SFE BULLETIN

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SFE REGULATORY OVERSIGHT FRAMEWORK - QUARTERLY CONTRACT EXPIRIES

Further to SFE Bulletin 29/04, which foreshadowed commencement of a market advisory process addressing Sydney Futures Exchange Limited's (SFE's) regulatory oversight approach to its market, the attached document provides a summary of the process undertaken together with formal guidelines regarding SFE's ongoing regulation of the quarterly bond futures contracts' roll and expiry process.

During late July and early August, SFE met with a broad range of portfolio managers, futures heads and compliance representatives from entities spanning a diverse range of users and trading styles, to discuss SFE's regulatory oversight process and proposed enhancements in relation to expiry monitoring, with focus on its bond futures contracts. The wide-ranging market feedback confirmed SFE's view that its bond futures contracts continue to provide significant, effective and cost-efficient risk transfer mechanisms for all market users, combining substantial liquidity with a straightforward and highly efficient expiry settlement mechanism. Almost every party (with only a very small minority dissenting) affirmed the desirability of the following key principles:

- That no single entity should hold an unreasonably large proportion of Open Interest at expiry;
- That any 'hard' position concentration limit at the end of the trading day prior to expiry (T-1) should be transparently published to ensure a 'level playing field;' and
- That specific regulatory discussions between SFE and individual SFE Participants and/or users should at all times remain confidential.

Continuing growth in the size of SFE's bond futures market combined with observable roll activity occurring later in the expiry cycle (resulting in much larger futures holdings in the final trading days) has prompted SFE, as market regulator, to consider measures to constrain position concentration which has the potential to negatively impact upon the orderliness of the market (by virtue of its potential to trade into the physical market at expiry causing a liquidity imbalance that threatens the orderly price convergence process.) Market users should note that similar concentration issues are not currently evident in relation to SFE's other traded futures contracts.

SFE has therefore focussed on the distribution of the spot month Open Interest (OI) towards expiry in its bond futures contracts and operates from the perspective of the desirability of avoiding concentration at expiry in its regulatory oversight process. In order to most effectively manage, from a regulatory perspective, the fast rate of growth in bond futures market activity and thereby preserve long-term confidence in ongoing market integrity, SFE has decided to extend its current regulatory oversight procedures approaching and at expiry of bond futures contracts and this bulletin is aimed at providing transparency and certainty to the market on the additional measures being implemented.

The formal guidelines attached involve expiry concentration position limits applicable at the close of trading on the day prior to contract expiry (T-1). In line with market feedback, these limits are defined in numbers of net open spot month positions and are applicable to all market users equally. Details of the expiry concentration position limits and relevant transitional arrangements are provided in the attachment. The limits, which are similar to measures previously implemented at other major international exchanges and which will be subject to ongoing review relative to prevailing market conditions, are intended to supplement and provide a necessary additional level of certainty to existing quarterly surveillance procedures which have been in place and have worked satisfactorily for a number of years.

SFE is confident that the new expiry concentration position limits will represent no practical constraint to the vast majority of market users, whilst at the same time preserving and adding to confidence in the integrity of SFE's market to the long-term benefit of all market users. The limits have been set at levels in excess of any actual market holdings (other than one isolated instance) noted to date at the close of T-1 and accordingly, in SFE's opinion, provide ample scope for all current market activities to continue unimpacted.

During the market advisory process, a number of additional mechanisms and constructive ideas were put forward by market users and canvassed by SFE, some of which have the potential to further assist in enhancing market and operational integrity during the quarterly contract roll and expiry period. SFE has undertaken to perform further analysis on these suggestions, many of which may have structural, system and regulatory implications, with a view to re-engaging with the market in the medium term.

Should you have any queries in relation to the above, please contact the undersigned on 9256 0652 or the following:

Expiry concentration position limits: contact Bronwyn Hill, Compliance and Surveillance Manager on 9256 0699 or bhill@sfe.com.au or Nick Gaut, Surveillance Market Analyst on 9256 0414 or ngaut@sfe.com.au .

