AFMA

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Manager, Financial Services Unit
Retail Investor Division
The Treasury
Langton Crescent
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By email: clientmoney@treasury.gov.au

Dear Sir/Madam

Handling and Use of Client Money in relation to Over-the-Counter Derivative Transactions Discussion Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Discussion Paper *Handling and use of client money in relation to over-the-counter derivative transactions* (the Discussion Paper). The client money provisions in the *Corporations Act 2001* (the Act) forms an integral part of the investor protection framework in Australia, and its effectiveness and efficiency in achieving the objective of protecting retail clients is critical. As such, we support the objective of the proposed reform measures and agree that there is a need for reform of the client money provisions as they apply to retail clients in over-the-counter (OTC) derivatives.

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets. AFMA represents over 130 market participants, including Australian and international banks, leading brokers, securities companies, State Government treasury corporations, fund managers, and traders in electricity and other specialised markets, including the market for Contracts for Difference (CFDs). AFMA represents a large cross section of the OTC CFD industry, which will primarily be affected by the reform options considered in the Discussion Paper. While AFMA's submission substantially focuses on the impact of the reform options on CFD market participants, our response also takes into consideration the impact on the broader financial market and a range of other market participants.

AFMA's submission does not identify a preferred reform option. Our members operate under different business models and structures, and so the reform options will impact differently on members. Instead, we provide an outline of the expected impact of the reform options on different market participants. We are aware that individual members are making separate submissions in support for varying reform options. If Treasury considers that alternative reform options, other than those canvassed in the Discussion Paper, should be explored further, we suggest further comprehensive consultation with the industry.

1. The Need for Law Reform

AFMA supports the objective of the Discussion Paper to ensure that the law surrounding the holding of client money in connection with OTC derivative transactions provides sufficient protections for retail clients. There is currently ambiguity in how the client money provisions, specifically Divisions 2 and 3 of Part 7.8 of the Act and their supporting Regulations, apply to OTC derivatives. As we understand it, the client money provisions were not designed with the growing retail OTC derivatives market in mind.

Apart from the use of section 981D enabling money related to derivatives to be used for general margining purposes, as noted in the Discussion Paper, the general nature of the provisions and the lack of clarity as to what constitutes client money has resulted in differing interpretations of the provisions within the CFD industry. This outcome is not desirable, as regulation should be applied consistently and on a neutral basis across the industry. There is clearly a need for a coherent statutory regime that applies in a meaningful way to licensees offering retail OTC derivative products.

As such, we support efforts to clarify, and amend the law where necessary, so that there are no uncertainties in the practical application of the law.

2. Scope of Law Reform

We support the proposed scope of any reform measures to be limited to OTC derivative products offered to retail clients. The client money provisions are applicable to a wide range of licensees offering different financial products. Care should be taken to ensure that the reforms are focused on the issues that have been identified, as a broader application of changes may have unintended consequences for licensees for which the current legislative provisions are working effectively.

Specifically, the reform measures should not apply to exchange traded derivatives, for example, futures traded on the Australian Securities Exchange. The counterparty risk inherent in principal-to-principal trading in OTC markets is mediated by the process of novation for exchange-traded products, and as such, the objectives of the client money provisions attaching to OTC and exchange-traded products are not identical. In addition, exchange participants are required to meet certain requirements, for example in relation to reconciliation of client money, under ASIC's market integrity rules.

As well, any reform measures should not apply to licensees' dealings with wholesale clients, as there has been no identification of any need for reforms in this area. ASIC Class Order 03/1112 *Relief from obligations to hold client money on trust* acknowledges the need for a more unrestrictive approach to dealing with wholesale client money.

3. The Impact on Different CFD Business Models

A key limitation of the current client money provisions is the ability of licensees to withdraw monies from s.981B accounts; through the s.981D exception for derivatives, broad interpretations of monies that licensees are 'entitled' to under Regulation 7.8.02(c) and generous withdrawal authorisations from clients under Regulation 7.8.02 (a). Limiting the circumstances in which licensees can make withdrawals from s.981B accounts may assist in reducing the risk of there being insufficient client money in such accounts in the event of a licensee's insolvency.

The key question for OTC derivatives is whether client monies can be withdrawn by licensees to meet the margin obligations related to their own hedging activity. Within this context, a key consideration is the degree to which the reforms should place limitations on withdrawals from s.981B accounts for hedging purposes; for example, allowing only initial and ongoing margin payments by clients to be withdrawn, or not allowing any client money to be withdrawn for hedging purposes whatsoever.

Several of the options considered in the Discussion Paper will effectively remove the ability of affected licensees to use client money for margining of the licensee's hedging transactions. The associated cost and impact of such measures will be greater for some members, relative to others. Specifically, some members providing a direct market access (DMA) service to their OTC CFD clients have advised that any reform option that effectively removes their ability to pass any client money to their hedging brokers will have a substantial impact on their business.

