Brian Salter
General Counsel

30 January 2012

Manager, Financial Services Unit
Retail Investor Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir/Madam,

Reforms to strengthen the protections for investors in exchange traded derivatives

We refer to the Discussion Paper on the Handling and Use of Client Money in Relation to OTC Derivatives Transactions dated November 2011. As one of Australia's largest investors in derivatives, AMP supports the Government's initiative to review whether the client money provisions of the Corporations Act 2001 provide sufficient protection for investors.

While the Discussion Paper explores options for improving client money protections for retail clients in relation to OTC derivatives transactions, it also invites comment on whether enhanced protections should apply to wholesale clients and exchange traded derivatives. AMP believes it is in the interests of a fair, orderly and transparent market to strengthen the current protections available for investors in exchange traded derivatives to protect client moneys and positions in circumstances where a broker becomes insolvent. In particular, AMP is concerned that following the insolvency of a broker:

1. it is not clear what action the exchange will take in connection with an insolvent broker. The exchange reserves to itself a wide range of powers but the impacts on investors vary widely depending on the actions the exchange takes;

2. it is not clear that all of those actions would be consistent with the insolvency laws applying to the insolvent broker; and

3. client moneys held by the exchange and the broker do not receive the same level of protection afforded in other jurisdictions.

We recommend that reforms be introduced to:

1. require the exchange to recognise clients as having an interest in positions and moneys held at the exchange;

2. require the exchange to clarify the actions it will take in respect of positions and moneys following the insolvency of a broker and provide for a client's positions to be transferred to another broker together with any moneys held by the exchange in respect of those positions;

3. introduce legislation to clarify that all actions taken to protect client positions and money will not be capable of being challenged under Australia's existing insolvency laws;

4. minimise the scope for a broker to use one client's funds to meet obligations owed in respect of another client's positions; and

5. ensure client moneys held by a broker receive priority on insolvency of the broker, including where those moneys are deposited by an ADI broker into its own account.

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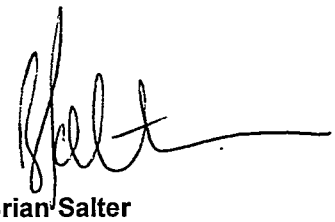
5. ensure client moneys held by a broker receive priority on insolvency of the broker, including where those moneys are deposited by an ADI broker into its own account.

We attach our detailed comments and recommendations on these issues.

AMP also notes the CAMAC Derivative Review Background Paper dated August 2011 relating to the review of derivatives under the Corporations Act. We are pleased to provide a copy of this submission to CAMAC for its consideration in connection with that review.

If you have any questions in relation to the foregoing or the attached, please do not hesitate to contact me on (02) 9257 5669.

Yours faithfully,



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ATTACHMENT

Part 1. Exchange level protections

An investor wanting to trade exchange traded derivative contracts in Australia must settle its transactions through a clearing participant of the exchange (referred to as a '**broker**' in this paper). In respect of each trade, the investor contracts with the broker who in turn contracts with the clearing house of the exchange (referred to as the '**exchange**' in this paper). The exchange does not recognise the client of the broker, being the underlying investor in that position.

In respect of ASX 24, the largest futures exchange in the country, the ASX Clear (Futures) Operating Rules (**Operating Rules**) provide that:

(a) each open contract (whether designated to a House Clearing Account or a Client Clearing Account) shall be between the exchange and the broker as a principal and not as an agent and no other person shall have any rights or obligations under any open contract between the broker and the exchange (Operating Rule 31.4); and

(b) the exchange shall not in any way be required to recognise any clients of the broker and shall not be in any way responsible for the performance of the obligations under open contracts to such clients. The exchange shall not in any way, be on notice in relation to any matter arising between the broker and any client or otherwise affecting the client (Operating Rule 42).

These Operating Rules specifically provide that the underlying client has no rights or obligations under any contract and the exchange is not required to recognise the underlying client. We do not think this is the correct approach and, instead, the exchange should be explicitly required when exercising its powers to act in the best interest of the underlying client, particularly when exercising its powers on the insolvency of a client's broker.

