

SFE NOTICE NO.

115/06

Date of Issue:

27 September 2006

Effective Date:

Exchange for Physical Transactions Specifically Relating to Primary Issuance of Bonds into the Market

The Exchange has received a number of queries from Participants seeking clarification on the compliance of some common market practices relating to Exchange for Physical (EFP) transactions with the Operating Rules and Procedures, Determinations and Practice Notes (PDP) of the Exchange. These queries have specifically related to the reversal of the physical leg of some EFPs directly related to primary issuance of bonds into the market.

The Exchange has amended its PDP (copy attached) to recognise the pre-existing intent to reverse the physical leg of EFPs **specifically related to primary issuance transactions only.**

The Physical side of the EFPs between the lead managers or facilitating entities that relates directly to transfer of risk associated with the Primary Issuance will, under this determination, be allowed to be reversed as part of the overall Primary Issuance transaction. Such EFPs registered with the Exchange will require reference to be made in the Comments field in SFEIN stating the name, amount, maturity date, coupon and the lead managers/facilitators of the associated Primary Issue. Participants are reminded that all other rules and determinations relating to EFPs remain unchanged. Consequently any EFP entered into with the intent to reverse or cancel the physical leg once the futures have been registered which is not directly related to primary issuance and hence falls outside this amended determination will clearly be in breach of the Operating Rules and subject to investigation and likely disciplinary action.

The Exchange is currently reviewing the EFP provisions in general and as part of this review will seek to amend its rules to further simplify the transfer of risk associated with the primary issuance of bonds into the market and resolve a number of other related issues. The anticipated timetable for these rule changes to be effected is 1st quarter 2007.

Should you have any queries, please contact Robert Coaldrake Senior Manager Compliance and Surveillance on (02) 9256 0495 or at rcoaldrake@sfe.com.au or Rohan Delilkhan, Manager Exchange Business on (02) 9256 0608 or at rdelilkhan@sfe.com.au .



ANNE T. BROWN
GENERAL MANAGER, RISK AND COMPLIANCE

SFE Corporation Limited

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30 Grosvenor Street
 Sydney Australia
 +612 9256 0555
 www.sfe.com.au
 ABN 74 000 299 392

Principles, Determinations and Practice Notes relating to EFPs

Rule 3.5 Exchange for Physical Trading

Explanatory Note

The EFP facility provides further flexibility in the management of price risk for clients of Participants. An EFP allows a futures position to be exchanged for a physical position in the underlying market at a price negotiated between the counterparties.

Determinations Made By The Exchange

Exchange For Physical Lodgement Times

Effective 21 March 2004 EFP's can be registered up until 5:00 pm only. EFP's agreed between 4:00 pm and 4:30 pm will require the seller and buyer to complete their registration within 15 and 30 minutes of execution respectively. Registration times for EFP sellers and buyers outside the 4:00 pm and 4:30 pm bracket will be set at 30 and 60 minutes respectively.

EFP's presented for registration after 5:00 pm will be processed on the next business day.

	Seller	Buyer
EFP's agreed between 7:00 am and 4:00 pm	Lodged within 30 minutes	Lodged within 60 minutes
EFP's agreed between 4:00 pm and 4:30 pm	Lodged within 15 minutes	Lodged within 30 minutes
EFP's agreed between 4:30 pm and 7:00 am	Lodged by 9:00 am	Lodged by 9:30 am

Trading Procedures

- 1 An Exchange for Physical transaction is effected where:
 - (a) a bona fide physical transaction in a commodity, instrument or other transaction as determined by the Exchange is completed whereby physical delivery takes place at the time of the transaction or is intended by both parties to take place at a later time is entered into;
 - (b) at or about the same time a Contract, opposite in effect, is traded for the same or similar quantity or amount of the commodity or a substantially similar commodity or instrument on behalf of the parties to the physical transaction;

The essential element of the EFP rules is that a bona fide physical transaction takes place at the time of the futures transaction or is intended to take place at a later time (thus both immediate settlement and deferred [e.g. seven day] settlements are accommodated).

Full Participants should note that purported EFP transactions not conducted in accordance with SFE's rules will be subject to cancellation, sanctions imposed by the Market Practices or Business Conduct Committees and may be held to be unenforceable.

