



ASIC

Australian Securities & Investments Commission

REPORT 60

Market assessment report: Yieldbroker Pty Limited

October 2005



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Annual assessment (s794C) report

Yieldbroker Pty Limited
ACN 092 250 345

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Executive summary

Section 794C of the Corporations Act 2001 (the Act) requires the Australian Securities & Investments Commission (ASIC) to assess how well a licensed market operator is complying with its obligations as the holder of a markets licence and in particular, whether a market operator has adequate arrangements for supervising the market it operates.

A market licensee's obligations are ongoing, and whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance. We therefore use our assessment process to:

- reach conclusions about the adequacy of the arrangements Yieldbroker Pty Limited (Yieldbroker) had in place for supervising its market;
- examine the changes Yieldbroker is making in response to recommendations ASIC made in the previous assessment; and
- identify any specific structural aspects that require strengthening or other matters that we believe may create risks to the licensee's ability to comply with its obligations under the Act in the future.

How we conducted this assessment

In conducting this assessment, we considered information relevant to the assessment period, obtained from the following sources:

- Yieldbroker's books, including policies and procedures for the conduct of its markets in general and its supervisory responsibilities in particular;
- trading activity on Yieldbroker's market; and
- interviews with Yieldbroker's management and a director of Yieldbroker.

We have sought and received comments from Yieldbroker on the factual matters set out in this report as well as our conclusions.

Compliance by Yieldbroker with statutory obligations

At the time of our assessment and taking into account the nature of operations of the Yieldbroker market, in ASIC's view Yieldbroker does, and is likely to continue to, comply with its statutory obligations under s792A(c) of the Act. Specifically Yieldbroker has adequate arrangements for supervising its market, including arrangements for:

- handling conflicts between its commercial interests and the need to ensure that the market operates in a fair, orderly and transparent manner;
- monitoring the conduct of participants in the market; and
- enforcing compliance with its operating rules.

Key observations and recommendations

In this assessment we focused on the adequacy Yieldbroker's supervisory arrangements and its responses to the recommendations made by ASIC in the report for the last assessment.

ASIC concluded in the last assessment that Yieldbroker's supervisory arrangements were adequate. Yieldbroker has made no significant changes to the supervisory arrangements in the interim period. As a result of this assessment ASIC has concluded that the supervisory arrangements Yieldbroker has in place continue to be adequate.

Section 1: Background

1.1 Yieldbroker

Yieldbroker is wholly owned by four entities being Citigroup Global Markets Holding Pty Limited, Deutsche Bank Aktiengesellschaft, Macquarie Bank Limited and ABN AMRO Australia Limited. The Board of Yieldbroker is comprised of employees of these entities.

1.2 Market summary

On 3 February 2004 Yieldbroker was granted a licence to operate two markets, the Dealer-to-Client market and the Interdealer market. During the assessment period only the Dealer-to-Client market was operated by Yieldbroker. As at August 2005 the Dealer-to-Client market had thirty-one participants, four of which are classified as 'dealers' and twenty-seven as 'clients'. The Dealer-to-Client market allows clients to request quotes from dealers. The system then presents the client with the various quotes from the dealers. The client may then choose to accept one or none of the quotes. The dealer whose quote the client has chosen then either accepts or rejects the trade. If the trade is accepted both counterparties are informed and the trade is settled outside the market.

The class of financial product traded on the Dealer-to-Client market is debentures. Debentures are defined in the operating rules of the Dealer-to-Client market as:

- debentures as defined in section 9 of the Act;
- an undertaking to repay money deposited with or lent to a body by a person if:
 - the person deposits or lends the money in the ordinary course of a business carried on by that person; and
 - the body receives the money in the ordinary course of carrying on a business that neither comprises nor forms part of a business of borrowing money or providing finance;
- an undertaking by an Australian authorised deposit-taking institution to repay money deposited with it, or lent to it, in the ordinary course of its banking business; or
- debentures, stocks or bonds issued or proposed to be issued by a government as set out in section 764A(1)(j) of the Act.

Within this class of financial product, the financial products traded on Yieldbroker's Dealer-to-Client market include corporate bonds and semi-government bonds.