Lack of clarity as to how the exchange would deal with an insolvent broker

In respect of the ASX 24, an insolvent broker will automatically be suspended from trading with the exchange (Operating Rule 10.11). The exchange then has various powers under Operating Rule 72.1 to deal with the client positions and client moneys held by the exchange in respect of the broker. Those powers include the power to:

(a) close out all or any open contracts of the broker (including those referable to the Client Account) by closing out any opposite positions and/or by buying or selling opposite positions on the exchange as if a request to close out had been made by the broker (Operating Rule 72.1(a));

(b) sell, realise, apply and set off any monies or other property deposited with the exchange (provided that money and property in the Client Clearing Account cannot be used to meet obligations in the House Clearing Account)... and apply the proceeds without being required to give notice or obtain the consent of the broker or any court order, with full power to execute any documents in its own name or as attorney for the broker for that purpose (Operating Rule 72.1(b));

(c) apply any surplus in the House Clearing Account to a deficiency in the Client Clearing Account (Operating Rule 72.1(c));

(d) transfer all or any open positions designated to a Client Clearing account to another broker together with any initial margins held by the exchange in respect of those positions (Operating Rule 72.1(d));

(e) exercise or abandon any options contract of the broker (Operating Rule 72.1(e)); and

(f) calculate a net amount due and payable between the broker and the exchange and, if payable to the exchange, demand immediate payment (Operating Rule 72.3).

Depending on the action the exchange elects to take, there can be very different impacts on the outcomes for clients.

If a client has an existing open position it uses for hedging purposes and its broker becomes insolvent, it would be undesirable for that client if the exchange exercised its power under Operating Rule 72.1(a) to close out that position. If the exchange closed out that position, the client would become unhedged and may need to re-establish the same position with another broker at short notice and additional cost. The net amount owing by the exchange (if any) in respect of that position would then be paid by the exchange to the administrator or liquidator of the insolvent broker. In turn, the client would deal with the administrator or liquidator requiring the client to navigate a variety of insolvency issues to obtain access to its money. It would be more desirable for the client in those circumstances if the exchange exercised its power under Operating Rule 72.1(d) to transfer the open position to another broker together with any margin held by the exchange in respect of that position. That approach would allow the client to remain hedged and would mean the client would only deal with the administrator or liquidator of the insolvent broker for any of its residual margin held by the broker rather than all moneys deposited by the client as margin in respect of that position.

We believe as an investor in exchange traded derivatives that it would be beneficial, and would provide greater certainty and security to the market, if the Operating Rules specifically set out what would happen to client positions and moneys on the insolvency of a broker. We believe this is preferential to the current approach of the exchange reserving to itself a wide range of powers and there being little guidance on how these would be exercised, particularly given that the exchange is not explicitly required to act in the interests of the affected underlying clients.

Exchange powers subject to insolvency laws

Further uncertainty arises for investors because the Operating Rules, which govern the rights and obligations between the broker and the exchange, have force in contract rather than force of law (section 822B of the Corporations Act 2001 (the **Act**) and Operating Rule 1.3). The effectiveness of the exchange's powers discussed above, therefore, will be subject to insolvency laws which may conflict with and prevent the exchange exercising certain of those powers.

It is long established in insolvency law that property of a bankrupt vests in the bankrupt's trustee in bankruptcy and that the bankrupts property may only be administered by the trustee. These principles are replicated in Australian corporate insolvency law. Under section 437A of the Act an administrator of an insolvent company assumes control of the company's business, property and affairs. Under section 437D of the Act, any transaction or dealing entered into by a person purporting to act on behalf of a company under administration is void unless the transaction or dealing was entered into by, or with the prior consent of, the administrator acting on the company's behalf or under a Court order. Similar provisions exist in relation to the winding up of an insolvent company. Under section 474 of the Act, the property of the company vests in the Court, or the liquidator by order of the Court. The liquidator has power to carry on the company's business (section 472(4) of the Act) and it is an offence for a person to purport to perform or exercise a function or power as an officer of the company without the approval of the liquidator or the Court (section 471A of the Act). Any disposition of property of the company without a Court order made after the commencement of the winding up, other than an exempt disposition, is void (section 468 of the Act).

