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Dear Sir or Madam

This is a response to the request for feedback and comments on the discussion paper released in November 2011, entitled "Handling and use of money in relation to over-the-counter derivatives transactions".

Summary

The discussion paper overlooks some very material issues.

We raise some of these issues below to help avoid distorted legislation which would be to the detriment of investors and to the market as a whole.

Even though the media release accompanying the release of the discussion paper, media release No. 154 of 19/11/2011, took the opportunity of referring to the then recent collapse of MF Global, the discussion paper does not deal with some of the key issues that are emerging in that particular collapse. If the legislative responses to this discussion paper do not address the very matters that are contributing to outcomes adverse for clients in that particular case and similar cases, then adverse outcomes will continue to harm retail clients.

There is a risk that if any of the four reform options described in section 2.9 are adopted, investors, including retail clients, will continue to be at severe risk of loss, potentially substantial losses.

This response first makes some general comments which apply to various topics raised throughout the discussion paper, rather than itemising responses to particular paragraphs in the discussion paper.

There follows a brief description of a structure already been adopted but some issuers. We submit this structure gives better protection for investors and addresses problems in the legislation which are not analysed in the discussion paper.

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General comments

Principal obligations

One significant feature that is not addressed in the discussion paper is that issuers of OTC derivatives have principal liability to their clients. There is extensive mismatch in the potential impact of the current provisions in the Corporations Act against the roles and responsibilities of any issuer of an OTC derivative, in contrast with those of a futures broker or stockbroker, regulated by ASIC and the relevant exchange (and possibly also a clearing house).

The brief references in the discussion paper to the history of the relevant provisions does not take full account of the original intended effect of the provisions, as they were to apply to *brokers*. It is noted in passing that stockbrokers who clear exchange traded options and futures brokers typically have principal liability to the clearing house, but they otherwise remain substantially in the role of agents for their clients.

One of the reasons for the OTC derivatives issuer acting as principal in respect of its retail clients is that it will only be able to access the hedge contracts if it acts as principal to the hedge counterparty, such as a prime broker. The hedge counterparty would not want to deal with the OTC derivatives issuer acting in a capacity as agent, even as agent for undisclosed principals (being the retail clients)[1]. In other words, the OTC derivatives issuer is acting as an economic intermediary into the institutional markets, matching and a meeting the needs of both retail clients and the institutional market participants, but cannot be a legal intermediary.

Therefore, in simple terms, the OTC issuer, acting as principal, will have full balance sheet exposure to its hedge counterparties, as well as to its retail clients. On the other hand, the discussion paper seems to assume that the OTC derivative issuer, acting as principal, should only have access to client payments under the original premise of it being legally and functionally an agent of the client.

One of the aspects of this consequence of the OTC derivatives issuer acting as principal is that it will have unsegregated obligations to each of its hedge counterparties. It will be completely unrealistic to expect OTC derivatives issuers to procure accounts with hedge counterparties that purport to have some segregation in relation to client accounts when it will be essential for the hedge counterparties to have a single, non-segregated exposure to the issuer.

It is possible for the hedge counterparties to provide an accounting/trading platform system which allows for sub-account identification by reference to the issuer's clients, as ASIC is well aware, but that does not provide any segregation of client assets. It would be misleading and deceptive to clients if they were led to believe that there is traceable segregation through to the issuer's own account with it hedge counterparties.

One of the chief problems in the original approach taken by ASIC was its unreconciled attempts to maintain client segregation on the client side despite the OTC derivative issuer's transparently having non-segregated obligations to its hedge counterparties. This kind of legal mismatch is not addressed in the discussion paper. It is to be hoped that any legislative response does not perpetuate this disregard for the legal reality of the hedge contracts (even for the market-making model).

Another consequence of the OTC derivatives issuer acting as principal is that it is liable, obviously, as principal, not as an agent, to the client on a financial product. It is a legal and financial mismatch to assume that the best model, as the discussion paper appears to assume, is that the OTC derivative issuer should be liable as principal to the client, but not have the client *pay* for the financial product. The discussion paper continues to assume that the client payment for financial products remains, or should always remain, client moneys, to be held in trust or on some other custody basis for the continuing benefit of clients, even though the issuer is entirely liable to the client as principal on the financial product.