1.3 The assessment process

Section 794C(2) of the Act requires ASIC to assess whether Yieldbroker complies with its obligations in s792A(c) of the Act. In addition, s794C(1) permits ASIC to extend the scope of its annual report to assess how well Yieldbroker complies with any or all of its obligations under Chapter 7 of the Act.

In conducting our assessment, we took into account the matters set out in ASIC Policy Statement 172 'Australian market licences: Australian operators'. PS 172 explains how ASIC will assess how well a market licensee is complying with its obligations.

This is ASIC's second s794C assessment of Yieldbroker. In this assessment we assessed the adequacy of Yieldbroker's supervision and the responses made by Yieldbroker to the recommendations made by ASIC in the first assessment of Yieldbroker. In conducting our assessment under s794C, we:

- analysed information we received from and about Yieldbroker in the ordinary course of our dealings with the licensee, including Yieldbroker's annual regulatory report under s792F;
- reviewed material obtained from Yieldbroker using our powers under section 30 of the Australian Securities and Investments Commission Act 2001, including:
 - supervisory policy and procedure documents; and
 - board minutes and reports; and
- following receipt and analysis of books obtained under notice, we visited Yieldbroker offices in Sydney on 1 September 2005 and spoke to Yieldbroker management and a director of Yieldbroker.

We have discussed the results of our assessment with Yieldbroker, seeking their comments on both the factual matters set out in this report and our conclusions.

Section 2: Observations and Recommendations

2.1 Overall compliance

After making our assessment, ASIC concludes that Yieldbroker has adequate arrangements for the supervision of its market in accordance with its obligations under section 792A(c) of the Act.

This conclusion is based on the following observations drawn from information gathered during the assessment process:

1. no serious market failures or disruptions came to our attention; and
2. there has been no significant changes made to Yieldbroker's supervisory arrangements.

Yieldbroker is still in the process of implementing changes in response to the recommendations made as part of the last assessment. ASIC will fully assess the changes as part of the next assessment.

2.2 Supervisory arrangements – s792A(c)

Section 792A(c) of the Act requires a market licensee to have adequate arrangements for supervising the market including arrangements for:

- handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market is fair, orderly and transparent;
- monitoring the conduct of participants on or in relation to the market; and
- enforcing compliance with the market's operating rules.

2.2.1 Conflicts of interest

Observations

Yieldbroker informed us that no conflict of interest events had occurred during the assessment period. We note that, due to the structure of Yieldbroker's market, there are limited opportunities for conflict of interest events to occur.

In the last assessment ASIC raised two areas of concern about Yieldbroker's conflict of interests arrangements - the seemingly limited understanding Yieldbroker staff had about conflict of interests and how it applied to their duties, and the composition of the Compliance Committee. Four recommendations were made in the previous assessment with respect to these concerns. The recommendations were:

1. Yieldbroker should develop procedures and provide appropriate training to ensure its staff is able to identify conflicts of interest between the supervisory and commercial objectives of Yieldbroker and know how to appropriately manage such conflicts of interests.
2. Yieldbroker should review its operating rules and procedures in regard to conflict of interest to ensure that they are consistent with the Act and ASIC Policy Statement 172.
3. Yieldbroker should ensure that the Compliance Committee has an appropriate composition in order to deal with all matters brought before it for its consideration.
4. Yieldbroker should consider the inclusion of an appropriately qualified independent person on the Compliance Committee.

In response to recommendations 1 and 2 Yieldbroker has written a new procedure specifically concerning conflicts of interest, how they can be identified and how they should be managed. The Compliance Officer has also conducted training with Yieldbroker staff about conflicts of interest. Yieldbroker has drafted operating rule changes in regard to conflicts of interest which it intends to have in place before the end of December 2005.

We have come to the conclusion that the new conflict of interests procedure is adequate but note that in the absence of any conflict of interests situations occurring, they are currently untested. We cannot comment on the level of understanding of conflict of interest of all Yieldbroker staff as not all staff were interviewed. However we did interview Yieldbroker management, who do demonstrate an adequate understanding of conflict of interests situations and how to manage these events. We intend to conduct interviews with non-managerial Yieldbroker staff in the next assessment in order to gauge whether other employees have an adequate understanding of conflict of interests situations and how to manage these events.

