

## STERLING INTERNATIONAL BROKERS LIMITED

### Annex 2

#### **Inter-Dealer Broking**

##### **Introduction**

The main business of an inter-dealer broker (broker) is to provide access to over-the-counter and/or exchange traded pools of liquidity, across a full range of asset classes and their associated derivatives. Typically, brokerage activity takes place in the wholesale financial markets, which includes cash deposits, financial derivatives, securities, equities, commodities, energy and credit.

The primary function of a broker is to act as an intermediary through which other wholesale market participants can conclude transactions by the matching of their trading needs with third party wholesale market participants having reciprocal interests.

Trading is conducted on an 'arms length' basis with counterparties who do not rely on the advice of the broker. Typically, counterparties in these markets would be wholesale market participants consisting of clearing and investment banks, investment firms, building societies, pension funds, public sector bodies, life and hedge funds etc and would not include any retail clients as defined under the FSA rules.

The majority of the brokerage activities are based on the principle of matching fast moving bids and offers. Prices, orders and expressions of interest will be communicated across a variety of mediums, including telephone, electronic instant messenger, electronic display screen, or by an electronic trading system (Multilateral Trading Facility as defined by MiFID).

In each market, brokers will communicate to the counterparties whether bids and offers are 'firm' or 'indicative' – in most cases unless otherwise stipulated during the course of dealing, market quotes provided by brokers represent tradable prices based on counterparties' bids and offers and market information then available.

Brokers will endeavour to match the counterparties' trading requirement or orders with other trading interests in the market. In most cases this means that brokers can only give the counterparty access to their own liquidity pools, and will pass prices or orders to and from its other counterparties. Brokers may use link brokers with whom they have a relationship in order to arrange a trade between the counterparty and a client of the linked broker.

Brokers, as instructed, will arrange trades on behalf of a counterparty, based either on a price or order that the counterparty has placed with them, or as confirmed by the counterparty following a period of negotiation.

Brokers utilise price dissemination screens in their role as voice brokers, and illustrate an actual or indicative mid-market price based on actual trading, orders and expressions of interest. While brokers intend to provide counterparties with the most accurate and reflective view of current price levels, it may not be possible to actually trade at the displayed prices if a corresponding order is not then available.

Unless otherwise communicated to the counterparty before trading, all orders submitted to a broker's MTF platform will be traded on price/time priority. Counterparties will also be able to view full order depth. Execution occurs on the basis of active acceptance of orders in the system submitted by other users. Eligibility, trading methodology, instrument descriptions and credit parameters are all set out in the user terms for the relevant MTF.

Prices are given and trades executed, excluding brokers' brokerage (i.e. a clean price). Brokerage rates are as agreed between the counterparty and the broker by product, often with volume discounts or other fee discounts based on market making activity.

## Business Models

To facilitate this activity brokers engage their clients on both an electronic and voice basis. In most cases brokers arrange trades on a 'name passing' basis. However there are two other brokerage business models: 'matched principal' and 'exchange give-up'.

In the cash equity and fixed income products, brokers may act on a 'matched principal' basis to the trade in order to provide anonymity to ensure client confidentiality to its counterparties and may engage in aggregation of trades to reduce the number of settlement counterparties.


In the derivatives markets, where a derivative exchange exists (e.g. Euronext.LIFFE, Eurex), the broker receiving a client order may engage in exchange trading under its own or a third parties name in the capacity of an 'Executing Broker', as defined in the Futures and Options Association's *International Uniform Brokerage Execution Services ('Give-Up') Agreement*, and give-up the trade to a client's clearer before the close of the day. Under this 'exchange give-up' model the broker is subject to intraday exposure of this principal position until the trade is accepted by the counterparty. The purpose of this is to facilitate the instructions of the principal as a client.