All open positions held by a broker with the exchange, and the moneys deposited by the broker with the exchange as margin in respect of those positions, represent the property of the broker. The powers granted to the exchange under Operating Rule 72 purport to permit the exchange to deal with the property of an insolvent broker (and in some cases execute documents and transactions in the name of the broker). For example, the exchange is permitted to:

(a) sell, realise, apply and set off any monies or other property deposited with the exchange by executing any documents as attorney for the broker under Operating Rule 72.1(b);

(b) transfer all or any open positions designated to a Client Clearing account to another broker together with any initial margins held by the exchange in respect of those positions under Operating Rule 72.1(d).

These contractual powers are supported by section 16(2) of the Payment Systems and Netting Act (1998) (**Netting Act**). That section applies to a market netting contract, which includes the contract created under the Operating Rules between the exchange and the broker. If a broker goes into external administration, section 16(2) provides that the termination of, and netting of amounts due under, contracts are effective against an administrator and liquidator of the broker. Section 16(2) also protects the exchange if it makes a payment or a transfer of property to meet an obligation under the contract to pay a deposit or margin call. These provisions make it clear that the exchange's power to terminate and net an insolvent broker's open positions will be enforceable during the insolvency of a broker. However, in our view, there remains the risk that other of the exchange's powers under Operating Rule 72.1 do not have adequate protection against the application of Australia's insolvency laws.

In particular, the power of the exchange to sell, realise or apply any monies or other property deposited with the exchange under Operating Rule 72.1(b) and the power to transfer margin held by the exchange to another broker under Operating Rule 72.1(d) do not, in our view, fall within the scope of section 16(2) of the Netting Act. If the exchange were to exercise such powers against an insolvent broker, there is a substantial risk that sections 437D and 468 of the Act operate to void the exchange's dealing in that property.

In the case of Macquarie Bank, one of the largest brokers on the ASX 24, there is additional uncertainty as to whether or not the exchange's unilateral exercise of certain powers under Operating Rule 72.1 would be enforceable during Macquarie Bank's insolvency. In addition to being a broker, Macquarie Bank is an authorised deposit-taking institution (**ADI**) for the purposes of the Banking Act 1959 (**Banking Act**). Macquarie Bank is subject to the ADI statutory management provisions set out in Part II, Division 2 of the Banking Act (there are other brokers on the ASX 24 that are also ADI's, such as Deutsche Bank, but each is a 'foreign ADI' and therefore not subject to Part II, Division 2).

Part II, Division 2 of the Banking Act provides at section 15C(2) that the appointment of a ADI statutory manager does not allow the contractual counterparty of an ADI to deny any obligations under that contract or close out any transactions relating to that contract. On Macquarie Bank's insolvency, the exercise of a power by the exchange under Operating Rule 72.1, which is not explicitly permitted under section 16(2) of the Netting Act, would require consent of the ADI statutory manager or a Court order.

The inability of the exchange to enforce certain of its powers against an insolvent broker is of concern to investors. AMP believes it is important for reforms to be made to ensure that insolvency law does not override any of the intended protections afforded to investors in exchange traded derivatives.

Client money protections conflict with insolvency laws

It is also uncertain as to whether the protections available to client moneys held by the exchange would withstand a challenge by the administrator or liquidator of an insolvent broker.

Client money rules require brokers and the exchange to segregate a broker's client moneys and house moneys (Section 981B of the Act, Market Integrity Rule (**MIR**) 2.2.6, Operating Rule 41). MIRs 2.2.6(a) and 2.2.6(c) require money received by the broker from a client or a person acting on behalf of the client to be paid into the client segregated account within 1 business day. When paying money to a broker in respect of any client positions, Operating Rule 44.7 requires the exchange to pay that money into the broker's client segregated account. The requirements in MIR 2.2.6 and Operating Rule 44.7 are clearly desirable for investors. They help ensure that the client moneys held by the exchange are transferred into the account with the broker that is subject to the client money protections of the Act and in particular the statutory trust and statutory payment priorities described in Corporation Regulations (**Regulations**) 7.8.03(4)-(6). AMP is concerned, however, that despite the requirements of MIR2.2.6 and Operating Rule 44.7, the administrator or liquidator of an insolvent broker may be entitled to access to those funds for distribution to all general creditors of the broker, not just the relevant clients.