This mismatch, whether actually accepted by an issuer or if to be enshrined in legislation, financially imperils the issuer's creditworthiness, to the detriment of clients without actually finding a solution to the clients' needs and expectations or for the issuer able to operate the business.

[1] Fundamentally, it might not have AFSL authorisation to deal with retail clients.

In simple terms, the discussion paper's (misplaced) assumption would, if applied to a grocer selling a client an apple, expect the grocer to hold payment for the apple on trust for the purchaser, while the grocer has to pay a market wholesaler for the apple. Sure, this is simplistic, but the principal-to-principal-to-principal legal relationship has been materially overlooked in the discussion paper such that the legislative response needs to go back to the simple basics on what actually occurs in practice, rather than assuming a legal model that actually rarely applies.

Direct market access versus market-making

The consultation paper fails to make adequate reference to the extremely significant differences between the direct market access models and the market-making models.

Some considerable concern in the discussion paper seems biased towards a solution which encourages market-making, to the exclusion of direct market access models. This blindsiding can only have the effect of ultimately jeopardising client positions, because of the less capital required for the market-makers, the greater volatility (as seen in the case of MF Global) and the greater potential for imprudent or even irresponsible margining as among clients.

Any legislative response should vigorously assess the differences between the two models, particularly to avoid windfall monopolisation by the market-making model, to the exclusion of the direct market access (which actually favours retail clients in terms of core risk management).

It may be in the interests of market integrity and client awareness for an issuer's disclosure to clients the highlight this in practical terms.

The current ASIC RG 227 on benchmark disclosures lightly deals with this, but not significantly in a way that actually would have meaningful disclosure for unsophisticated clients who in fact ought to appreciate the differences before trading.

In the market making model, the OTC derivative issuer can effectively call for far less margin from the client, because the market maker does not need to pay for margin for hedges that reflect less than 100% of the client positions. Further, the market maker is not subsequently exposed to further margin calls, because it is not acquired the same extent positions which require that further margin which would be required if there was 100% hedging.

Alternatively, the market maker might choose to take an amount of margin from the client close to that which would be required if it were on a direct market access model, but use those funds effectively for allowing other clients to take positions beyond what is justified by the margin called from them (a distortion arising from economic cross-collateralisation). The market maker could also use those surplus funds sourced from higher than necessary margining of some clients to hedge requirements to take principal positions unrelated to any client positions.

The net result is a market maker with a balance sheet far more risky, volatile and difficult for a retail client ever to know at any moment in time.

It would appear from the proposed reforms raised in the discussion paper that the bias is towards encouraging only the market-making model and, moreover, without explaining why. If the legislation which arises out of the discussion paper leads to that outcome, then it might well be expected that the direct market access model businesses will tend to disappear (except, perhaps, if provided by significant financial institutions which are prepared to deal with retail clients) and so retail clients will have fewer options and those options will tend to be far more risky for them. If that is the intended outcome, then that should be explained to the retail clients.

Alternatively, any changes to the legislative provisions should take account of the direct market access model.

The direct market access model has advantages for retail clients which are not available through a market-making model. One of the advantages is the more transparent pricing – perhaps the essence of this model.

In terms of client exposure to the credit worthiness of the OTC derivatives issuer, the more important characteristic of the direct market access model is that it requires 100% hedging. This reduces the risk exposure of the OTC derivative issuer, also to the benefit of the retail client. A more complex analysis of this is outside the scope of this response but definitely should be undertaken in the course of establishing a principle-based approach to any legislative change.

It should be appreciated the initial 100% percent hedging and obtaining of margin cover for that does not assure continued levels of the same risk exposure because the positions will change in relation to the client and the hedge counterparties. Both must be managed by the issuer.