There must only be two beneficial parties to an EFP; the buyer of the physical must also be the seller of the futures and the seller of the physical must be the buyer of the futures.

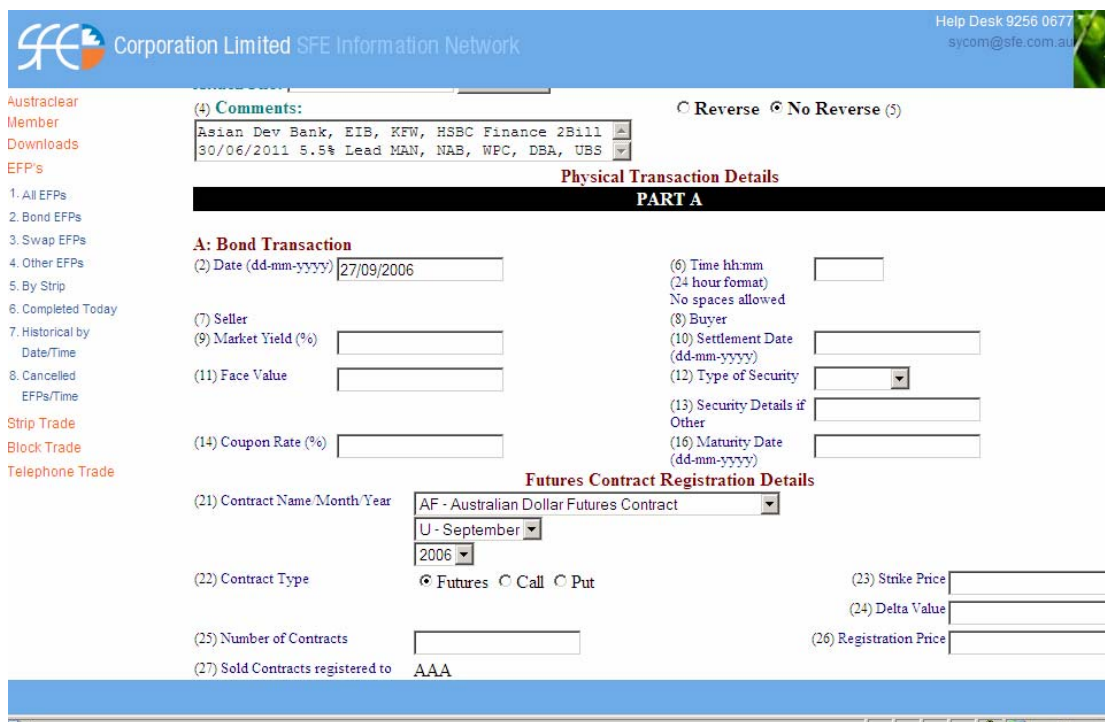
No Full Participant may transact business for a discretionary account by way of an EFP transaction.

With respect to EFP transactions in the d-cypha SFE Electricity Products, where the Over The Counter (OTC) component of an EFP is within 10% of the size (e.g. MWhs) or value, SFE will accept the following construction in relation to d-cypha SFE Electricity EFP's:

- i) OTC Swaps, Caps and/or Options against d-cypha SFE Electricity Futures and/or Futures Options.

2. Bona Fide Physical Transaction

A physical transaction is not *bona fide* if there is a pre-existing intent to reverse or cancel the physical deal once the futures transaction is registered **unless the EFP transaction complies specifically with a scenario as determined by the Exchange.** Currently the only scenario in which the Exchange has determined to allow the pre-meditated reversal of the physical side of the transaction is where the EFP specifically relates to a Primary Issuance of bonds into the market. The physical side of the EFP's between the lead managers or facilitating entities that relate directly to the transfer of risk associated with the Primary Issuance will, under this determination, be allowed to be reversed as part of the overall Primary Issuance transaction. Such EFP's registered with the Exchange will require reference to be made in the comments field in SFEIN stating the name, amount, maturity date, coupon and the lead managers/facilitators of the associated Primary Issue. An example of such a reference is contained in the screen dump of the relevant SFEIN page below. All other requirements relating to record keeping and evidence of physical transactions must be adhered to.



