Response to Consultation Paper

Implementation of a Framework for Australia's G20 OTC Derivatives Commitments

15 June 2012

www.yieldbroker.com
Yieldbroker Pty Limited (ACN 092 250 345)
Level12, 130 Pitt Street, Sydney, NSW, 2000
Tel. +61 (2) 9994 2890

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1. Executive Summary

Yieldbroker welcomes the opportunity to comment on the options for the implementation of a legislative framework to meet Australia's G20 commitments on over-the-counter (OTC) derivatives. Yieldbroker has a long history of working collaboratively and effectively with the regulators and is pleased to be working with the supervisory bodies again on what is a critically important piece of legislation for the Australian financial market.

Yieldbroker was founded in 1999 and has been offering an OTC market to Australian participants for over 10 years. As a holder of an Australian Market License who is approved to operate a Dealer & Client and Interdealer Market for derivatives we are already well positioned to respond to market needs. This year we are continuing to expand our product offering in Interest Rate Derivatives. Our enhanced Interdealer derivatives platform has been in operation since April this year and has received significant support already. Yieldbroker has processed a traded volume of nearly AUD$100 trillion calendar year to date and with close to 100 companies actively using the Yieldbroker platform we can demonstrate the significant presence we have established in the market.

Yieldbroker is enthusiastic about working with the regulators and market participants to develop electronic solutions that set the standard domestically and globally. We have a proven track record of delivering first class solutions with the AOFM and RBA selecting Yieldbroker's auction system as the market standard for their government security tenders and long-dated open market operations respectively, and our fixed income platform is consistently the Australian market leader for domestic securities.

In this paper we describe some of the key benefits electronic trading platforms can bring to the market; which includes creating fair and open markets, encouraging competition and increasing liquidity through the support and facilitation of standardised products. While we note some of the differences between the Clearing and Execution functions and why the approach to mandating obligations for one function may not necessarily make sense for the other, mandating Clearing obligations may give rise to a need for an electronic trading solution if, and where, certainty of clearing must be achieved. We support the view presented by the regulators that it may be premature to impose mandatory trade execution obligations and that a sensible approach is to analyse transaction data collected from trade repositories while also working with the industry to develop industry-led solutions avoiding unexpected consequences from unnecessary regulatory intervention.

Yieldbroker is encouraged by the consultative approach taken by the regulators and the recognition that an industry-led approach is preferred. Our experience in working with large scale systemic change is that successful outcomes are best achieved by actively engaging with market participants and most often by implementing changes iteratively. For this reason we support rules and regulations which are flexible and allow the industry to develop over time.

2. Yieldbroker General Comments

Trade execution on electronic platforms can provide significant benefits to the market. Specifically automated facilities provide a fair and open place for participants to interact and trade with one another. This fair and open access promotes market integrity and independence, which may not always be the case where human intermediaries are used. Electronic platforms can increase transparency by providing pre-trade and post-trade information, where it is appropriate to do so; to this point pre and post-trade information only adds value where there are minimal adverse impacts on maintaining liquidity and no self-defeating risk to the accuracy of the data.

Multi-dealer execution facilities encourage competitive execution by allowing participants to view or request multiple quotes, make informed trading decisions and demonstrate best execution. As we will explain in more detail, electronic trading platforms support product standardisation which will further improve their liquidity. An additional benefit of standardisation is increased trade fungibility, allowing for better risk management, portfolio optimisation and improved liquidity. Finally, electronic platforms are generally set up to process trades STP (straight-through-processing) and have the tools needed to ensure a complete record and audit trail of trades is maintained.

In this way there are significant efficiency, operational and information benefits to be gained from executing through electronic trading platforms. These benefits exist without the need to mandate execution on a trading platform and we anticipate that the trend towards greater electronic execution will continue due to natural market forces. However, global and domestic pressure for market reform in the wake of the global financial crisis has placed electronic trading firmly in the spotlight. With a proven track-record of delivering industry-led solutions, Yieldbroker is well placed to work with the regulators and market participants to deliver electronic trading solutions that complement the Australian market.

Electronic trading platforms naturally lend themselves to more standardised and liquid products than bespoke products; for the simple reasons that the products need to be straightforward so they can be defined unambiguously on a multi-dealer platform, understood easily by a broad range of users, and there needs to be a certain degree of flow that warrants investment by the platform owners. It is worth noting that electronic entry of non-standard derivative trades and single-dealer request-for-quotes would be relatively straightforward to support. However the attraction of electronic trading platforms is to be able to request quotes from multiple participants and choose the most competitive quote. This works for standard products that are straightforward to price; however, non-standard derivative trades require interpolation, bespoke pricing methodologies and other time consuming measures which are more productive in bilateral relationship-based business.

