

**SFE Clearing Bulletin No:** 42/03**From:** SFE Clearing Corporation Pty Ltd ABN 91 050 615 864**Date of Issue:** 31 Dec 2003**Effective Date:** 31 Dec 2003**CLOSING OUT OF OPEN POSITIONS – RELEASE OF PRACTICE NOTE 39**

Open Interest (OI) is one of a number of indicators of a market's depth of liquidity, but its definition and measurement is complex. SFE's OI is calculated and reported to the market by summing the long positions reported on a daily basis by SFE Clearing Participants in SFE's OM SECUR clearing system, and this process is consistent with the practice of most major international exchanges. The accuracy of the resulting OI is subject to correct trade allocation, the integrity of a Clearing Participant's closeout process; and any difference in interpretation regarding what should be closed out versus back-to-back open positions<sup>1</sup> that are reported as gross positions (as a better reflection of underlying depth of liquidity).

SFE Surveillance has expended significant effort during 2003 to improve the general robustness of Clearing Participants' closeout, mandatory settlement and OI reporting processes (resulting in either one-off corrections and/or systemic process enhancements). As a consequence, the overall quality of published OI has improved and this has been recognised by Participants and market users alike.

However, in times of significant market volatility or increased trading activity – in particular, approaching major contract expiries - the completeness, accuracy and/or timeliness of some Clearing Participants' close-out activities are not always maintained, leading to potentially inflated OI in the days immediately preceding expiry. Given that the integrity of OI takes on increased importance at and around contract expiries, whilst SFE recognises that Clearing Participants' back office workloads increase at these times, this is not considered an acceptable reason for failure to maintain what is generally a straightforward and highly automated daily process.

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<sup>1</sup> Back-to-Back Open Position are long and short open positions held by the same individual account in the same contract which can be matched and settled against each other.

The third aspect of OI noted above – potential differences in interpretation of what constitutes a valid back-to-back open position – has also been the subject of ongoing dialogue with Clearing Participants and this consultation has identified some inconsistencies across the market.

Therefore, in order to more effectively encourage and enforce timely and consistent Clearing Participants' close-out activities going forward, SFE advises that minor enhancements are being introduced into the SFE Clearing Business Rules and the attached Practice Note has been issued.

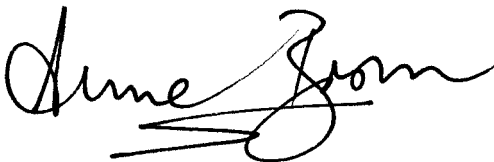
Practice Note 39 outlines in detail the general principle and preferred practice to which Clearing Participants must now adhere in regularly closing out back-to-back open positions. In addition, a new Operating Rule will be introduced which will grant SFE Clearing the ability to direct Clearing Participants to exclude back-to-back Open Positions from being submitted to OM SECUR.

Failure by a Clearing Participant to adhere to the general principle and practices outlined in Practice Note 39 may lead to SFE Clearing issuing formal directions to the Clearing Participant to close out back-to-back positions which do not contribute to market liquidity. Failure to adhere to such directions will in turn constitute a breach of SFE Clearing's Operating Rules.

Accordingly, Clearing Participants are strongly encouraged to review and address any remaining weaknesses in their daily closeout and OI reporting procedures with a view to full compliance with Practice Note 39 by Friday, 13 February 2004. Clearing Participants should also note that they may need to obtain client instructions before this date, so early action in this regard is advised.

SFE will monitor adherence to Practice Note 39 as part of its observation and enforcement of Clearing Participants' OI reporting with a view to ensuring that published OI remains a relevant and reliable indicator of the market's depth of liquidity.

Should you have any queries in this regard, please contact Bronwyn Hill, Manager Compliance and Surveillance on 9256-0699 or at [bhill@sfe.com.au](mailto:bhill@sfe.com.au), or Nick Gaut, Market Analyst, Compliance & Surveillance on 9256-0414 or at [ngaut@sfe.com.au](mailto:ngaut@sfe.com.au).