MIR 2.2.6 applies only to money received by the broker from its clients or *a person acting on behalf of the client*. As the exchange does not act on behalf of clients (it does not even recognise the client under Operating Rules 31.4 and 42), it seems doubtful that MIR 2.2.6 applies.

It also seems open for the administrator or liquidator of an insolvent broker to request the exchange to pay any amounts owing in respect of client positions to an account other than the client segregated account. In the absence of any legislative requirement for the exchange to pay such amounts to the client segregated account (Operating Rules do not have force of law), it seems open to the exchange to agree to the administrator or liquidator's request. In fact, the exchange may well expose itself to liability if it denies the administrator or liquidators request. Liability for the exchange may arise under section 437D of the Act for dealing in property of the broker without consent of the administrator, under section 471A for purporting to exercise a function or power of an officer of the company without approval of the liquidator or the Court and under section 486B for removing property of the company.

Offshore position

The position of an investor on a futures exchange in the United States is stronger.

The US Bankruptcy Code, Commodity Exchange Act ("**CEA**") and related Commodity Futures Trading Commission ("**CFTC**") regulations provide robust customer protections in the context of a commodity broker's liquidation. In the CFTC's brief to the US Bankruptcy Court in connection with the bankruptcy of MF Global, it was noted that:

(a) these laws are designed to ensure the property entrusted by customers to their brokers will not be subject to the risks of the broker's business and will be available for disbursement to customers if the broker becomes bankrupt; and

(b) accordingly commodity customers are granted the highest priority against he bankrupt broker's estate in the liquidation of a commodity broker under Title 11 of the US Bankruptcy Code,

(*see Brief of the CFTC pursuant to the Court's November 17, 2011 Order dated December 12, 2011 in connection with In re. MF Global Inc., paragraph 1).*

Section 766(h) of the US Bankruptcy Code provides that "the trustee shall distribute customer property rateably to customers on the basis and to the extent of such customers' allowed net equity claims, *and in priority to all other claims*" [emphasis added] except for certain expenses attributable to the administration of customer property. "Net equity" is the total claim of a customer against the estate of the debtor based on the commodity contracts held by the debtor for or on behalf of such customer less any indebtedness of the customer to the debtor.

In addition, the CEA and the CFTC regulations require all margin received by a clearing member from a customer to be made available to the clearing member carrying the customer account upon demand. US Bankruptcy Code section 764 permits the exchange to transfer customer positions and property to another clearing firm within 5 days of the bankruptcy filing with the permission of the CFTC.
These measures, if introduced in Australia, would help mitigate the concerns we raise.

Recommendation

It is AMP's submission that exchanges should be required by law to recognise underlying clients. It is also our submission that the exchange should be required to exercise its powers against an insolvent broker having regard to the interests of investors. In particular, we believe that the exchange should be required to clarify the actions it will take in respect of client money and positions following the insolvency of a broker and provide for client positions to be transferred to another broker together with any moneys held by the exchange in respect of those positions.

We also submit that legislative clarification is necessary to provide that moneys in the exchange's client moneys account are not be available to general creditors of the broker and must instead be transferred to

another broker (along with the related open positions) or returned to the broker's client segregated account to be held on trust for clients where such moneys will have the benefit of the existing statutory protections.

Part 2. Broker level protections

The legal protections available to client moneys held by an exchange broker do not align with international best practice. Specifically:

(a) in Australia, client moneys deposited with a broker are pooled with other client moneys and are *not* held on trust for clients; and

(b) the difference in the timing and basis for margining clients and brokers in Australia exposes client moneys to additional risk.

These points are discussed below.

