



ASIC

Australian Securities & Investments Commission

REPORT 45

Market assessment report: Yieldbroker Pty Limited

June 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 and the sufficiency of resources (including financial, technological and human resources) it had to operate the market properly and for the required supervisory arrangements to be provided; 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 and which we will therefore continue to monitor and engage with the licensee directly.

This report outlines our assessment of Yieldbroker's compliance with its obligations under s792A(c), adequate supervision arrangements, and s792A(d), adequate resources, of the Act. This is our first assessment of Yieldbroker.

How we conducted this assessment

In conducting this assessment, we considered information relevant to the period from the date Yieldbroker was granted its Australian market licence (3 February 2004), 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 management and staff.

We also considered Yieldbroker's *Annual Compliance Report for the period 11 March to 30 June 2004* (submitted to ASIC on 20 September 2004 under s792F of the Act).

We have sought and received comments from Yieldbroker on the factual matters set out in this report as well as our conclusions and recommendations for future action. Where Yieldbroker has identified ongoing actions to be implemented within certain timeframes as a result of our recommendations we have noted them in this report.

Compliance by Yieldbroker with statutory obligations

At the time of our assessment and taking into account the present size 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) and s792A(d) 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.
- adequate human, technology and financial resources to supervise and operate the market.

Key observations and recommendations

The structure of Yieldbroker's market limits the possibility for conflicts of interest between Yieldbroker's supervisory obligations and its commercial interests. However we noted that Yieldbroker's staff had a narrow understanding of the actual and potential conflicts of interest that Yieldbroker has between its supervisory obligations and its commercial interest. ASIC recommends that Yieldbroker review its procedures in regard to conflict of interest.

We examined the composition and role of the Compliance Committee and found there are conflict of interest issues in regard to composition of the Compliance Committee. As well there was some confusion as to the role of the Compliance Committee. ASIC recommends Yieldbroker should review the composition and role of the committee.

We found no evidence of any major breaches of operating rules during the assessment. In section 2.2.3 of this report we discuss how Yieldbroker deals with breaches of the market performance criteria. We have recommended that Yieldbroker undertake further work in this area.

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 composed 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. The Dealer-to-Client market at 7 October 2004 had twenty-seven participants, four of which are classified as dealers and twenty-three 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. We also examined whether Yieldbroker met its obligation under section 792A(d) to have sufficient resources to supervise and operate the market.

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 first s794C assessment of Yieldbroker. The assessment covered the period 3 February 2004 to 22 September 2004. In this assessment we assessed the adequacy of Yieldbroker's supervision and resources. 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;
 - board minutes and reports; and
 - files in relation to participants; and
- following receipt and analysis of books obtained under notice, we visited Yieldbroker offices in Sydney from 18 to 22 October 2004 and spoke to Yieldbroker management and staff.

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 and has adequate resources to operate the market properly and for the required supervisory arrangements to be provided in accordance with its obligations under section 792A(d).

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;
2. the Yieldbroker staff responsible for supervision monitored the market in an active and thorough manner;
3. supervision and monitoring of participants and trading are guided by policies and procedures consistent with statutory obligations; and
4. Yieldbroker has sufficient market infrastructure (including technology) to support its obligation to maintain a fair, orderly and transparent market.

2.2 Supervisory arrangements – s792A(c)

2.2.1 Conflicts of interest

Observations

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.

Conflict of interest

As part of the assessment we interviewed employees of Yieldbroker as to their understanding of conflict of interest and how it applied to Yieldbroker. We came to the conclusion that Yieldbroker staff have a narrow view of the concept of conflict of interest, which accords with the definition set out in the market rules and procedures. The conflicts of interest identified by staff are generally that they should not give information about one dealer to another dealer, or information about a particular trade to any participants that are not party to that trade.

In particular, Yieldbroker staff appeared to have a limited understanding of the concept of "conflict of interest between the commercial interests and supervisory obligations" as per section 792A(c)(i) of the Act. This lack of understanding may arise in part because there are very few areas where such a conflict might arise due to the nature of the market and the operation of the system limits. However, we believe that all staff need a good understanding of this concept so that they are able to recognise a conflict of interest when it arises and are able to deal with the situation in an appropriate manner.

Composition of the Compliance Committee

The General Operating Rules and the Compliance Manual state that the Compliance Committee's role is to:

- supervise the operation of the market;
- if there is a dispute between participants and the Compliance Officer, hold a hearing; and
- in response to a recommendation from the Compliance Officer, hold a hearing and make recommendations to the Board of Directors where there is a breach of the operating rules.

The operating rules state the Compliance Committee ".is a sub-committee of the Yieldbroker Board of Directors that will comprise not less than 5 persons It will include a majority of members who are neither executive employees nor directors of Yieldbroker or the participants and may include members who are compliance officers of the Dealers.". Currently the Compliance Committee consists of two employees of one of the Dealers and an employee each of the other three Dealers. Dealers are participants of the Client-to-Dealer market and currently all entities which are classified as Dealers are shareholders of Yieldbroker.