In response to recommendations 3 and 4, Yieldbroker is currently investigating the possibility of the inclusion of an appropriately qualified independent person on the Compliance Committee. Yieldbroker has also drafted changes to the operating rules to clarify who can become a member of the Compliance Committee.

As the overall changes are yet to be fully implemented ASIC is unable to comment on these changes.

2.2.2 Monitoring the conduct of participants

Observations

Yieldbroker is currently responding to the recommendation in our last report that the role of the Compliance Committee should be clarified. Yieldbroker says that the Compliance Committee does not have a day-to-day role in the supervision of the market; rather the Compliance Committee role is an oversight role. The Compliance Committee did not meet during this assessment period.

Yieldbroker is drafting changes to its operating rules to clarify the role of the Compliance Committee. The changes to the operating rules will emphasize that the Compliance Committee supervisory role is an oversight role, whilst the Compliance Officer has the day-to-day supervisory role. Yieldbroker expect to have the changes to the operating rules in place by December 2005.

ASIC believes that an oversight role for the Compliance Committee is appropriate given that members of the Compliance Committee are not members of the Yieldbroker staff and are unable to monitor the market on a day-to-day basis. We will review the impact of the rule changes in our next assessment.

To keep the members of the Compliance Committee informed of participant's compliance with operating rules the Compliance Officer is sending the members of the Compliance Committee both the monthly and annual compliance reports prepared by the Compliance Officer.

We believe that is important that members of the Compliance Committee be kept informed of participants' compliance with the operating rules and welcome Yieldbroker's decision to send them both the monthly and annual compliance report.

2.2.3 Enforcing compliance with operating rules

Observations

Yieldbroker has not substantially changed the processes it has in place for enforcing compliance with its operating rules since our last assessment. There were no formal investigations of operating rule breaches during the period and the Compliance Officer made no recommendations to the Compliance Committee. Accordingly the Compliance Committee did not convene.

ASIC noted in our last assessment that Yieldbroker was not treating breaches of the market performance criteria (MPC) as breaches of operating rules. Yieldbroker's operating rules state that a participant classified as a Dealer must provide price information to Yieldbroker and

if a participant requests a quote, to that participant. This price information must be supplied in accordance with the MPC. Breaches of the MPC may occur when Dealers exceed the time limit on responses to requests for quotes for participants or when Dealers do not supply indicative prices to Yieldbroker. ASIC made two recommendations in regard to breaches of MPC by participants, namely that:

- Yieldbroker must ensure that breaches of the MPC are reported to the board as operating rule breaches and if necessary, the appropriate penalties are applied, as set out in the operating rules.
- Yieldbroker should document any consideration of any operating rule breaches.

Yieldbroker is currently responding to the first recommendation. Yieldbroker says that breaches of the MPC may occur due to circumstances beyond the control of the Dealers, such as breakdowns in IT systems or unexpected staff absences. Such circumstances may result in the Dealer inadvertently incurring infractions beyond the monthly allowable limits. It appears that Yieldbroker monitors the consequences of all infractions, however it does not necessarily consider those occasions as material breaches.

Yieldbroker is addressing this issue by making modifications to the MPC to create a more pragmatic approach to compliance with the MPC. The proposed changes to the MPC will primarily be aimed at reducing the likelihood of any technical breaches which have little or no impact on market operations. Yieldbroker is currently modifying procedures and making changes to operating rules. Yieldbroker intends to have changes to its operating rules in respect of MPC in place before the end of December 2005. Once these operating rules are effective, the related procedures will be considered operative by Yieldbroker.

We will review the impact of these changes in our next assessment.

In response to second recommendation Yieldbroker has advised that the Compliance Officer will record consideration of operating rule breaches in a database. The database will describe:

- the nature of the potential breach;
- the considered potential impact to the market;
- steps taken to mitigate impact by Yieldbroker;
- all communication with the involved participant(s);
- what (if any) further action is required; and
- whether the event was ultimately deemed a breach or not and why.

ASIC will review the impact of these changes in our next assessment.