Recognising, however, that an OTC derivative issuer can be an intermediary providing retail clients with indirect access to the institutional markets, as desired by both the retail clients and the institutional market participants, the risk on each side will fluctuate from time to time. The necessary difference in, say, margin required from a client and a margin payable to the hedge counterparty has important ramifications for determining adequate surplus capital held by the OTC derivatives issuer and also the margin policy as it applies to its clients.

Regulation

Some of the themes of the discussion paper continue problems with previous regulation of CFDs and other OTC derivatives over six or more years.

ASIC has been reviewing and is aware of CFDs in some detail for at least six years. ASIC and its predecessors have been directly aware of spread betting (the precursor to CFDs in Australia) for perhaps 10 years or more. Various *margined* OTC derivatives have been on the market for retail clients some considerable time, even preceding the 2001 benchmark year named in the discussion paper.

Nevertheless, ASIC has, for a number of years, been labouring under the burden of trying to apply Corporations Act Part 7.8D literally to a legal structure in a financial market for which those provisions are not adapted. ASIC could have adapted the regime (prior to statutory change) to the legal and financial features of OTC derivatives, as it has done for other many other market concerns, but for whatever reason has chosen not to do so. Persevering with applying Part 7.8D despite the legal and financial nature of margined OTC derivatives will perpetuate the problems, even if individual provisions are tweaked.

In the face of this regulatory inactivity and lack of clarity of clear legislative principles applying to a market sector that emerged years ago, a significant number of OTC derivative issuers have already adopted a solution which does not need statutory change. The solution was adopted to avoid problems with ASIC's attempt to apply a Part 7.8D without much regard to the legal and financial aspects of the market, to address the needs of hedge counterparties (ultimately for the benefit of retail clients) and to give better investor protection.

We strongly urge that there not be a short-term legislative outcome which superficially applies individual structural features adopted from other jurisdiction's regimes that do not have sufficient similarity with Australian legal issues, *entire* regulatory structure and financial markets.

We submit that serious consideration should be given to the practical solution, described later in this submission, already adopted in Australia before choosing to adopt inappropriate features from structurally different regimes.

Section 2.7

Section 2.7 is deficient due to proposing reforms, based on extremely limited scenarios, that ignore the direct market access model and also ignore the more likely structural (not fiduciary) issues that arise on a day-to-day basis, including those which appear to have led to the problems with obtaining a quick resolution of client positions held with MF Global.

It should be expected that any legislative change should be based on a more comprehensive analysis of the range of models and rigorous analysis of the range of problems that arise from each of them. If not, then it is likely that they will continue to be significantly adverse outcome for clients, despite the legislative change.

One of the problems with the limited scenarios addressed in this section arises from the wrong assumption that client payments must remain client moneys beneficially held for the client. It should be remembered that the OTC derivatives issuer undertakes a principal position with its hedge counterparty, whether it hedges 100% of the client position or some lesser percentage.

It would be effectively mandating a legislative preference for the market making model if client payment for a financial product issued as principal could not be used by the issuer to hedge its position on that product issued to the client. In fact, it would be encouraging volatile market making, with the competitive pressure to take less margin from clients due to the inability to use margin which is mandated to be held on trust. Therefore the reforms described in section 2.7 would actually encourage, if not mandate, a drive towards minimal margin cover yet maximum market making with minimal hedging, to the considerable risk of clients.

The problems can arise where there is insufficient margin call from the client, the subsequent margin requirements are not maintained relative to the risk position taken by the issuer, payment for some clients margin is used to benefit trading by another client, there are problems with the counterparty or there are regulatory problems with the counterparty (such as lack of clarity in the regulation of moneys paid to their hedge counterparty).

In addition to those risk management issues, there are innumerable business issues that can actually affect the outcome for retail clients, even if the issuer acted in good faith and with the utmost prudence. There are differences as among prime brokers as to how they deal with assets provided to them, differences as among the products traded (fx, commodities, metals, futures), differences as among the way underlying securities on exchanges are traded or held in custody and differences as to whether the counterparties have the benefit of any regulation or licensing or capital requirements[2].