In Australia, the DMA model has been developed for CFDs based on individual shares listed on the ASX. When a client enters into a CFD position, the CFD provider will generally hedge this position by entering an identical trade on the ASX. This trade is facilitated by a hedging broker, who will require the CFD provider to pay a margin amount to secure the hedge transaction. Currently, many members use some client money to fund a portion of these hedging costs; typically the initial and ongoing margin payments provided by clients.

All CFD providers, regardless of business model, will have a hedging strategy to minimise their market exposure. While the amount of hedging will generally be dependent on the size of a provider's business and their hedging strategy, rather than business model, providers offering a DMA service to clients will have less discretion in determining their hedging strategy. This is because such providers are generally required to hedge all client positions.

Affected members have advised that such reform measures, if implemented, may require them to cease providing a DMA service to clients. From an industry perspective, the proposed reform measures may have an impact on the competitive landscape of the market.

4. Discussion Paper Questions

4.1. Pooling of Client Money or Property Relating to Derivatives

1. Should the law be amended so that:
   (i) client monies held on behalf of a retail client cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee; or
   (ii) the monies deposited by one client in connection with a derivatives transaction cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee on behalf of people other than that client?

Some members, with UK-based parent companies, have been affected by recent changes in the UK client money rules that limit the use of client monies, as proposed. As such these members support amending the law so that client monies held on behalf of a retail client cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee. Such reform measures will certainly heighten the protection of retail client monies.

However, as noted, such reforms will have a substantial business impact on some OTC CFD providers who offer a DMA service to their clients. We are aware that some members have considered alternative reform options that will increase protections for retail clients; for example, more stringent regulation of monies that have been withdrawn from s.981B accounts and heightened capital requirements for licensees who use limited client monies for hedging purposes. If Treasury considers that these alternative options merit further consideration, we suggest comprehensive consultation with the industry.

In relation to whether the law should be amended so that monies deposited by one client in connection with a derivatives transaction cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee on behalf of people other than that client, this question raises the issue of “pooling” client money and when that may or may not be problematic for retail clients. As discussed further below, we do not believe that pooling of client monies poses risk for retail clients, provided there is adequate protection of the pooled funds. If the law were to be amended to remove the ability of licensees to use client monies for hedging purposes, then this becomes a non-issue. If the ability of licensees to use client monies for hedging purposes were to be retained, then appropriately defined limitations on what client monies can be withdrawn and effective “top-up” requirements for clients in negative equity positions will address the risk of the pooled funds being deficient due to the negative equity position of any one client.

2. Should licensees continue to be able to pay such funds into client segregated accounts, or should they be required to pay them into separate trust accounts for each client?

We are strongly of the view that any requirement for licensees to hold client monies in separate trust accounts for each individual client will be impractical and will have no added benefit to retail clients. Placing all client monies in one or several pooled accounts will not create risks for clients, provided such funds are calculated, managed and tracked in accordance with clear rules and parameters.

There are many benefits to allowing client monies to be pooled. Pooling enables prudent risk management by spreading client monies in accounts across several financial institutions. The administrative burden associated with the requirement to have individual accounts for each client will not likely enable such diversification to occur.

The initial cost of opening separate accounts for each client will be significant. However, there are also ongoing costs and lost operational efficiencies that are associated with such a requirement. In practice, this will entail the daily monitoring and reconciliation of every single bank account. This is particularly onerous for actively traded products like CFDs, where balancing adjustments to reflect running profits and losses will be required. As the management of individual accounts will increase administrative complexity, this also increases the likelihood of operational errors.

3. Should the above changes to the law concerning client money be limited to derivatives issued OTC or include all derivatives, including those which are traded on an exchange (such as futures)?

As discussed, we believe any reforms considered should be appropriately scoped and should not be applied to exchange-traded derivatives or wholesale clients.

4. Should the regulations be changed to limit the ability of a licensee to pay money out of the client money account at the written direction of the client to instances where the client provides a specific written direction for each individual payment out of the account (thereby restricting the use of general client directions in the form of clauses in the client agreement)?

We agree that general client directions should not be used inappropriately to give licensees broad authorisations to make withdrawals from s.981B accounts. However, any restrictions on the use of general client directions should be limited to retail clients. An alternative option is to specify in the regulations the purposes for which general directions may be used, rather than limit written directions to specific directions for each individual payment.

5. Should licensees be required to conduct a regular reconciliation of client money and have a documented process in place to escalate and resolve any unreconciled variances that are identified?

We agree that licensees should be required to conduct daily reconciliation of client money and have documented processes in place to escalate and resolve any unreconciled variances that are identified.