Bond futures contract specifications: contact Maurice Farhart, Senior Manager Interest Rate Products, on 9256 0183 or mfarhart@sfe.com.au .

Anne T. Brown
General Manager, Business Risk

Quarterly Contract Expiries
SFE Regulatory Oversight Framework – August 2004

SFE ROLE, OBLIGATIONS AND POWERS

As part of its market operator licence which imposes front-line market regulatory authority and obligations, SFE must *"to the extent that it is practicable to do so, do all things necessary to ensure that the market is a fair, orderly and transparent*[1] *(FOT) market.*" In fulfilling its regulatory obligations, SFE recognises that the continuing robustness of the regulatory environment underpins and enhances user confidence in the integrity of the market.

SFE's Operating Rules, explicitly reviewed and approved by ASIC and the Parliamentary Secretary to the Treasurer, contain specific powers and provisions to facilitate fulfilment of its licence obligations. SFE has identified a wide variety of options in relation to the action it may consider necessary to protect and maintain the integrity of its market. However, whilst its ultimate "last resort" powers will be utilised when considered necessary, SFE has no desire to reactively resort to such remedies where preventative yet measured procedures can be pro-actively implemented which more effectively manage any market integrity concerns and also benefit the long term confidence in the market.

Provision of increased clarity to the market regarding SFE's regulatory oversight process does not, however, extend to sharing confidential individual Participant/user dialogue. SFE will continue to maintain confidentiality in relation to all surveillance-related discussions held, information obtained and interventionist action taken (except where it considers that there is a prevailing public interest requirement), and expects Participants and users to do the same.

CURRENT APPROACH

In the lead up to contract expiries, SFE's normal surveillance monitoring (and internal management reporting) of market activity increases, with particular focus on large futures position holders and significant positional movements, together with physical volumes and other relevant market liquidity issues.

Whilst a large position is not necessarily an issue *per se*, closer attention is paid to larger long and short positions within the quarterly roll period, both in regard to the portion of the futures market that such a position might represent and in regard to the market power that has the potential to be exercised in the physical market by attempting to unwind the futures position at expiry. SFE's surveillance focus in this regard primarily reflects the possibility that, even if unintentionally, unwinding of hedge positions could lead to a disorderly physical market on expiry.

SFE's regulatory oversight focus is the size of futures positions held going into the day of expiry, and aims to ensure that no single beneficial owner holds a disproportionate size of spot month OI that could potentially prejudice the orderly convergence process.

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[1] In the absence of formal definitions/guidelines relating to these regulatory concepts, SFE has previously developed its own specific definitions for the express purposes of front-line market regulation as follows:

- Fair – pertaining to the parity of information available to market users;
- Orderly – pertaining to impacts on the integrity of fair-value pricing via manipulation or other undesirable activity; and
- Transparent – pertaining to the market's ability to facilitate effective price discovery.

In relation to large position holdings, clarification and assurances are generally sought in strictest confidence from relevant Participants (and/or underlying clients as appropriate) regarding the nature of the position and trading intentions towards expiry. Where such assurances are not forthcoming to SFE's satisfaction, discussions are escalated, both within SFE and with the relevant Participant. The potential to consider pre-emptive action is more likely in relation to a number of factors including:

- observance of systematic behaviour (for example, where systemic levels of roll activity do not correlate to normalised futures trading activity or futures market share);
- where there is a lack of trading history, knowledge or available information on an entity;
- where requested information or assurances have not been provided to SFE's satisfaction; or
- where previous trading history or events suggest that assurances should not be accepted at face value.

The additional arrangements outlined below are intended to supplement and provide a necessary additional level of certainty to existing quarterly surveillance procedures which have been in place and have worked satisfactorily for a number of years.

