. Rather, it acts primarily on referrals of suspected breaches from other ASX units.

Taking appropriate action on breaches is a key part of ASTC and OCH ensuring compliance with their respective rules. I&E therefore plays a central role in supervising both facilities.

### **Assessment process**

#### *Documents and information reviewed*

We reviewed the following documents as part of the assessment:

- I&E's documented policies and procedures;
- 21 I&E case files from 1 July 2002 to 30 June 2003 relating to CS matters;

We also drew upon knowledge of I&E's general operations gathered during our previous assessment of ASX under s794C.

We have no specific observations or recommendations.

## A5 Audit of control objectives

### Background

An audit of the CHES control objectives and procedures is required under the SCH Business Rules 17.8.1 and 17.8.2. ASX also undertake an audit of the Derivatives Clearing System (DCS) even though there is no mandatory requirement for this under its operating rules. The purpose of the audit is to obtain an opinion as to whether or not the CHES and DCS control procedures are suitably designed to meet the control objectives.

The audit report expresses an opinion on whether or not the control procedures operated effectively to provide *reasonable*, but not absolute assurance, that the control objectives were achieved.

The audit approach is similar to financial audits and is conducted in accordance with Australian Auditing Standards. However from the point of view of the retained auditors these audits are classified as audits to report to third parties. The main users of the reports are ASTC, CHES participants, and their auditors.

The scope of the audit is based on a set of pre-determined CHES control objectives and procedures. The management and staff of ASTC are responsible for maintaining an effective internal control structure, including the CHES control objectives and procedures.

The audits are conducted twice a year in June and December. The December CHES audit report takes the form of an internal management report that is referred to as the "Issues List". These are for internal discussion purposes and are not distributed to participants.

### Annual audit certificate

For the period 1 July 2001 to 30 June 2002 KPMG completed the annual audit report and noted that ASTC maintained suitably designed and effective control procedures

The audit opines on the controls that seek to ensure that:

- securities holdings recorded and maintained by CHES and ASTC are safeguarded against unauthorised use and loss;
- transactions initiated by participants or registries as CHES messages are processed in a timely manner in accordance with electronic instructions sent by authorised participants or registries; and
- the exchange of “irrevocable” payment for good title to securities occurs or does not occur as intended by the SCH Business Rules and other associated agreements.

## Observations

KPMG have been conducting the audit for the last 8 years. KPMG has a dedicated senior manager and a manager to conduct this audit and they appear to have a detailed understanding of the systems.

KPMG and ASX liase in relation to what the internal control objectives should be but not on how the audit itself is to be conducted. The ASTC board has to approve all changes to control procedures. The control objectives and the list of controls are separate for both CHES and DCS.

The process has evolved over time and the focus at the time of our assessment in January 2004 was said to be on change control testing. The number of tests undertaken in relation to proposed changes to the systems depend on the level of comfort to be gained. However, the extent of change is incremental.

The audit itself is detailed and it feeds into the external ASX audit, which is also conducted by KPMG. The June CHES annual audit report is distributed to participants through the ASX Bulletin. KPMG distributes the DCS audit reports to participants by mail.