With a long and deep history working with the market Yieldbroker can attest to the fact that liquid markets take time to develop, which is why we support rules and regulations that are flexible and allow the industry to develop over time. Once liquidity increases significantly it can become possible to display price information with lower risk of adversely impacting liquidity or transparency. Mandating competitive transparent execution too early could result in a significant increase in risk to the market and reduction in liquidity. The market is already working through solutions that support the evolution of electronic trading. We encourage the regulators not to mandate against trading models which may not always display full pre-trade volume and price transparency but do encourage market participation, for example dark pools and auctions.

Where possible, Yieldbroker would encourage the regulators to take an industry-led approach to forming the regulations. Both as an active member of AFMA and directly, we have worked closely with the majority of the buy and sell-side participants for over 13 years. We know there are many different views, business models and objectives and from experience we believe the best outcomes are achieved with measured, consultative and often iterative approaches. Yieldbroker recognises that the consultative approach being taken by the regulators is in line with an industry-led solution and we encourage the regulators to continue with this approach. Yieldbroker is confident that it can play a pivotal role in a consultative process by working with the regulators and market to develop solutions in a timely and efficient manner. We have demonstrated our ability to do so in the recent past with the AOFM and RBA choosing Yieldbroker's auction system as the market standard for their government security tenders and long-dated open market operations respectively.

The scope of the regulations is far-reaching and our experience with successfully introducing systemic change to the market highlights the need to approach such changes iteratively and with the relevant stakeholder engagement. We believe that the legislation should not mandate approaches but focus on achieving the objectives.

As OTC derivative reform is being undertaken globally and a significant majority of derivative volume is being executed offshore by Australian-domiciled counterparties, or onshore by foreign counterparties executing in the Australian market, there is a need to consider the ramifications of regulations in other jurisdictions. Yieldbroker would encourage the regulators to take a lead in the cross-jurisdictional issues and where possible push for multilateral or bilateral recognition of licencing regimes. Where complete recognition is not possible then we would encourage the regulators to provide guidance on where differences exist. One approach for platforms operating in, or with, other jurisdictions may be to build solutions to the most stringent of all the global regulations; however, this may place unnecessary and impractical burdens on Australian market participants if those global standards are not suited to the domestic market.

As with multilateral recognition we encourage the regulators to seek clarification and provide guidance on where there is an overlap in jurisdictions between the laws of Australia and the laws outside of Australia, and where possible eliminate any areas of potential conflict.

3. Yieldbroker Comments to Selected Questions

The following represents Yieldbroker's response to those questions that directly relate to Yieldbroker in its anticipated role as a Derivative Trade Execution facility.

1. *Do you have any comments on the general form of the legislative framework?*

Yieldbroker is comfortable with the general form of the legislative framework.

2. *Do you have any comments on the definition of 'transaction'?*

The definition of a 'transaction' as set out in the consultation paper is:

"A 'transaction' includes the making, modifying or termination of a contract for derivatives".

Yieldbroker, and we presume the market in general, would perceive the definition provided to be reflective of the life cycle of a derivatives trade. There are three distinct stages (making, modifying and terminating) and not all facilities are involved in each of these three stages. As an example, electronic trading facilities are typically involved in the "making" part of the process. Whilst there is always the ability to extend involvement into the additional two stages, Yieldbroker typically extends services based on market demand and to date, there has been no demand to do so. Consequently, we seek further clarification as to why the regulator may require a trading platform to be involved in all three stages of the life cycle and the benefit of doing so.

Furthermore a transaction is generally understood to be one step in the life cycle of a trade, for example an interest payment transaction, and therefore the definition presented may be at odds with market practice.

Yieldbroker would welcome a more detailed and example driven explanation of how the intended transaction definition should be applied to each of the three constructs of the regulation (trade reporting, clearing and execution)

3. *Do you have any comments on the definition of 'party'?*

The definition of party is a little ambiguous as it includes a circular reference to the word "party".

"A 'party' means any domestic or foreign person who is dealing in a derivative (including on its own behalf) and is a party to a derivative transaction"

The term 'participant' is well understood by the industry and may form a better basis for any new definitions required.

Yieldbroker notes that the proposed amended Act will include obligations which will be imposed on "a party to a transaction". For this reason, it is important that it is clear who will be "a party" so that it is also clarifies who will have the corresponding reporting obligations.