A handwritten signature in black ink, appearing to read 'Anne Brown', with a horizontal line drawn underneath the name.

**Anne T. Brown**  
**General Manager, Business Risk**

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## PRACTICE NOTE

<b>SUBJECT:</b>	CLOSING OUT OF OPEN POSITIONS
<b>RELEVANT LAW/ BUSINESS RULE:</b>	SFE CLEARING CORPORATION BUSINESS RULE 46 SFE CLEARING CORPORATION SCHEDULE 6
<b>FIRST ISSUED:</b>	December 2003
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### Introduction

Open Interest (OI) is one of a number of indicators of a market's depth of liquidity. SFE's OI is derived from the summing of Open Positions held by all Clearing Participants in their House Clearing Accounts and Client Clearing Accounts (collectively referred to as "Clearing Accounts") at the end of each trading day. These figures are submitted daily by the relevant Clearing Participant into SFE Clearing's OM SECUR clearing system in accordance with Clearing By-Law 46.1.<sup>1</sup>

A Clearing Participant would derive the figures to be submitted into OM SECUR from the summing in its back office of Open Positions held in Individual House Accounts<sup>2</sup> and Individual Client Accounts<sup>3</sup> (collectively referred to as "Individual Accounts").<sup>4</sup> Accordingly, the fundamental level at which market liquidity is held is at the level of the Individual Account.

It has come to SFE Clearing's attention that not all Clearing Participants have been netting Individual Accounts in their back offices in a manner which enables the most accurate OI to be derived. In particular, SFE Clearing is concerned with the failure of certain Clearing Participants to consistently Close Out in their back offices Back-to-Back Open Positions<sup>5</sup> within Individual Accounts. If submitted into OM SECUR, such Back-to-Back Open Positions may inflate the OI figure without actually indicating an increase in the true liquidity of the market.

**To thus enhance the integrity of OI, SFE Clearing now requires that, in fulfilling their obligations under By-Law 46.1, Clearing Participants adhere to the general principle (as outlined in this Practice Note) of Closing Out Back-to-Back Positions within each Individual Account on a daily basis in their back offices in order that such positions do not form part of the total number of Open Positions submitted into OM SECUR towards the relevant Clearing Account.<sup>6</sup>**

This general principle is illustrated in the Tables overleaf.

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<sup>1</sup> Clearing By-Law 46.1 requires a Clearing Participant to advise SFE Clearing on a daily basis of the number of Open Positions which it wishes to remain open. This advice is effected through the Clearing Participant submitting that information into OM SECUR.

<sup>2</sup> An 'Individual House Account' is an individual account established by an Exchange Participant on its own behalf for the purposes of Trading on the Exchange.

<sup>3</sup> An 'Individual Client Account' is an individual account established by an Exchange Participant for a Client for the purposes of Trading on the Exchange.

<sup>4</sup> The total Open Positions held in a particular Clearing Participant's House Clearing Account should be derived in that Clearing Participant's back office from summing the number of Open Positions held in each of its Individual House Accounts. The total Open Positions held in a particular Clearing Participant's Client Clearing Account should be derived in that Clearing Participant's back office from summing the number of Open Positions held in each of its Individual Client Accounts.

<sup>5</sup> 'Back-to-Back Open Positions' are Open Positions within an Individual Account which can be matched and settled against each other.

<sup>6</sup> Such a practice would also reduce the risk of incorrect settlements being made in error.

## **Application of the General Principle**

In Table 1 below, assume that a Client Clearing Account of a Clearing Participant contains Individual Client Accounts which hold the following Open Positions in a particular futures contract<sup>7</sup>:

*Table 1 - Example of a Client Clearing Account*

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<u>Client Clearing Account</u>	<u>Short</u>	<u>Long</u>	<u>Net (to be submitted into OM SECUR)</u>
Individual Client Account 1	-400	+50	-350
Individual Client Account 2	0	+500	+500
Individual Client Account 3	-300	+500	+200
<i>Total</i>	<i>-700</i>	<i>+1050</i>	<i><b>-350, +700</b></i>

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### Closing Out Back-to-Back Open Positions in Individual Accounts