Client money protections

As an Australian financial services licensee, each broker is required to deal with client moneys in accordance with Division 2 of Part 7.8 of the Act. Generally, those provisions provide for client moneys (other than loans) to be:

1. paid into an account with an Australian authorised deposit-taking institution, an approved foreign bank, a cash management trust or certain cash common funds (section 981B(1)(a) of the Act, Regulation 7.8.01(2) and ASIC Class Order 04/1063);

2. protected from attachment (section 981E of the Act); and

3. held on trust for the benefit of the client (section 981H of the Act).

The obligation to hold client moneys on trust for the benefit of clients, however, does *not* apply to client moneys received by a broker in connection with exchange traded derivatives. Regulations 7.8.01(5) and 7.8.01(8) permit such moneys to be held in a client segregated account, rather than in a trust account. For wholesale clients, a broker that is also an ADI may also exempt itself from the obligation to hold client moneys on trust by agreement with the client (ASIC Class Order 03/1112).

Additionally, a broker is permitted by Regulation 7.8.01(9) to commingle all such client moneys in a single account. Section 981D of the Act and MIR 2.2.6(d)(i) also permit the broker to use moneys in the client segregated account to meet the brokers obligations to the exchange in respect of *all* client positions.

Margining

In respect of any trading day on the ASX 24, brokers are margined daily by the exchange on a net basis and are generally required to deposit margin with the exchange by 10.30am on the following business day. Clients, however, are margined by the broker on a gross basis and generally do not have to pay margin until after the broker has paid margin to the exchange.

Part 4 of the Operating Rules provides the exchange with broad powers to margin brokers for an amount determined by the exchange in its absolute discretion and include the power to call for extra margin and intra-day margin (Operating Rules 43 and 45). In respect of any trading day, we understand it is the practice of the exchange to issue a single margin call, or advise of a daily settlement payment, to each broker before 10:00am on the following business day. Those payments are made by the exchange, or required to be made to the exchange, by 10:30am on that same day.

The legal arrangements for margining clients are governed by the terms of the agreement between the broker and the client. The Market Integrity Rules stipulate certain minimum terms for those agreements and also specify protections in relation to client moneys. These include:

(a) brokers are permitted to call for payment of margin in such amount as the broker, in its absolute discretion, feels is necessary to protect itself from the personal obligation it incurs by dealing in positions on behalf of the client (MIR 2.2.5(b)(i));

(b) time for payment of margins is of the essence and margin must be paid no later than 24 hours of margin call for a client in Australia or 48 hours if the client is offshore (MIR 2.2.5(b)(iii) and 7.2.6(a)); and

(c) liability to pay margin accrues from the time a trade is executed regardless of when margin call is made (MIR 2.2.5(b)(v)).

In practice, we understand the margining process works as follows:

(a) In respect of any trading day (**T**), we understand that most brokers will issue margin calls to their clients during the evening of T. The amount of margin called will be determined by the broker with reference to the closing prices published by the exchange for relevant positions. In effect, that amount is an estimate of the margin the broker will be required by the exchange to hold under MIRs 7.2.2 and 7.2.3 the next day (although the estimate is usually accurate).

(b) Following the margin call by the broker, the client will be required to deposit margin into the client segregated account by the evening of T+1 (or T+2 in the case of an offshore client). The earliest time a broker will know if the client has defaulted in payment of margin will be the morning of T+2 (or T+3 in respect of an offshore client). That is the time when the broker is able to reconcile all payments into the client segregated account for the previous day. If a client has defaulted, and continues to default, the broker has until close of business on T+5 to 'top up' the client segregated account in respect of the shortfall arising from the client's default (MIR 2.2.6(f)).

The risk for investors

The combination of pooling of client moneys without protection of a trust, and the difference in the timing of margin calls for clients and brokers, results in money in the client segregated account belonging to one client being available to meet obligations owed to the exchange in respect of other clients' positions. If a client defaults on its margin call and the broker becomes insolvent, non-defaulting clients will be exposed to any shortfall in the client segregated account. We believe this is a substantial weakness in the current system. That risk is compounded by the difference in the basis for margining clients and brokers (gross versus net). At any point in time a considerable proportion of client money will be held in the client segregated account rather than the client clearing account at the exchange. This situation arises because the broker is likely to hold offsetting positions across all its clients (in respect of which it is not margined by the exchange) and because some brokers require excess margin to be deposited by clients.