The screenshot shows the SFEIN system interface. At the top, it says 'SFE Corporation Limited SFE Information Network' and 'Help Desk 9256 0677'. On the left, there is a navigation menu with options like 'Austraclear', 'Member', 'Downloads', 'EFP's', and 'Strip Trade'. The main content area is titled 'Physical Transaction Details PART A' and contains the following information:

(4) Comments: Asian Dev Bank, EIB, KFW, HSBC Finance 2Bill 30/06/2011 5.5% Lead MAN, NAB, WPC, DBA, UBS

A: Bond Transaction

(2) Date (dd-mm-yyyy): 27/09/2006

(7) Seller: [Empty]

(9) Market Yield (%): [Empty]

(11) Face Value: [Empty]

(14) Coupon Rate (%): [Empty]

(6) Time hh:mm (24 hour format): [Empty]

(8) Buyer: [Empty]

(10) Settlement Date (dd-mm-yyyy): [Empty]

(12) Type of Security: [Dropdown]

(13) Security Details if Other: [Empty]

(16) Maturity Date (dd-mm-yyyy): [Empty]

Futures Contract Registration Details

(21) Contract Name/Month/Year: AF - Australian Dollar Futures Contract, U - September, 2006

(22) Contract Type: Futures Call Put

(23) Strike Price: [Empty]

(24) Delta Value: [Empty]

(25) Number of Contracts: [Empty]

(26) Registration Price: [Empty]

(27) Sold Contracts registered to: AAA

Whether a physical transaction is *bona fide* is a question of fact in each case, however, in deciding whether or not a transaction is *bona fide*, SFE will have regard to the normal dealing conduct and arrangements of the parties in relation to physical transactions generally. All relevant indicia of a *bona fide* transaction including transfer of cash will be considered.

Thus, SFE would expect to see the physical transactions related to EFPs recorded in the same way as any other similar physical transactions conducted by the parties. Instances where reversals or cancellations regularly take place other than in the ordinary course of business will be regarded as evidence of lack of *bona fide*.

There are no limits on the type of physical, however it must be of similar value or quantity to the futures being traded and be highly correlated with the futures contract. The onus is on the Full Participant to provide relevant information about the physical enabling SFE to determine that the futures transaction is "of similar quantity or amount" to the futures transaction.

A physical trade between two parties with the intention of being traded back in a reversal of the EFP or in exchange for other futures contracts (such as a roll trade or a curve spread trade) is being used merely as a tool to conduct off-market futures trading and is thus explicitly considered not to be part of a *bona fide* physical transaction. Submitted trades believed to fall into this category will not be approved.

3. Multiple Futures and Physical

An Exchange for Physical trade may involve more than one type of futures or physical. The most common EFP involves one type of physical (e.g. a certain number of a particular bond) to be offset against a certain type of futures contract. However a Multiple Futures EFP involves one type of physical and two or more types of futures (e.g. a combination of Ten Year and Three Year Bond Futures or a strip of Bank Bill Futures). Alternatively a Multiple Physical EFP involves two or more types of physical (e.g. bonds of different maturities) and one type of futures. A combination could involve two or more types of futures and two or more types of physical.

4. Price

There are no restrictions regarding the price for futures contracts traded in an EFP. However if the price of the futures were substantially different from that of the current market price SFE would seek good reason as to why the parties wish to trade at this price. In this regard it should be noted that SFE reserves the right to disallow an EFP.