These are the sorts of sources of problems which actually create risk to the client, rather than wrongly insisting on client payment for a product issuer's principal should be retained as client moneys in order not to be actually used by the issuer to fund the hedge of the client' s position.

This wrong characterisation appears to lead to the startling assumption in the discussion paper that client directions are used to undermine client money protections. This is misguided for at least two major reasons.

First, it continues to assume, wrongly, that moneys paid by client should never leave a trust account, notwithstanding the issuer has issued as principal a financial product to them and has incurred a risk position in order to issue that product.

Secondly, it overlooks that the reason for the relevant provisions allowing for a client to give directions was to deal with moneys that probably need not have been in a trust account in the first place. If the moneys were paid into the trust account but were not paid in order to pay for a product (including for margin on it), then one wonders why it is in a trust account the first place. Therefore it is understandable that there are statutory provisions to allow for a client giving written direction to make the withdrawal.

If, for illustration, client moneys remain in the trust account, then the financial product is issued before the issuer is paid for it, then the issuer would be entitled to withdraw the moneys from the trust account without a direction from the client. That practice is financially imprudent for the issuer, as ASIC is aware, but this is feature is not addressed in the discussion paper.

It would be somewhat surprising and contrary to general market practice (including in relation to selling apples), if legislative changes mandated or encouraged issuance of financial products *before* payment for them.

In practice, the problem with Part 7.8D arises when the client pays money in advance of actually acquiring a financial product *and* it is not possible, with certainty required to comply with legislation, to know that the financial product will be issued *immediately* after the issuer receives those funds within the meaning of Corporations Act section 1017E.

If there is to be any legislative change, it should be to this section. This would allow some reasonable and practical approach to knowing when client money must actually be paid into a trust account *at* all, let alone when it may be withdrawn.

It is a prevailing practice, and possibly the overwhelming reality, that margined OTC derivatives are not issued in isolation from each other. This does happen, but our impression is that the vast bulk of margined OTC derivatives which have given rise to client losses, almost always are in the context of the client establishing an account with the issuer.

The account structure is appropriate for both the client and new to offer a number of reasons.

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[2] as distinct from being a subsidiary of an entity, which though regulated, has no liability to support the subsidiary

In brief, the account structure allows the client to pay money in advance of trading. It would be financially adverse, creating high market risk, if the financial product issuer is required to issue the product before receiving payment.

Practically, the client is likely not to know what specific financial products it will trade or even when it wishes to trade. That is the essence of arranging indirect access to virtually 24/7, international trading. For this, the client needs to have credit posted to an account, or before identifying a particular financial product, by whatever legal means, prior to trading in order to take advantages of opportunities at any time, on any market.

Providing money to an issuer in order to post credit on the client account allows for more efficient margining across positions, including sub-accounts created and chosen by the client. For example, an investor may have positions in shares, fx or other instruments, long or short, in different currencies. Depending on the trading platform, an amount posted as credit to an account can usually cover all of those positions.

This is in contrast with an extremely inefficient and expensive approach of requiring individual margin for each position, which could lead to the client actually losing enormous amounts quite unnecessarily.

Another feature, not recognised in the discussion paper but of which ASIC is aware, is the apparent dilemma of managing volatile positions and meeting margin calls despite payment system delays and problems outside the control of the client and the issuer. A client who is seeking to be more prudent would post more margin. This increases their exposure to the issuer. A legislative response which would have the effect of discouraging prudent margin chosen to be paid by a client would have the perverse effect of exposing more clients to more margin calls, and probably to further losses in their positions arising from closed positions due to margin not being paid on time.

The account structure, barely recognised in the discussion paper, gives rise to a single exposure amount as between the client and issuer in respect of all of the client's OTC derivative positions and credit/debit balance. For the sake of a simple illustration, assuming no client money is retained in a section 981B trust account, then the account structure properly reflects ultimately each of the client and the issuer being unsecured creditors of the other, and their exposure amounts to a single amount calculated after netting all individual positions, including any "cash" (credit or debit) balance.