In the above table, Individual Client Account 1 holds Back-to-Back Open Positions of 50 lots and Individual Client Account 3 holds Back-to-Back Open Positions of 300 lots. Individual Client Account 2 does not contain any Back-to-Back Open Positions. Before determining each Individual Client Account's contribution to the Client Clearing Account, Back-to-Back Open Positions are to be eliminated from each Individual Client Account in the Clearing Participant's back office. As shown in the 'Net' column of the above table, the resulting net positions to form part of the total to be submitted into OM SECUR would be -350 short in Individual Client Account 1 and +200 long in Individual Client Account 3. As no Back-to-Back Open Positions are held in Individual Client Account 2, the entire +500 long positions held would form part of the total to be submitted into OM SECUR as part of the Client Clearing Account total.

**Therefore, for the purposes of submitting the most accurate representation of the Open Positions within the above Client Clearing Account into OM SECUR, the Clearing Participant must submit the gross sum of the individual net positions of each Individual Client Account, -350/+700.**

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### Affiliated Accounts

Individual Accounts may be grouped together as an "Affiliated Account."<sup>8</sup> Within an Affiliated Account, there may be a mix of long and short positions in a given contract in separate Individual Accounts (sub-accounts). In order to provide an accurate representation of the holdings within an Affiliated Account, Clearing Participants are required to submit the gross sum of the net holdings of each sub-account into OM SECUR. That is, each sub-account within the Affiliated Account, as opposed to the Affiliated Account as a whole, is considered to be an Individual Account for the purposes of calculating and Closing Out Back-to-Back Open Positions.

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<sup>7</sup> The same principle would apply to a House Clearing Account and Individual House Accounts.

<sup>8</sup> An Affiliated Account is defined in the Sydney Futures Exchange Limited Business Rules and is also known as an "omnibus account" (but is distinct from a Clearing Account). Affiliated Accounts are often held on behalf of fund management entities and trading desks which run a number of books for different purposes. In addition, SFE Clearing is aware that some Clients mandate use of a single account to trade multiple strategies (for example, long trades for funding, short trades for hedging). SFE Clearing considers that such an account is in fact a number of Individual Accounts comprising an Affiliated Account and should be treated by Clearing Participants as such for the purposes of submitting Open Positions into OM SECUR.

By way of illustration in the table below, assume that an Affiliated Account of a Clearing Participant contains sub-accounts which hold the following Open Positions in a particular futures contract:

*Table 2 - Example of a Client Clearing Account*

<u>Client Clearing Account</u>	<u>Short</u>	<u>Long</u>	<u>Net (to be submitted into OM SECUR)</u>
Affiliated Account			
Sub-account 1	0	+100	+100
Sub-account 2	-600	+150	-450
Sub-account 3	-500	+700	+200
<i>Total</i>	<i>-1100</i>	<i>+950</i>	<i><b>-450, +300</b></i>

### Closing Out Back-to-Back Positions in Affiliated Accounts

For the example in the above table, it would not be appropriate for a Clearing Participant to Close Out positions within the Affiliated Account as though the Affiliated Account were one Individual Account (i.e. by netting -1100 short against +950 long, resulting in a net position of -150 short). Rather, each separate sub-account would be netted individually and the resulting net positions form part of the total to be submitted into OM SECUR. In the above table, Sub-account 2 in the Affiliated Account holds Back-to-Back Open Positions of 150 lots and Sub-account 3 holds Back-to-Back Open Positions of 500 lots. Sub-account 1 does not contain any Back-to-Back Open Positions. Before determining each sub-account's contribution to the Client Clearing Account, these Back-to-Back Open Positions must be eliminated from calculation in the Clearing Participant's back office.

As shown in the 'Net' column of the above table, the resulting net positions to form part of the total to be submitted into OM SECUR would be -450 short in Sub-account 2 and +200 long in Sub-account 3. As no Back-to-Back Open Positions are held in Sub-account 1, the entire +100 long positions held would form part of the total to be submitted into OM SECUR as part of the Client Clearing Account total.