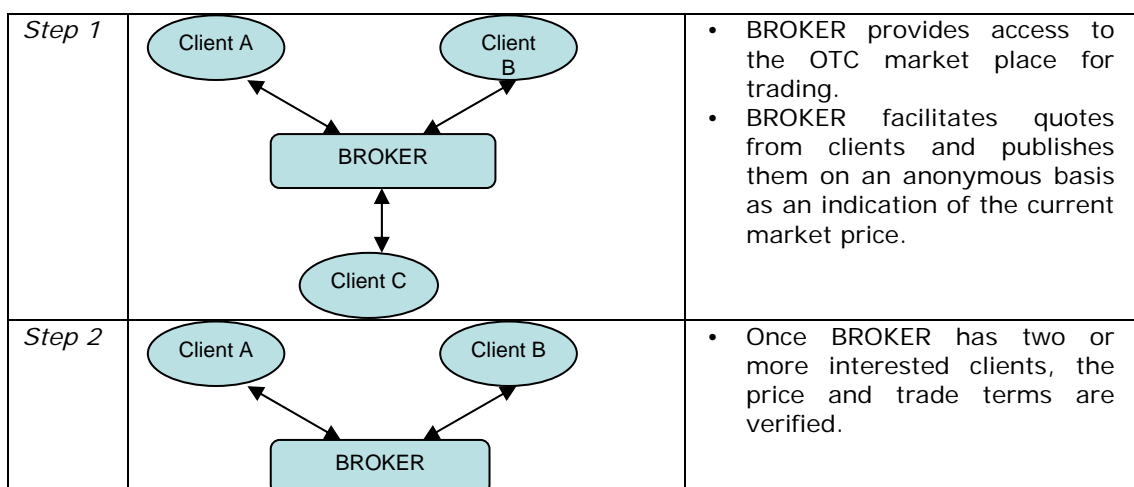
## Name Passing

The name passing brokerage model is the traditional model, through which the broker takes on an arranging role in a transaction between two or more counterparties. The broker, through price dissemination, distributes quotes to other market participants showing both price and volume. For voice brokered products, these prices and volumes are dependent upon market convention, either firm or indicative levels of interest, and must be confirmed prior to the trade being completed. For electronic brokered products through MTFs, these prices and volumes are typically firm and are traded without further communication.

Once the trade price, volume and terms have been agreed, either through further conversation with the broker or with the direct hit or taking of prices on an MTF, the counterparties' names are disclosed and the broker steps away from the transaction. Bilateral agreements are then enforced between the counterparties and the broker will invoice the brokerage fee on a monthly basis

Example:

 = broker custodian



Step 3		<ul style="list-style-type: none"> <li>• Once a trade has been confirmed as good, BROKER discloses the clients' names.</li> <li>• A bilateral trade is then formed between the two clients and BROKER steps out of the trade process.</li> <li>• BROKER sends a broker confirmation to each client.</li> </ul>
Step 4		<ul style="list-style-type: none"> <li>• At the end of the month, an invoice is sent to each client for the brokerage value for their trading activity.</li> </ul>

### Matched Principal

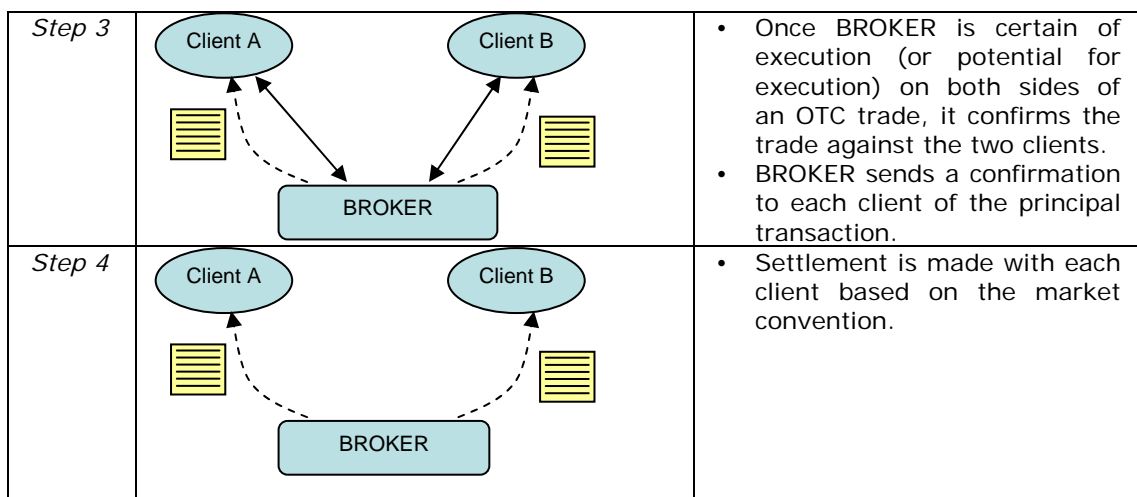
In the matched principal model, the broker facilitates its clients in anonymous trading activity in cash products by taking part in a matched transaction as principal. The broker can provide for its clients an indication of market prices and volumes for OTC cash products (e.g. investment grade bonds), or for exchange traded cash equity products the client can use the exchange as an indication of the market.