This benefits the issuer by having greater certainty as to its exposure to the client, which in turn allows it to manage its exposure to a hedge counterparties.

It would be impractical nightmare if an issuer had to treat each OTC derivative and each payment for it separately. The traditional outcome of transactions without set-off or netting is a significantly reduced credit exposure allowed by each counterparty. It may be considered that the Commonwealth's payment netting legislation has always been designed to support netting, including netting for accounts, for its considerable benefits to financial markets and to commercial business. Even the apple grocer benefits from this in being allowed a credit line by the wholesaler.

It would be quite surprising if the legislative response to this discussion paper were to ignore a considerable history of support for account structures.

In the absence of anything else, such as the solution described later in this submission, the client is exposed for the net amount as an unsecured creditor. If on the other hand there are moneys retained in trust for the client, there might appear to be a benefit for the client from that, except practical experience in Australia shows repeatedly that those moneys can be used for other purposes, which is a problem with the current wording of the legislation, as recognised by the discussion paper. Therefore forcing the retention of client moneys (of any legal nature) in a statutory trust account on the current basis actually exposes the client.

ASIC attempted to address this by requiring greater disclosure to retail clients on the risks of retaining money is in statutory trust account. A feature of this attempt has been increased confusion and variation in disclosure. Again, the underlying problem is that the statutory trust accounts were not designed for issuance of OTC derivatives. The discussion paper repeats a mantra that retail clients may be presumed to be unsophisticated. The disclosure about the risks of moneys in a statutory trust account, as mandated by ASIC, would probably baffle the most sophisticated of clients, let alone the assumed unsophisticated retail client.

It is therefore suggested that the better response is to change the structure, or better recognise a structure, of payment for an *account* for issuance of margined OTC derivatives, rather than window dressing the disclosure about any mandated but flawed structure.

Direct market access <u>and</u> market-making model

Before describing the solution already been adopted by a number of issuers, we wish to stress that there ought to be place in Australia for both models.

Comments in this response are not intended as criticism of the market-making model. On the contrary, there are considerable virtues in that model for retail clients, such as pricing, innovations, different trading platforms and different access to markets. Indeed, the market-making model is used by many new businesses, reflecting introduction of capital and ideas from overseas, benefiting the local markets, clients and employees.

Rather, we urge that responses to this discussion paper should not have the unintended outcome of effectively closing down retail clients' access to the direct market access model. This would diminish the opportunities available to retail clients, increase their risk without giving them a choice and, ultimately, distort the market without any principles or evidence to explain that outcome.

It is appreciated, as ASIC has acknowledged in its publications, that in reality there is usually no definitive and precise model for each of those categories. Rather there can be a spectrum of approaches.

Indeed, an issuer could have both models on offer to clients.

The legislative responses should accommodate an issuer offering both to clients.

We therefore urge that the legislative response accommodate issuer and retail client choice of any permutation of the models.

An adopted solution

The following is a <u>brief</u> outline of the solution already adopted or in the process of being adopted by issuers of a variety of margined and non-margined OTC derivatives.

For the purposes of this public response, the outline and discussion given below should be sufficient. More details are available if requested.

Some further background and discussion is helpful for understanding the general nature of the adopted solution.

It is a principle adopted by the issuer that client money is provided to pay for a financial product issued as principal to the client. The payment is to be properly recognised as payment for the financial product, not held as a security for a product which is not paid for. The legal contract of the financial product should provide this. The account terms should provide this. The disclosure documents reflect this.

This actually accords with clients' understanding that they need to pay for a financial product issued to them. It is not been our experience that clients have misunderstood by believing that they are trading on an exchange and do not need to pay for a product. We caution against a legislative response which simply and uncritically assumes a single, outdated and untested client survey, without transparent analysis generally applies to all margined OTC derivatives, without regard to current client engagement and product disclosure standards.