For example, could a trading platform be considered a “party” to a derivative transaction because it is facilitated the trade or will trading platforms always be exclusively referred to as “eligible facilities”? Therefore, Yieldbroker requests further clarification be provided around the definition of “party”.

4. Do you have any comments on the definition of ‘eligible facility’?

Yieldbroker will only be commenting on the definition of an ‘eligible facility’ in the context of trade execution. The definition notes:

“An eligible facility means:
- *An AML which has been authorised to operate a market for the prescribed class of derivative; or*
- *Such other entities as prescribed by regulation”*

Yieldbroker supports the definition, particularly the inclusion of facilities that hold an AML licence as this provides a clear benchmark to the market, it requires a substantial level of commitment by the operators of the facility and it permits oversight by the regulators.

In addition, Yieldbroker requests that the regulatory powers clarify how the existing exempt (from the market licencing provisions) facilities may be classified in terms of being an ‘eligible facility’.

Yieldbroker notes that the consultation paper proposes that a broad range of derivative classes may be mandated in regulation later this year. Yieldbroker would like clarification on how these proposed derivative classes will align with the current classes of derivatives provided for in many AMLs. Yieldbroker recommends that due consideration be given to avoiding amendment of licences on a widespread basis.

5. Do you agree that non-discriminatory access requirements should be imposed on eligible facilities?

While Yieldbroker fully supports that some of the objectives of the regulation are to increase competition and transparency in a fair and open manner the use of the term “non-discriminatory access” requires further consideration. Specifically the regulators need to be mindful of potential conflict with other objectives to increase liquidity and reduce risk. Unless carefully defined the use of the term “non-discriminatory access” could result in greater risk and reduced liquidity.

The Corporations Act already requires licensees to operate a fair market and we question whether it is necessary to introduce a new obligation of non-discriminatory access when there is presumably some overlap with “fair”.

The regulators are asked to consider, for example, existing market segments, namely Interbank (Sell-side) and Buy-side. Also, regulators often even choose to distinguish the Buy-side further e.g. Institutional and Retail. Market infrastructure has and will continue to be built around these broad market types primarily because of the different objectives of each type of markets. Non-discriminatory access within each these segments is generally an appropriate objective but even here consideration must be given to allowing appropriate and necessary incentives to promote investment in, and participation on, relevant facilities.

6. Do you have any comments on the rule-making power that will be available to ASIC?

Yieldbroker supports the view that the regulations should define as clearly and unambiguously as possible what are the obligations of the entities involved, and ASIC (the rule-making power) should be concerned with matters relating to administration and supervision of the regulations.

Commercial organisations need regulatory certainty to justify investment in developing market infrastructure. Yieldbroker believes such development should be undertaken in accordance with robust regulations and in consideration to ASIC's ability to fine tune parameters to provide practical relevance.

The paper makes reference that "The DTRs may also impose obligations on eligible facilities with respect to how these facilities are used to meet any obligations". This statement is somewhat confusing and regulators are asked to make it as clear as possible who will be defining obligations.

7. What should be the minimum period of consultation imposed on ASIC in developing DTRs?

We believe this should be industry-led and will likely differ depending on the DTR

8. What should be the minimum period of notice between when a DTR is made and when any obligation under the DTR commences?

As above

10. From the point of view of your business and/or of your clients, do you have concerns around any 'back loading' requirements? For example, are there any problems with obligations applying to transactions that are outstanding at the time the rule is made?

We believe that the back-loading of trades requirement is likely being directed at the Trade Repository and Central Clearing functions, however without any specific mention as to the types of functions it is intended to apply to we will comment in relation to Trade Execution facilities.

We noted in our response to question 2 that the majority of electronic trading platforms are focussed on the first part of the definition of a transaction i.e. 'making'. If the requirement is to modify or terminate a transaction on an execution platform then trade execution facilities will be required to make some connection to the previous version of the trade. This may or may not require back loading of the positions of the specific trade to be modified or terminated. However we see little benefit in requiring back loading all or wide sets of trades in execution facilities.

> 11. *Do you agree with the option of prescribing a broad range of derivative classes to be subject to the mandate for trade reporting? If not, what other option do you prefer?*

In general we support prescribing a broad range of derivatives classes for trade reporting, at least initially, if this is to be the basis for determining future regulations for trade execution.

> 12. *Do you agree with the option of including a broad range of entities in the mandate to report trades? If not what option do you prefer?*

As with the answer to question 11 in general we support the option of including a broad range of entities in the mandate to report trades, at least initially, as this will be the basis on which to mandate regulations for trade execution.