**Thus for the above Affiliated Account, a -450/+300 holding (which has been derived from a sum of the individual net position figures in each sub-account within the Affiliated Account) would be submitted to OM SECUR as the most accurate representation of the holdings in that Client Clearing Account.**

In order that an account can be treated as an Affiliated Account (and be entitled to hold Back-to-Back Open Positions), Participants must request explicit instructions in this regard (as well as the rationale for it) from their clients (which may include entities related to the Participant) and must retain these instructions on file. Further, Participants must instruct their clients to provide them with daily instructions as to the number of Back-to-Back Positions required to be left open in order to report their Affiliated Account in accordance with these principles.

**If a Participant does not receive instructions from its client that an account is being operated as an Affiliate Account, the general principle must be followed and Back-to-Back Open Positions must be closed out of the account. If the Client wishes to operate an account as an Affiliated Account, they must commit to informing the Participant daily of how many open positions are to be maintained (or how many back-to-back positions are to be closed out) in line with these Principles.**

## **Exception to the General Principle**

### **Differentiated Deliverable Commodities**

The principle of Closing Out Back-to-Back Open Positions outlined above applies to cash-settled contracts (e.g. SPI 200™ futures contracts, Commonwealth Treasury Bond futures contracts etc) and deliverable contracts where all deliverable commodities are functionally identical (e.g. Individual Share Future contracts, currency future contracts etc), as Back-to-Back Open Positions in such contracts do not contribute to market liquidity.

However, Back-to-Back Open Positions which are held in deliverable contracts where the deliverable commodities may vary in quality, nature or some other means (e.g. Greasy Wool) may represent a contribution to market liquidity, where there is intent or likelihood to both take and make a delivery at a single expiry. Accordingly, such Back-to-Back Open Positions may be maintained and included as part of the number of Open Positions submitted into OM SECUR.

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### **Inappropriate Practices**

Open Positions held within an Individual Account, whether or not it is a sub-account of an Affiliated Account, must not at any time be settled or offset against Open Positions held within another Individual Account or sub-account, even if these positions belong to a single legal entity, unless these positions are formally transferred into the same Individual Account.

Any such activity may represent inappropriate off-market trading and may constitute a breach of the Rules or the law.

For example, in Table 1 above, if the Open Positions within Individual Client Account 1 are inappropriately offset against the Open Positions within Individual Client Account 3 the resulting net position would be -150 short. However, the correct number of Open Positions to be included in the total to be submitted to OM SECUR are -350 short for Individual Client Account 1 and +200 long for Individual Client Account 3. Similarly, in Table 2, if the Open Positions in Sub-account 2 of the Affiliated Account are inappropriately offset against the Open Positions in Sub-account 3, the resulting net position would be -250 short. However, the correct number of Open Positions to be included in the total to be submitted to OM SECUR are -450 short for Sub-account 2 and +200 long for Sub-account 3.

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### **Implementation**

Clearing Participants are required to follow the principle and best practice described in this Practice Note in their treatment of Back-to-Back Open Positions. Where not already in place, Clearing Participants should ensure implementation of this principle and best practice as soon as possible, with a view to full compliance by 13 February 2004.

**After this date, Clearing Participants must be able to identify each Individual Account within which Back-to-Back Open Positions are maintained and hold instructions or other documentation to justify why these Back-to-Back Open Positions have not been Closed Out by the Clearing Participants' back offices.**

Documentation held in this regard may be reviewed as part of a Clearing Participant compliance inspection or operational review and must be made available to SFE Clearing on request.

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Clearing Participants are also reminded of the importance of maintaining appropriate Close Out procedures, as outlined in this Practice Note, approaching the expiry of contracts.

Clearing Participants are further advised that SFE Clearing is in the process of drafting a new Clearing By-Law which grants SFE Clearing the ability to direct Clearing Participants to exclude Back-to-Back Open Positions which do not contribute to market liquidity from being submitted into OM SECUR. Where Clearing Participants are found to be acting in a manner inconsistent with this Practice Note, such a direction may be issued in the interests of more transparent and accurate market reporting.

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