The operating rules state that where a matter comes before the committee, that causes a material conflict of interest for a member of the committee, that member must excuse him/herself. We note that if an issue comes before the committee that conflicts two Dealers the committee may be unable to form a quorum and make a decision on the matter. To form a quorum there must be three members of the committee present.

We noted that the operating rules use the description 'executive employees of the Dealer'. Yieldbroker was unable to tell what was meant by the term 'executive employee'. We believe for clarity Yieldbroker should define this term in its operating rules.

Material conflict of interest

Yieldbroker's operating rules, procedures and Compliance Manual refer to a "material conflict of interest". It is not adequate for Yieldbroker to refer to a "material conflict of interest" as this is not consistent with the Act or ASIC policy.

Recommendations

1. Yieldbroker should develop procedures and provide appropriate training to ensure its staff are 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.

Yieldbroker has informed ASIC that it will in regard to recommendation 1 and 2:

- Yieldbroker has commenced a review of its operating rules and procedures in relation to conflicts of interest;
- draft any changes to its operating rules resulting from the review by July 2005; and
- implement new procedures and staff training before the end of 2005.

In regard to recommendation 3 and 4 Yieldbroker will:

- in the Board meeting in July 2005 discuss the composition of the Compliance Committee;
- schedule a review of the Compliance Committee for completion within six months of receiving a directive from the Board; and
- draft necessary changes to its operating rules by July 2005.

2.2.2 Supervision

Observations

Role of the Compliance Committee

As already noted, one of the duties of the Compliance Committee is to supervise the operation of the market. In regard to its other obligations there were no reported disputes or breaches of operating rules during the period covered by the assessment and thus the Compliance Committee did not need to hold a hearing to consider such issues. However as it did not convene at all during the period we were unable to satisfy ourselves as to how it supervised the operation of the market.

The General Manager was very knowledgeable about the operation of the Compliance Committee. However, although the operating rules state that under certain circumstances the Compliance Officer is to interact with the Compliance Committee, we noted that the Compliance Officer was less familiar with the operation of the committee. The Compliance Officer was aware that the operating rules and procedures set out the details about the Compliance Committee.

Role of the Compliance Officer

Yieldbroker's operating rules, in particular General Operating Rule 9.2, state that the Compliance Officer is also responsible for supervising the operation of the market. This supervision includes monitoring and assessing compliance with operating rules and monitoring the conduct of participants on and in relation to the market. Rule 9.2 states that the Compliance Officer reports directly to the Board of Directors. The Compliance Manual also states that the Compliance Officer is responsible for monitoring the conduct of the participants.

Procedures for monitoring the conduct of participants are outlined in General Operating Procedures, the Compliance Manual and various workplace procedures.

The Compliance Officer has access to all market data and on a continuing basis reviews this data, including all completed trades, to ensure that no operating rules have been breached or identify any inappropriate market activity. As part of this supervision the Compliance Officer provides to the Yieldbroker Board of Directors a monthly report that notes any investigations by the Compliance Officer and any breaches of the operating rules identified.

The Compliance Officer also oversees the work of other Yieldbroker staff and will step in to resolve any operational issues as necessary.

Recommendation

Yieldbroker should clarify the role of the Compliance Committee as it is not clear how the committee is currently meeting its obligations under the operating rules to supervise the operation of the market.

Yieldbroker has advised that:

- the General Manager and the Compliance Officer met during May 2005 and conducted a review of the Compliance Committee role; and
- changes necessary to its operating rules will be drafted by July 2005.

2.2.3 Actual or suspected breaches

Observations

Yieldbroker's operating rules clearly set out how participants are to participate in the market. The General Operating Procedures and the Compliance Manual outline the procedures that the Compliance Officer will use to review and assess compliance by participants with the operating rules. The General Operating Rules also outline what occurs if a participant has breached a rule.

General Operating Rule 11.1 states that if a participant has breached an operating rule, the Compliance Officer must take disciplinary action by issuing a warning or fine to the participant in accordance with the Market Performance Criteria (MPC), where a warning or fine is set out in the MPC for that type of breach, and may make a recommendation to the Compliance Committee. General Operating Rule 11.2 states that the Compliance Committee may make a recommendation to the Board of Directors where there is a breach of the operating rules. The operating rules state it is the role of the Board of Directors to decide whether to take disciplinary action. The disciplinary actions the Board may take include issuing a warning or fine to a participant in accordance with the MPC, suspending or terminating a participant's trading access and/or removing all of the participant's current pricing references from the market.

As already noted the Compliance Officer provides to the Yieldbroker Board of Directors a monthly report that notes any investigations by the Compliance Officer and any breaches of the operating rules.

There were no formal investigations of operating rule breaches during the period, thus the Compliance Officer made no recommendation to the Compliance Committee and the Compliance Committee did not convene.

