



ASIC

Australian Securities & Investments Commission

REPORT 149

Market assessment report: Mercari Pty Limited

ACN 102 928 727

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About this report

This report summarises ASIC's third annual assessment of Mercari Pty Limited (Mercari) under s794C of the Corporations Act 2001 (Corporations Act).

This assessment covers the period 19 March 2007 to 20 December 2007 (assessment period).

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Previous reports on Mercari

Mercari was granted an Australian market licence to Mercari Direct on 30 May 2005.

Report number	Date released
REP 80	September 2006
REP 105	October 2007

Contents

Key findings and observations	4
A The assessment	5
Purpose and scope	5
Background	5
Our methodology	6
B Our observations	8
Supervisory arrangements	8
Resources	10
Reporting obligations	11
Conclusion	11
Key terms	12

Key findings and observations

Key findings

- 1 We are satisfied that Mercari has adequate arrangements for supervising its market under s792A(c) of the Corporations Act.

Recommendations

- 2 We do not have any recommendations to make in relation to Mercari's current supervisory arrangements.

A The assessment

Key points

ASIC conducts annual assessments of market licensees, such as Mercari, because it is required to do so under s794C of the Corporations Act.

The scope of our assessment must always include the obligations found in s792A(c), but we can include other Chapter 7 obligations too.

ASIC uses the licensee's self-assessment reports, information from its previous assessments, ASIC's observation of the licensee's performance, market intelligence and other things to form a view of how well a licensee has operated its market.

Purpose and scope

- 3 ASIC is required to assess how well a market licensee complies with its obligations in s792A(c) at least once a year (s794C(2)).
- 4 A market licensee is required to have adequate arrangements for supervising the market (under s792A) including 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.
- 5 In addition, we are permitted to extend the scope of our assessment to review how well a licensee complies with any or all of its obligations under Chapter 7 (s794C(1)).

Background

- 6 Mercari's Australian market licence permits Mercari to operate its financial market, Mercari Direct. Mercari Direct is an electronic bilateral negotiated market that facilitates trading in foreign exchange derivatives and interest rate derivatives. The total turnover in the Australian Over-the-Counter (OTC) financial markets for 1 July 2007 to 30 June 2008 was \$79,576

billion. The turnover for foreign exchange and interest rate derivatives in the Australian OTC financial markets for the same period was \$60,469 billion.¹

- 7 The participants of Mercari Direct are wholesale entities, and are either banks or subsidiaries of banks.
- 8 On 8 January 2008, Financial and Energy Exchange Ltd (FEX) became the holding company of Mercari. FEX is an Australian registered company that is developing a suite of services for the Asian energy markets. As a result of the new ownership structure, Mercari's board now comprises two directors who are also directors of FEX. The former Mercari directors are now the general managers reporting to the new directors. FEX has informed us that its medium-term plan for Mercari is that it will remain a separate business unit operating on its existing resources. Mercari will have access to additional resources as required and made available by FEX.
- 9 In addition to an Australian market licence, Mercari continues to hold an Australian financial services (AFS) licence authorising it to carry on a financial services business to wholesale clients in relation to certain financial products. A copy of Mercari's Australian market licence and the terms of its AFS licence are available on our website at www.asic.gov.au.

Our methodology

Our assessment process

- 10 A market licensee's obligations are ongoing. Whether it is likely to comply with its obligations in the future cannot be judged merely by reference to its past compliance.
- 11 We therefore use the assessment process to:
- reach conclusions about the adequacy of the arrangements a market licensee has in place for supervising its market in accordance with its obligations under the Corporations Act at the time of the assessment; and
 - identify issues, which in our view need, or may need, to be addressed to ensure ongoing compliance.

What we considered

- 12 In conducting our assessment of Mercari we:

¹ Australian Financial Markets Association, *2008 Australian Financial Markets Report*, p2.

- analysed information we received from and about Mercari in the ordinary course of our dealings;
- reviewed policies and procedures for the conduct of Mercari in general and its supervisory responsibilities in particular;
- considered how well Mercari might comply with its obligations in the future; and
- interviewed one of the new Mercari directors and the Chief Operating Officer (COO) of FEX about their responsibility for the supervision of Mercari.

Consultation

- 13 Mercari has had the opportunity to view and comment on the findings and recommendations contained in this report. Where appropriate, this report reflects Mercari's responses.

What we focused on for this assessment

- 14 The focus of this assessment was to review how well Mercari complied with its ongoing supervisory and reporting obligations under its Australian market licence and the Corporations Act.
- 15 Further, in light of Mercari's new ownership and management structure, we wanted to ensure that the executives of the new holding company, directors and management of Mercari are aware and have an understanding of the various obligations under Mercari's Australian market licence.

B Our observations

Key points

We consider that Mercari has adequate arrangements and resources for supervising its market including:

- 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.

We also consider Mercari is complying with its reporting obligations under the Corporations Act.

Supervisory arrangements

- 16 We are satisfied that Mercari has adequate arrangements and resources for the supervision of its market in accordance with its obligations under s792A(c).
- 17 During the course of our interviews, senior responsible executives and directors demonstrated an understanding of:
- (a) the operations of the market;
 - (b) Mercari's obligations under its Australian market licence; and
 - (c) Mercari's supervisory role.