It is recognised, under this adopted solution, that the client is at risk if at any time any client moneys are retained in the trust account. This arises due to the permitted uses of money in the statutory trust.

The client remains an unsecured creditor of the issuer for any amount other than that which is in the trust account and which is paid out to the client.

Assets of the issuer are at a considerable risk in the event of external administration of the issuer. This pattern has been repeated over many years, without any viable solution offered by ASIC or the discussion paper.

One concern is that the assets of the issuer are used towards paying the fees of the external administrator over in the interests of the clients. This problem is not addressed in the discussion paper.

The liquidator or other external administrator has no clear statutory duty to give preference to clients (after allowance for tax and employee interests), particularly as they are unsecured creditors of the issuer.

The discussion paper also does not address another problem which has been experienced, namely, an external administrator accessing client moneys in the statutory trust account. This utterly undermines the point of a statutory trust account. Nevertheless, this has been permitted and ASIC does not appear to have made any attempt to prevent this recurring.

Presumably the argument is that the external administrator ought to be paid appropriately to resolve the company's affairs for the eventual benefit of clients, but this overlooks a number of critical issues. The clients are not giving any precedence, despite their specific moneys being accessed. Secondly, the clients did not pay the moneys in the expectation that they would be accessed by an external administrator to pay itself fees. In fact, ASIC overlooks this in its mandated disclosure for OTC derivatives. Thirdly, in using the client moneys, the external administrator has no obligation to use the moneys actually to advance the interests of clients, the source of those moneys. Therefore there is an outcome of the external administrator accessing client moneys, for a number of other priorities, which may never actually financially benefit the clients.

Also, the problems in resolving hedge or (broker or clearing house) custody positions held for the issuer, still being experienced by MF Global, are not addressed in the discussion paper. The external administrator has ***no clear duty*** to prioritise resolving those positions or even to pursue prompt resolution, by negotiation or court action. In the absence of any other structural arrangement, the benefit of those positions with hedge counterparties, or even with a clearinghouse, falls to the general account of the issuer, not to the specific benefit of clients.

The typical, insidious outcome is that *immediately* available client assets (in trust or some other custody) are used by the external administrator to access hedge counterparty positions and at probably benefits secured creditors, payment of fees of the external administrator and creditors generally but does not directly assure a better outcome for the (unsecured) clients. All of the available client moneys could easily be used up recovery which never actually benefits the retail client. This is, economically, a gross misapplication of client moneys, though perfectly legal and proper under the current legislation.

It is even worse for the prudent client who avoided high leverage. Such a client would have paid more as margin, so has more to lose for the same trading positions. In contrast, the high-risk taking client who minimised payment of client moneys will benefit more from the prudent clients' money being accessed to generate an outcome shared by all.

Neither ASIC nor the discussion paper addressed this.

The solution adopted by some is essentially to create a protective trust which covers the two main things that ought to be held, at least economically, ultimately for the benefit of clients. These two are:

- the benefit of claims against hedge counterparties; and
- surplus funds which are not required for immediate management of the hedge positions.

The claims could be either a beneficial interest in money or shares or other assets, such as money held in a statutory trust or custody account with the hedge counterparty.

The claims can also be the benefit of contractual rights against the hedge counterparty. This typically applies in respect of prime brokerage agreements, despite the existence of a custody account.

The surplus moneys reflect a number of things.

Moneys are received by the issuer in payment for the issuance of a financial product before it is issued. (Moneys which remain in the statutory trust account are not moneys for the benefit of the issuer.) Moneys will be withdrawn in payment prior to insurance of the financial product.

(If it issues the financial product, while retaining the client moneys in a trust account, the issuer is increasing its credit exposure on the basis of a believing it has a right to hold and to withdraw the moneys from the trust account, to the exclusion of the client's beneficial interest in the moneys.)

Accordingly, the practical outcome is that the issuer who is not operating a market-making model should be withdrawing moneys from the trust account before issuing a product and it is those moneys which can be paid into this additional protective trust.