The broker will not trade speculatively for a client or for his own book in the market. The trade will only be executed as a result of a firm client order to buy or sell at a set price or size. Once the trade is complete, price, volume and terms are communicated through the broker and back office confirmations.

Settlement is made between each client based on the market convention with the brokerage fee, being either incorporated in the all-in price passed to the client through a disclosed brokerage or through a monthly invoice.

Example:

Step 1		<ul style="list-style-type: none"> <li>• BROKER provides access to the OTC market place for the trading of illiquid cash fixed income transactions.</li> <li>• BROKER facilitates quotes from clients and publishes them on an anonymous basis as an indication of the current market price in the OTC market. This service is not required for Exchange based trading, as the market rate is widely known.</li> </ul>
Step 2		<ul style="list-style-type: none"> <li>• For OTC transactions, once BROKER has two or more interested clients, the price and trade terms are verified.</li> <li>• For exchange based transactions, a firm client order is given (either volume or price) prior to the execution of the order against the exchange.</li> </ul>



### Exchange Give Up

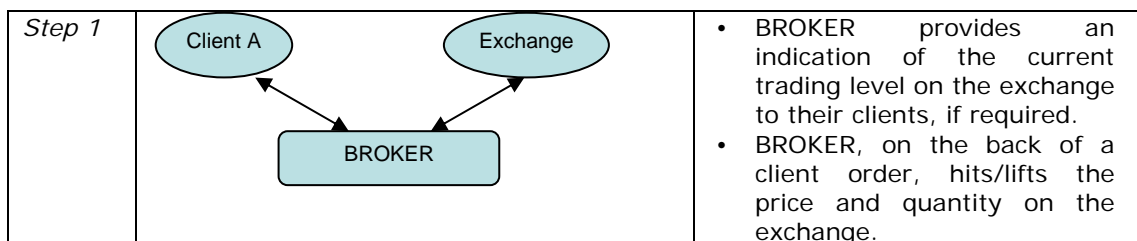
In addition to name passing and matched principal brokerage models, brokers can facilitate the trading activity of their clients on derivative exchanges (e.g. LIFFE, Eurex, CME, etc). Upon receiving the relevant price information from the broker, the client will instruct the broker to place an order on the appropriate exchange, either in its own name (if a member of the exchange) or through a third party. The broker can provide the client with an indication of the market based on the current price and volume activity on the exchange.

Once the execution has occurred, the executed position is then given-up to the client through the clearing services of the exchange clearing house. This process typically occurs within the day and so the broker will have no house position at the end of each day and will be flat. During the give-up process the broker will maintain a daylight position until the trade is taken-up by the client.

At the end of each month, the broker will invoice the client for the trading activity during that month.

A derivation of this business model is where OTC trades are crossed on the exchange to provide the clients with a settlement process through a central counterparty (CCP settlement).

Example:



<p><i>Step 2</i></p>		<ul style="list-style-type: none"> <li>• Once BROKER has executed the trade on the exchange, it is delivered directly into BROKER's house account at their custodian for that exchange.</li> <li>• BROKER then instructs for the onward delivery of the trade to their client's custody account.</li> <li>• The client acknowledges the trade and takes the position into their accounts.</li> <li>• BROKER is now in a flat trading position.</li> </ul>
<p><i>Step 3</i></p>		<ul style="list-style-type: none"> <li>• BROKER sends a broker confirmation to the client.</li> </ul>
<p><i>Step 4</i></p>		<ul style="list-style-type: none"> <li>• At the end of the month, an invoice is sent to the client for the brokerage total for their trading activity.</li> </ul>