> 20. *Do you consider that there are any OTC derivative classes for which an execution on trading platforms mandate would be appropriate at this time? If so, please provide any evidence which supports your view.*

We support the approach suggested by the regulators to use transaction data from trade repositories. Analysis of this data will enable regulators to not only determine the derivatives classes that should be mandated (presumably based on characteristics such as volume, ticket size etc.) but also the degree of standardisation in these products e.g. non-standard fixings, multiple resets and payment frequencies, stubs etc.

For standardised derivatives products with reasonable liquidity there are many benefits that electronic trading can bring to the market and we ask the regulators to refer back to the opening comments at the start of this paper. If the regulators are hoping to increase standardisation in certain derivatives classes then mandating trading on an electronic trading platform may be useful lever; however, we moderate that comment with the observation that a large majority of non-standard derivative trades do have a real purpose in the market: They look to replicate real cash-flow profiles of corporate and institutional investors.

Our recent experience is that there are some Interest Rate Derivatives that could transition relatively easily to mandated electronic trading execution, such as vanilla Australian Dollar IRS, FRA and OIS and that this is best achieved with an industry-led approach.

> 21. *Alternatively, do you agree with the option of applying the same approach to prescribing entities, transactions and derivative classes as has been applied for mandating clearing?*

Clearing and execution functions are quite distinct. Clearing requires a significant level of capital in order to meet margin calls and other risk requirements, which may make it costly for certain entities to participate. Execution facilities however generally do not have capital requirements and barriers to entry are much lower so a wider set of entities may be applicable. Further, some clearing houses are able to support a wider set of bespoke products than electronic trading platforms which tend to be focussed on standardised vanilla products and have a recognised liquid market.

Also as mentioned previously the electronic trading market is aimed at execution, when the counterparties are deciding who they want to trade with, and not yet at modification and termination transactions where the counterparty has already been determined. Clearing houses are currently equipped to deal with the complete life cycle of a trade.

If the regulators do wish to impose mandates for a general set of entities, transactions and derivative classes in order to create consistency we would encourage the regulators to look at product sets that can be supported by both trading platforms and clearing houses, rather than mandate entities, transactions and derivative products for clearing first and presume this will work for execution.

22. If a derivative class is prescribed for mandated use of CCPs should it also be mandated for execution on a trading platform?

If a derivative class is prescribed for mandated use of CCPs then the question that remains is whether the trade must be guaranteed to clear at the point of execution. If a trade must be guaranteed to clear then this will require credit/eligibility checking of the participants involved with the transaction (counterparties, clearing member). Confirmation will need to be provided back to the client at the time of booking the trade, and as the vast majority of interest rate derivatives only have a very short timeframe for firm pricing then if trades must be guaranteed to clear within that timeframe this already lends itself to an electronic solution.

Therefore if the regulators mandate certainty of clearing we anticipate that the market will naturally move towards an electronic solution and mandating execution on a trading platform may not be necessary. This is in line with an industry-led approach.

One point we encourage the regulators to take into account is that some of the global CCPs are not currently operational for the majority of the Australian business hours. If certainty of clearing is to be mandated then this will presumably require that the CCPs be operational during this timeframe. This is a problem that the industry will need to work through, and there are many options to consider in how best to solve this issue. We encourage the regulators to take this into consideration when deciding on timelines for implementation.

23. Do you agree with the option of initially excluding the same entities and transactions from the mandate to execute trades on trading platforms as those for the mandate to clear through a CCP? If not what option do you prefer?

Yieldbroker believes that further discussions need to be undertaken in regards to which entities and transactions are being targeted in the regulations and as a result which entities are being considered for exclusion. As Yieldbroker is a service provider we believe this question is best debated by those entities who are counterparties to derivative trades. The regulators may wish to apply the same approach for consistency reasons however we would again encourage an industry-led approach.

24. Do you agree with the option of using the same definition of a transaction in Australia for the purposes of mandating executing a trade on a trading platform as for mandating clearing transactions through a CCP? If not, what definition do you prefer?

Please refer to the answer to Question 2.

25.4 Should the prices and sizes of individual transactions reported to trade repositories be made publicly available? If so, do you have any views on the time frame in which the information should become publicly available? Should there be different time periods for public release of transaction data depending on the size of particular transactions?

In an established liquidity pool, and for continuously traded standard market parcels, Yieldbroker generally agrees that dealt rates should be revealed to promote market liquidity. As trades become less standard and less liquid there is a strong argument for delaying release of public data to allow dealers to clear risk. We nonetheless acknowledge that the general trend is towards greater disclosure of post-trade information.