5. Exchange for Physical Registration

- (a) Full details of the futures transaction and the physical transaction are provided to the Exchange in such form as determined by the Exchange. The “Notification of Exchange for Physicals” form must be lodged with SFE using the electronic SFEIN system for approval. Full Participants should be aware that failure to comply with the aforementioned may result in the EFP being rejected or disciplinary action being taken.
- (b) As per Rule 3.5.3 where a Participant enters into a Contract on behalf of a Clearing Participant and the position is to be registered in the name of the Clearing Participant, the Participant shall immediately send, or cause to be sent by the Clearing House, a document in a form determined by the Exchange, setting out the following information in relation to each such trade:
 - (i) name of the Clearing Participant;
 - (ii) name of contract;
 - (iii) delivery month;
 - (iv) contract price;
 - (v) number of lots (distinguishing those bought and those sold);
 - (vi) name of the Full Participant; and
 - (vii) date of the trade.
- (c) As per rule 3.5.9(b) where either before or during a particular month a Full Participant has entered into a Contract in accordance with this Operating Rule on behalf of a Clearing Participant and the Contract has not been disposed of, and as at the end of that month, the Participant's Contract is registered in the name of the Clearing Participant, the Participant shall, after the end of the month, send or cause to be sent by the Clearing House, a document setting out the following in relation to each such trade:
 - (i) name of the Clearing Participant;
 - (ii) name of contract;
 - (iii) delivery month; and
 - (iv) number of lots (distinguishing those bought and those sold).
- (d) The Exchange shall in respect to all EFP transactions publish to Participants after receipt of each EFP transaction the commodity, quantity, time and price of the EFP transaction and the identify of the Full Participants who conducted the trade.
- (e) As per rule 3.5.6, except as otherwise provided by the Operating Rules a Participant shall:
 - (i) submit all Contracts which it trades; and

- (ii) submit or ensure the submission of all Contracts traded by a Local Participant to which an undertaking given by the Full Participant under Operating Rule 2.3 is applicable, to the Exchange, for registration with the Clearing House in accordance with the Clearing Rules
- (f) As per Rule 3.5.7 a Participant shall ensure that any Open Position not given up to another Participant, created by trading on the instructions of a Client including discretionary trading on behalf of a Client, is either:
 - (i) carried in the Participant's name as an Open Position with the Clearing House; or
 - (ii) carried in the Participant's name as an Open Position with another Participant.
 - (iii) Where in accordance with the Clearing Rules, the Clearing House wishes to protect its position by entering into transactions with Full Participants, Full Participants may with the approval of the Exchange agree to buy or sell Futures Contracts or Options Contracts as traded in the Exchange's Markets directly with the Clearing House and without trading on the Exchange's Markets. Such transactions may be registered by the Clearing House in the same way as contracts traded on the Exchange's Markets.

6. Retention of Records

As per Rule 3.5.9(a) where a client or the Full Participant is a party to an EFP transaction, the onus is on the Full Participant to obtain and keep on record appropriate evidence of the physical transaction. SFE considers that “best practice” is adopted where the Full Participant:

- (i) obtains and retains the physical evidence of the EFP transaction on their files;
- (ii) maintains authorised Full Participant signatory lists for employees to approve EFP transactions on the electronic SFEIN system and on paper if need be. If paper forms are used the signatory lists must be copied to the Compliance and Surveillance Department of SFE.

Appropriate evidence would include, but is not limited to:

- (i) Swap Agreement forms, such as ISDA documentation;
- (ii) Bond Confirmation Forms and third party confirmation i.e. Austraclear and RITS statements, and Euro-clear Documentation; or
- (iii) Greasy Wool Warehouse Receipts.

Where the Full Participant is able to employ “best practice”, all documentation relating to EFP transactions should be retained and maintained by the Full Participant in a manner and form which will enable the Compliance and Surveillance Department to conveniently and readily conduct a review. EFP documentation will be reviewed as part of the Compliance and Surveillance Department’s routine Full Participant inspection program.

Some Full Participants may find that it is both administratively and procedurally burdensome for them to retain on file the physical evidence relating to the EFP transaction. In these cases, SFE would consider that the Full Participant has satisfied the requirements of Rule 3.5 by undertaking the following procedures:

- (i) retaining and maintaining an updated authorised Full Participant signatory list for EFP transaction which must be copied to the Compliance and Surveillance Department of the SFE;
- (ii) obtaining and retaining executed copies of the general “Client Undertaking Form” (CUF) prior to transacting EFP business on the Client’s behalf. (See the attached form.); and
- (iii) requesting appropriate physical evidence (as referred in the “Notification of Exchange for Physical” form) on an “as needs” basis from the client when requested by SFE’s Compliance and Surveillance Department.

Participants should note that the futures side of an EFP transaction does involve trading of futures contracts, even though it has not been executed on SYCOM. Participants must retain all documentation normally required by such a transaction including order records as per Rule 2.2.23 and voice recordings as per Rule 2.2.28.