The 'residual' client monies retained by the broker provide a buffer that permits the broker to meet its obligations to the exchange in respect of client positions without having to top up the client segregated account with its own monies. This buffer increases the risk of a broker being able to hide deficiencies in the client segregated account.

Gross margining exchanges, such as the Chicago Mercantile Exchange in the United States, tend to hold a higher proportion of customer funds at the exchange level. AMP views this as a as a more favourable outcome for clients as the exchange is generally considered to be less likely than the broker to contravene client money segregation requirements. This is because the exchange is subject to a higher degree of supervision and is likely to have superior systems in place to maintain proper segregation than brokers.

Offshore Position

The protections available to client monies in several offshore jurisdictions are superior to those in Australia. In the United States, the CEA and the CFTC regulations require all margin received by a clearing member from a customer to be accounted for separately, not co-mingled with the clearing members own funds and *not used to margin the trades of or to extend credit to any other person.*

In Hong Kong, brokers are not permitted to conduct any futures business for new clients, or clients without a demonstrated track record of meeting margin calls, unless and until the client has provided collateral adequate to cover the client's minimum margin requirement (HK Futures Exchange Rule 617(a)). Brokers may exempt their established clients from that requirement provided that margin is paid the next day and the client has no margin overdue for settlement (HK Futures Exchange Rule 617(b)). An established client is one who has a track record of consistently meeting margin calls and maintaining a sound financial position.

Recommendation

AMP believes that legislative reforms are required to prohibit the use by a broker of one client's funds to meet obligations owed in respect of another client's positions.

Part 3. ADI as Broker

AMP believes there is confusion as to the treatment of client monies where the broker is also an ADI and operates the client segregated account as a deposit account held with it. Each deposit in a bank account is a debt owed by the ADI. It does not represent a property interest in any particular money held by the ADI. If an ADI broker becomes insolvent, clients' claims against the ADI for the balance of the client segregated account are no different to the claims of other depositors with that ADI. The fact that the deposit account is a client segregated account does not provide a superior claim for futures clients over the claims of other depositors with that ADI broker. In addition, the ability of the ADI broker to deposit client moneys into an account held by it, permits the ADI broker to fund its other operations with client moneys that would otherwise be subject to restrictions on withdrawals and use under the client money provisions of the Act (section 981C and Regulation 7.8.02).

In the case of an ADI broker that maintains the client segregated account as a deposit account held with it, the rights of a client in respect of the moneys deposited in that account upon the insolvency of the broker are the same as the rights of any other depositor with that ADI.

In the case of a non-ADI broker that maintains its client segregated account with an ADI (or an ADI broker that has maintained its client segregated account with another ADI), upon the insolvency of the broker Regulation 7.8.03(4) provides for those moneys to be held by the broker on trust for clients.

The outcomes for clients upon the insolvency of the broker are quite different. In the former case, clients will be owed a debt carrying the benefit of the Banking Act depositor protection provisions (Part II, Division 2 in the case of a non-foreign ADI, and section 11F in the case of a foreign ADI) and will rank equally with other depositors of the ADI. In the latter case, clients moneys will be held on trust for distribution to clients only. While in both cases clients are ultimately exposed to the risk of an ADI becoming insolvent, we believe there is a misapprehension among clients of ADI brokers that their deposits in the ADI broker's client segregated account have a superior ranking to other depositors with the ADI.

As noted Part 1 above, the US Bankruptcy Code section 766(h) provides for customer property of an exchange broker to be treated in priority to all other claims of the broker.

Recommendation:

AMP recommends that it is in the interests of maintaining a transparent and informed market to ensure that an ADI broker which maintains the client segregated account as a deposit account held with it, is required to explicitly inform its clients that the client moneys it holds are not protected on the insolvency of the ADI broker and are treated pari passu with other depositors of that ADI. We also believe that surplus moneys held to the credit of the account and not needed for margin calls at the exchange should not be available to be applied for the ADI's other operations but should be segregated and appropriately invested in authorised investments specifically marked as held on trust to meet any moneys owing to clients of the ADI broker.