SFE Corporation Limited

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Improvements to the Bond Roll and Half Basis Point Pricing in 3 Year Treasury Bond Futures

Market users will be aware of the recent substantial growth in managed funds and bank balance sheets in Australia that has added to a growing dependency on the market efficiency benefits delivered by SFE's CGS futures market. Equally importantly, the health of the 'over the counter' interest rate swap market is itself dependent on banks being able to hedge 'outright' interest rate risk in SFE's CGS futures market so as to more efficiently price credit risk in the swap and bond markets.

Given this dependency, a number of market initiatives have recently been put in place to mitigate potential serious market operation issues both for the underlying CGS (cash) market and for SFE's CGS futures market. The extension of the menu of eligible 'repo' securities by RBA, the introduction of a CGS stock lending facility by the AOFM, and the introduction of CGS futures contract (t-1) expiry position limits by SFE in September 2004 have improved the efficiency of the CGS futures expiry process. The continued growth in the trading of 3 Year and 10 Year Treasury Bond futures is symptomatic of the financial system's continued dependency on SFE's CGS futures market. For these reasons, SFE is committed to making interest rate risk transfer as efficient as possible through:

- ensuring that the integrity of the futures trading mechanism (including the quarterly roll process) remains intact;
- supporting the market's need for greater liquidity; and,
- lowering the costs of trading for the majority of users.

Having invited market participants in April 2003 to provide written submissions to SFE regarding a range of potential initiatives (including a reduction in minimum price movement in the 3 Year and Bank Bill futures contracts), an extended consultation process through a representative sample of market users in the Bond Roll Focus Group was also conducted in late 2004, as well as many face to face meetings with customers.

Domestic and international customers that were consulted included fund managers, treasurers, proprietary traders, local participants, hedge funds and CTAs. In several cases written submissions were provided to SFE.

Having carefully considered the diverse views of these customers on a wide range of initiatives, as well as the impact of changes on different customer segments, SFE will implement the following:

1. With effect from 15th November 2005, the opening of trading in both the morning and evening sessions for bond and interest rate futures and options contracts will be 'staggered'. This will alleviate the pressure on brokers to enter significant numbers of orders on market open. Further details regarding the timing of these changes will be issued under separate notification to the market.

2. With effect from 5.10pm on 8th March 2006, ½ basis point pricing will be introduced for the period of the roll for the 3 Year Treasury Bond futures contract. 1 basis point pricing will be re-introduced from 5.10pm on 15th March 2006, after the expiry of the March 2006 contract. This will decrease the propensity for users to proliferate orders in an attempt to gain favourable queue position and decrease the overall costs of natural users rolling positions.

3. With effect from 5.10pm 8th June 2006, ½ basis point pricing will be re-introduced for the period of the roll for the 3 Year Treasury Bond futures contract. 1 basis point pricing will be re-introduced from 5.10pm on 15th June 2006, after expiry of the June 2006 contract.

4. During the 2nd half of 2006, ½ basis point pricing will be permanently introduced in the 3 Year Treasury Bond Futures contract. This will further decrease the overall costs of trading and provide finer pricing to create new trading opportunities for existing and new users.

5. Timed to coincide with the permanent introduction of ½ basis point pricing, an extension of the existing Proprietary Trading Scheme will be introduced to provide lower capitalised proprietary traders with access to lower fees at higher volumes.

SFE has received a wide range of other suggestions from market users to also help achieve the objectives outlined above. These included removing the ability for users to view their queue position, introducing a pro-rata matching algorithm, introducing good-til-cancelled orders for the roll, de-linking the bond roll market from the outright market and introducing a pre-opening phase for the bond roll. SFE gave these suggestions thorough consideration, and whilst some of these solutions were deemed neither effective nor practical, SFE will continue to review further measures that may be necessary once the impact of ½ basis point pricing has been assessed.

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