Conflicts of interest

- 18 Mercari's written policy and procedures detail how conflicts between its supervisory and commercial interests are managed. They include:
- the obligations and priorities of Mercari's employees;
 - how a conflict of interest may be identified;
 - procedures to minimise conflicts of interest; and
 - how employees may avoid conflicts of interest.
- 19 The procedure states that all Mercari employees must report any conflict of interest they identify to the directors of Mercari. The directors then assess the conflict of interest and respond to the staff or clients involved by either

meeting with them or by written announcement. In response to a conflict of interest the directors may:

- rearrange the allocation of client representatives to avoid or reduce the conflict of interest;
- decline to provide services to the particular client;
- initiate internal or external disciplinary action where warranted; or
- refer to an appropriate and independent body to offer alternative solutions for managing the conflict of interest.

20 All conflict of interest situations reported or observed and all actions taken to correct conflict of interest situations are recorded in the Compliance (Breach) Register.

21 The new directors understand and have familiarised themselves with Mercari's conflicts of interest policy and procedure.

22 No conflicts of interest events were recorded in the Compliance (Breach) Register during the assessment period.

Monitoring the conduct of participants

23 A description of Mercari's supervisory arrangements for monitoring the conduct of participants on or in relation to the market is set out at section 2.2 of ASIC's report on its first annual assessment of Mercari (REP 80) issued in September 2006.

24 Mercari has an adequate framework of operating rules and procedures in place to monitor the conduct of participants and supervise the market.

25 Mercari's surveillance officer reports any suspected or actual breaches of operating rules to the directors and provides a written recommendation about what penalty should be imposed upon the participant.

26 Mercari did not identify or take action in relation to any breaches during the assessment period.

Enforcing compliance with operating rules

27 Operating rule 2.2 states that all participants of the market must comply with the operating rules of Mercari. Under operating rule 3.1, to participate in Mercari Direct, a participant must operate in accordance with the operating rules. Operating rule 3.2.10 gives Mercari the right to suspend or cancel the authorisation of any participant or employee of a participant if they breach an operating rule. Operating rule 6.4 gives Mercari the right to remove any order from the dealing screen at any time. Clause 5 of Mercari's Client

Agreement gives Mercari the right to remove a participant's order from the dealing screen at any time and for any reason.

- 28 Compliance with the operating rules is largely facilitated through the operation of Mercari Direct. The system rejects certain trading activity, which is or may be in breach of the operating rules.
- 29 Market supervisors and the compliance officer use internal procedures to monitor participant conduct and enforce compliance with the operating rules.
- 30 Mercari informed us that during the assessment period, there were:
- no changes to the operating rules; and
 - no breach or potential breach of the operating rules was identified.
- 31 We conclude Mercari has adequate arrangements for enforcing compliance with its operating rules.
- 32 During the assessment we did not identify any substantial changes to the processes which were outlined in Mercari's application for an Australian market licence to enforce compliance with its operating rules.

Resources

- 33 We conclude Mercari has sufficient human, technological and financial resources to operate its market properly.

Human

- 34 Mercari has employed staff in various capacities for commercial, supervisory and technological functions. There are no changes in staff numbers as a result of the new ownership of Mercari.
- 35 Under the new ownership, the COO of FEX acts as an additional compliance line for the compliance officer and the board, enhancing the reporting of issues such as conflicts.

Technological

- 36 The current technology has coped with existing volumes on the market and no serious market disruptions have occurred.
- 37 Currently FEX is reviewing the Mercari technology with a view to upgrading future hardware to increase performance characteristics if required.

Financial

- 38 Financial resources to operate Mercari Direct include:
- income generated by brokerage fees;
 - net assets within Mercari's ownership and control; and
 - funding from its parent company, FEX.
- 39 We have been assured by FEX that they have the means to supplement Mercari's funding should the need arise.

Reporting obligations

- 40 Mercari's s792F annual regulatory report and 6-monthly financial reports were lodged on time and contained the information required.
- 41 We also received an independent audited financial report that had not been qualified.

Conclusion

- 42 We consider that Mercari has adequate arrangements for the supervision of its market in accordance with its obligations under s792A(c).
- 43 Our conclusion is based on the following observations drawn from information gathered during the assessment process:
- ASIC is not aware of Mercari substantially changing the arrangements it has in place for supervising the market from the description provided in its Australian market licence application;
 - no serious market failures or disruptions have come to our attention; and
 - during the assessment period no information came to our attention to suggest that the supervisory arrangements in place were not operating properly.

Key terms

Term	Meaning in this document
\$79,576 billion	An amount in Australian dollars (in this example 79,576 billion)
AFS licence	Australian financial services licence
ASIC	Australian Securities and Investment Commission
assessment period	The period covered by this report being 19 March 2006 to 20 December 2007
COO	Chief Operating Officer
Corporations Act	The Corporations Act 2001 (Cth)
FEX	Financial and Energy Exchange Ltd
market licensee	Holder of a s795B Australian market licence
Mercari	Mercari Pty Limited
Mercari Direct	Mercari's market (an electronic bilateral negotiated market that facilitates trading in foreign exchange derivatives and interest rate derivatives)
s794C (for example)	A section of the Corporations Act (in this example, numbered 794C)