SUMMARY OF NEW ARRANGEMENTS

- **Introduction of end-of-contract (close of trading on T-1) spot month open position expiry concentration limits in relation to SFE 3-Year and 10-Year Treasury bond futures contracts. Implementation effective for December 2004 contract expiries.**
- **'Level playing field' application of these limits to <u>all</u> market users at a 'group' level.**
- **In SFE's view, supported by the vast majority of market users, concentration limits are very unlikely to impact current market activity – they are principally aimed at arresting a potentially undesirable trend given the increasing divergence between constrained physical liquidity and growing futures open interest, and providing greater certainty to existing surveillance procedures.**
- **Ongoing review and revision of published limits based on evolving market conditions (for example, widening of the eligible repo securities menu, imminent introduction of a CGS stock lending facility…etc).**

DETAIL OF NEW ARRANGEMENTS

Effective for the December 2004 bond futures contract expiries, SFE will introduce expiry position concentration limits applicable to the December 2004 3-Year and 10-Year treasury bond futures contracts, based solely on spot month net open positions at the end of the trading day prior to expiry (T-1) and enforceable intra-day over the remainder of the contract life (ie. during the last trading day).

Given the market's clear desire for certainty in relation to any concentration limit regime introduced, SFE has decided to define these limits as follows:

	SFE 3-Year Treasury bond futures contract	SFE 10-Year Treasury bond futures contract
Maximum number of spot month net open position to be held at close of trading on T-1 at a corporate 'group' level	20,000	15,000

In its desire to maintain a 'level playing field' approach to its market surveillance, SFE advises that these expiry concentration position limits should be considered by market users as hard limits applicable to all market users (with beneficial ownership applied at 'group[2]' level), regardless of the particular type or style of trading activity undertaken. However, the SFE Operating Rules (and any relevant amendments) will unequivocally provide SFE with discretion to validly vary the limits on an exceptional case-by-case basis, with such discretion likely to be exercised on an infrequent and judicious basis only.

These limits have been based upon consideration of a number of factors including:

- SFE's assessment of overall futures market size and a maximum acceptable degree of OI concentration;
- physical market turnover and liquidity on expiry day (ie. the size of the cash market); and
- turnover and liquidity within the repo market.

Whilst the expiry position concentration limits have been set at levels significantly below the levels of positions which various participants can and do, from time to time, hold during the course of a contract, they have been set at levels in excess of any actual market holdings (other than one isolated instance) noted to date at the close of T-1 and accordingly, in SFE's opinion, provide ample scope for all current market activities to continue unimpacted.

Based on high quality input to the market consultation process, SFE is also confident that the increased certainty of users in the ongoing robustness of the market is the overriding objective of a vast majority of market users.

SFE has no current concerns with positions being held in excess of these expiry position concentration limits during a contract's life. SFE considers that the optionality to trade in excess of these end-of-contract limits during a contract's life is desirable, and it is a matter of choice for individual entities to develop their trading policy around these published expiry concentration limits.

Going forward, SFE also intends to regularly review and as, necessary, revise its view of appropriate expiry position concentration limits based on changing market conditions and related factors and to publish any such amendments to the market on a timely basis.

Please note that SFE's imposition of expiry position concentration limits does not obviate or reduce the ongoing responsibilities of all market users to continue to act and utilise SFE's market in an appropriate manner.

TRANSITIONAL ARRANGEMENTS

As previously noted, following any relevant Rule amendments, the new expiry position concentration limits will be applicable to SFE's December 2004 3-Year and 10-Year Treasury bond futures contracts. However, the above expiry position concentration limits should be considered by market users as a 'rule of thumb' for the September 2004 bond futures roll period.

Whilst no special market-wide transition arrangements are considered necessary by SFE, if any market user considers that they may be impacted by the new expiry position concentration limits, they are strongly encouraged to directly contact SFE Surveillance as soon as practicable to discuss the matter in confidence.

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[2] Application of limits at a 'group' level as the default (i.e. consolidating all affiliated corporate entities) is considered to be the most straightforward and reasonable basis. However, genuine disparate holdings by international branches of a global institution, or by proprietary trading and funds management divisions of a bank may be examples where SFE would utilise its discretion to vary limits as required.