

CIRCULAR TO: FULL MEMBERS

No. 151/00

EXCHANGE FOR PHYSICAL TRANSACTIONS
INVOLVING A PRIMARY BOND ISSUE

The Market Practices Committee (MPC) recently found Members in breach of the Exchange's Business Rules in regard to Exchange for Physical (EFP) transactions where they involved a corporate bond issue. Accordingly, the purpose of this Circular is to clarify the correct practice for transacting Exchange for Physicals (EFP) in this regard.

In the enquiry where the breaches were identified, Members were found to have purchased bonds via an EFP directly from the issuer, whereas the futures were transacted with another party. Therefore, the EFP trades involved three (3) parties whereas the Exchange's Business Rules stipulate that there can only be two parties.

It was identified that the issuer of the corporate bonds sold the bonds without buying futures, and instead the lead manager bought the futures. This did not comply with the Exchange's Business Rules on the basis that the seller of the physical bond was not the same legal entity as the buyer of the futures.

In this regard, it should be noted that both parties to the EFP transaction were held responsible for the trade failing to comply with the Exchange's Business Rules and Corporations Law.

In regard to the above, Members should be aware that the issuer of bonds may only sell the physical bond via an EFP trade if it also buys futures. Also, should the lead manager of a bond issue wish to buy futures via an EFP from another party in order to hedge a swap with the issuer, the lead manager must also sell the physical bonds to the same party. This involves a prior transfer of all bonds, which are to be traded via EFP, from the issuer to the lead manager.

Further, the co-manager of a bond issue may only obtain bonds directly from the issuer if it also sells futures to the issuer. Should an issuer not want to buy futures, it cannot sell the bonds via an EFP to the co-managers. Instead the co-manager can access its bonds via an EFP directly from the lead manager.

It should also be noted that all EFP transactions must involve a bona fide physical transaction, such as the sale of a new bond issue, which takes place at the time of the futures transaction or which is intended to take place soon after (immediate settlement or deferred settlements are accommodated).

EFP transactions not conducted in accordance with Exchange rules may also be in breach of Section 1258 of the Corporations Law and may lose the protection of Section 1141 of the Corporations Law. Such trades may also be held to be unenforceable.

Further information can be obtained from:

- (i) Corporations Law sections 1258 and 1141;
- (ii) Exchange's General By Laws G.7; and
- (iii) Practice Note 1 issued by the Exchange.

Should you have any queries in relation to the above, please do not hesitate to contact the undersigned on 9256 0177.

TRISTAN STROBL
SURVEILLANCE ANALYST

28 JULY 2000