Infractions of Market Performance Criteria

Section 792A(c)(iii) states that a licensee must have adequate arrangements to ensure that the market participants comply with the operating rules. It appears that Yieldbroker is not meeting this obligation in regard to breaches of Terms of Use rule 2.4 by participants.

Terms of Use rule 2.4 states that a participant classified as a Dealer must provide price information to Yieldbroker in accordance with the MPC. The MPC is set out in schedule 1 of the Terms of Use. The MPC states that all Dealers will be subject to a penalty for each infraction in excess of the monthly allowable limits. The MPC states that the penalties for infractions are to be determined by the Board, but also states that initially no formal penalty will apply to infractions.

Infractions of MPC occur when participants time out on responses to requests for quotes or when Dealers do not supply indicative prices.

We note that on occasion, some Dealers incurred infractions well over the monthly limit allowed in the operating rules. This is a breach of Yieldbroker's operating rules. Yieldbroker explained that such a large number of infractions may occur simply as a result of the failure of a Dealer's indicative price feed.

In the Compliance Officer's monthly report to the board, we noted that, although the infractions were operating rule breaches they were not identified or treated as breaches. We asked under what circumstances fines for infractions might be imposed. Yieldbroker's response was that the penalty provisions were designed for the Interdealer market, and it is therefore unlikely that fines will ever be imposed for infractions in the Dealer-to-Client market. We note, however, that both markets have operating rules regarding MPC.

Recommendations

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

Yieldbroker has advised that:

- operating rules will be redrafted so that the MPC criteria is more meaningful and enforceable. Operating rules will be redrafted when Yieldbroker next change its operating rules; and
- procedures will be redrafted in light of the changes to the operating rules.

2.2.4 Complaints handling

Observations

Since being granted its Australian market licence, Yieldbroker has not received any complaints relating to its market, system or otherwise in relation to Yieldbroker.

Complaints made by participants (whether Clients or Dealers) against other participants may be escalated into 'disputes'. The Operating Rules prescribe that parties involved in disputes must use reasonable efforts to resolve the dispute, but where resolution is not achieved, the parties may refer the dispute to Yieldbroker. The Compliance Officer is responsible for managing disputes and assisting parties to achieve resolution.

Yieldbroker's complaint management procedures state that a complaint 'represents a formal notification by a party of a situation they believe to be erroneous and/or which may require action by Yieldbroker with regard to operating rules'. Within the procedures the terms 'complaint', 'dispute' and 'routine or casual inquiry' are not clearly defined. We suggest that to prevent any confusion Yieldbroker should consider defining 'complaint', 'dispute' and 'routine or casual inquiry' in its procedures so as to clearly delineate the different categories in order to strengthen the procedures for dealing with each category. In doing so, we encourage Yieldbroker to provide examples. Further, we suggest that Yieldbroker incorporate into its procedures an explanation of how and under what circumstances a complaint is escalated into a dispute, and if a complaint is escalated into a dispute who is responsible for managing the dispute.

We believe the current procedures to be adequate but note that in the absence of any actual complaints, they are untested.

2.3 Sufficient resources

Observations

Yieldbroker appears to have adequate resources (including human, technical and financial resources) to operate the market properly and for the required supervisory arrangements to be provided.

Human resources

Yieldbroker has staff employed in various roles for commercial, supervisory and technological functions. Each staff member appears to have the technical skills and experience to undertake their particular roles. Each staff member has a specific job description, which outlines his or her individual responsibilities. Apart from IT functions (system

maintenance and programming) the staff are generally cross-trained and capable of undertaking several roles within the organisation.

Yieldbroker advised key person risk was managed by having in place policies and procedures that would ensure continuity of the market operation by the remaining staff or replacement staff as necessary.

The senior operations and compliance positions are undertaken by one individual. Both roles appear to complement each other and the individual undertaking this role does not appear to have any inherent conflicts as he does not have any role in generating business for Yieldbroker or encouraging the use of Yieldbroker. The Compliance Officer/Operations Manager can also refer matters to the Compliance Committee for consideration.

Technical resources

Yieldbroker's technical resources comprise the various hardware assets, software applications and processes that together allow for trading between participants, as well as system auditing, monitoring and reporting by Yieldbroker of market activity on both a "live" and historical basis.

Nothing has come to our attention that would lead us to conclude Yieldbroker's technical resources are not adequate. We note that in making this judgement we did not conduct a detailed analysis of Yieldbroker's technical resources nor did we request an independent report regarding the adequacy of Yieldbroker's technical resources.

Yieldbroker has committed resources to periodic reviews of system security to identify and resolve any significant risks.

Financial resources

Yieldbroker funds itself primarily through fees. There is a six-month notice period for termination of a Participation Deed and this should ensure that Yieldbroker is able to meet its on-going financial commitments. Yieldbroker also derives some income from distribution of certain market data.