6. Do you consider there is a lack of clarity as to the meaning of the law, as described above under the heading 'Interpretation of the provisions'? If not, what is in your view the correct interpretation? What should be the preferred interpretation?

We consider that there is a lack of clarity as the meaning of the law for the treatment of client monies in connection with retail OTC derivatives.

7. If the current general approach in the law is retained, should its application be altered? If so, would it be preferable to continue to allow pooling of clients' money, or to specify the circumstances in which monies can be used? Should the right to use client money be temporary, e.g. requiring that any shortfall arising from one client's money being used to cover the obligations arising from another client's trading is topped up by the licensee within a short period of time? Please provide any other options you would like us to consider.

If the current general approach in the law is retained, at the minimum, the following measures should be considered to strengthen the protection of retail OTC derivatives client monies:

- A prompt (no more than 24 hour period) top up requirement to cover any short fall arising, ie when a client enters a negative equity position;
- An individual client account reconciliation requirement, where pooled funds are required to be reconciled to the individual client level; and
- Limit the amount of client monies that can be withdrawn by licensees to initial and ongoing margins payed by clients for OTC derivatives.

We are aware that some members are considering alternative protections for retail clients in OTC derivatives that give some protection to these clients' monies after they have been withdrawn from s.981B accounts. These options should be explored if Treasury considers that the current general approach to the law should be retained.

8. What would be the impact of the possible changes identified in this paper? Please provide as much detail as possible of any costs or other impacts.

If the law were to be amended so that client monies cannot be used for hedging purposes, members already required to operate under similar provisions in the UK will not experience material impacts to their businesses. However, as discussed, the impact on some members offering a DMA service to their OTC CFD clients is likely to be significant.

9. Should any enhanced protection apply to the money and property only of retail clients? Why?

As discussed, any enhanced protection should only apply to the money and property of retail clients and enhancements are not required in respect of dealings with wholesale clients because of the level of sophistication of these clients.

10. Given that changes could impose additional compliance costs, are there any other regulations in this area that you would like to see improved or removed to reduce compliance costs? If so, please explain what they are, how they could be improved or removed and what cost savings this would deliver.

No.

11. Are any additional protections needed for client money where the licensee holds the financial products outside Australia?

No, the provisions pertaining to the handling and maintenance of client monies apply to all AFSL holders. No additional protections should be required.

12. Should the law be amended to limit the bases on which a licensee can claim an entitlement to money held in a client money account?

The law should be amended to clarify the purposes for which a licensee may make an entitlement claim.

13. Should the law contain express requirements as to what money must be segregated? Specifically, should licensees be required to segregate amounts that would be due to a client if a derivative position was closed?

While some level of prescription provides certainty to licensees, the broad application of the client money provisions to all licensees makes its undesirable for regulation to contain express requirements. If certainty is desired, a better outcome can be achieved if ASIC were to issue guidance to narrow categories of licensees, for example, guidance specifically for licensees offering retail OTC derivative products.

4.2. Reporting Requirements

1. Do you agree that there is a gap in the information being provided to OTC derivatives clients by the Act not requiring monthly reporting of money and property held on their behalf?

An information gap is possible, as there is no comprehensive client reporting regime for OTC derivatives. However, any reporting requirement should be flexible enough to enable clients to access client money information in a way that meets the policy objective of informed clients, and in the method that is most efficient for individual licensees. For example, while there is currently no comprehensive reporting regime for OTC derivatives, some members have in place systems that enable clients to access real time data on their positions and client money held. Clearly, such clients are well informed. However, any requirement for these licensees to provide prescribed monthly statements would be a duplication of effort and would create no additional benefit for clients. On the other hand, the introduction of reporting in a prescribed form, for example a monthly statement, would require extensive systems changes and involve significant costs.

2. Are the items listed above information which would benefit clients?

The law should not be so prescriptive as to the information that should be disclosed to clients.

3. Can you give an indication of the cost of preparing monthly statements covering these items and providing them to clients electronically?

No comment.

4. Please indicate if there are any other reasons why it would be inadvisable to require monthly reporting.

The proposed monthly report may not be a useful information tool for retail clients in OTC derivatives, such as CFDs, which are typically actively traded daily. Within this context, lagged reporting on a monthly basis may not be appropriate.

5. Would it be preferable to give the client a statutory right to ask for such a statement (rather than requiring it to be provided monthly)?

No comment.

6. Given that these changes could impose additional compliance costs, are there any other regulations in this area that you would like to see improved or removed to reduce your compliance costs? If so, please explain what they are, how they could be improved or removed and what cost savings this would deliver.

No comment.

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Thank you for the opportunity to comment on the Discussion Paper. The reform options considered will have a significant impact on many AFMA members, so we would be happy to facilitate further consultation between the Treasury and the industry if required.

Yours sincerely

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