Further, inevitably because of the intermediation role of the issuer it ought to have a net exposure to the hedge counterparties less than the aggregate of all of the individual client margin payments from each of its clients. If it does not do so, then it has imperilled its business and is possibly trading while insolvent.

Therefore in the ordinary course of the prudently managed business, the issuer will have received from clients more money than it needs to pay its hedge counterparties.

It could choose to pay all of the surplus funds across to hedge counterparties. That would increase the issuer's exposure to hedge counterparties. This exposure is exacerbated where there is only one hedge counterparty. The discussion paper has not addressed this aspect of surplus moneys and ASIC has not particularly addressed it in its recent guide on benchmarks.

Therefore it is prudent for the OTC derivatives issuer, and ultimately for the benefit of retail clients, for the issuer to refrain from sending more surplus moneys across to hedge counterparties. Therefore, an amount ends up in the protective trust, representing an amount which is not immediately needed, but should be earmarked for managing the hedge positions if margin calls made by the hedge counterparties.

Other amounts arise in the protective trust by reason of clients closing positions.

These and other amounts can be handled by the terms of the protective trust.

In this regard, we are somewhat surprised by scenario two at the end of section 2.7. It rather blithely assumes that the OTC derivative issuer has overheads which should never be funded by client payments. The scenario is deficient in not addressing the fact that the any issuer will inevitably have overheads, which can only funded by its profit on in its revenue derived by these financial products, such as by fees, a spread on prices or interest charges or, it is a market-making, profit on its book.

It is literally true that it is an inappropriate use of client moneys in the statutory trust account for purposes such as described in the scenario. The scenario, however, and the rest of the discussion paper seem to overlook the need to pay for and process the profit component. This does not arise so much on each transaction as it commonly does in agency trades. Rather, the account structure not only accrues amounts earned by the issuer on say, a monthly basis or on closing the account. It would be extremely selective to make legislative changes focusing on misconduct which has rarely occurred in this sector and lead to the loss was the clients.

Therefore, if there is any legislative recognition of the solution which is briefly described in this response, it should take into account that these revenue components derived in respect of client positions must be allowed, because the protective trust must allow regular withdrawals of those amounts, in fact accrue even after issuance of a financial product.

The example given in that scenario also omits the very real experience, described above, of external administrator accessing client moneys from the trust account. This is a more serious issue for retail clients than a simplified, hypothetical scenario.

There are some features of the protective trust, which are beyond the scope of this response, the deal with establishment, nomination, beneficial interests and accounting. For the purposes of this response, it should be sufficient to identify that while the issue operates under a trust in respect of the claims and surplus moneys, there is appropriate operational flexibility until there is a trigger event. The terms of the protective trust actually achieve protections against even the problems described in that scenario, and many more.

Before the trigger event, it can be argued that the protective trust achieves for the client what the statutory trust should achieve if it did not have the problems caused by its current wording.

After the trigger event, such as insolvency of the issuer or of the hedge counterparty, other features begin to apply which maximise the potential for beneficial outcome for clients.

Perhaps external administrators would object to this structure because they would not be allowed to access any of the surplus funds or the benefits of pursuing claims against counterparties to pay their fees. Nevertheless, the protective trust seeks to have this outcome, so there may be a problem in funding liquidators effectively to act in the best interests of clients in priority to their own fees.

This dilemma is not addressed in the discussion paper, namely, maximising client moneys or other protection to clients, while facilitating quick and speedy resolution by an experienced professional liquidator who has a legitimate interest in being paid an appropriate value for their services.

If there is to be a legislative imperative to maximise return to clients, then this kind of protection of the claims and the surplus funds must be preserved in priority to paying fees external administrators. Further, they should be under a clear duty to maximise the prompt return from positions with hedge counterparties to the extent they use client funds to pursue those claims.

The security structure achieves both in the interests of clients in priority over the interests of the issuer in its own right and the fee interest of external administrators.

(A solution would be to appoint from a panel of market practitioners, not liquidators, a controller to manage client related and hedged positions. The controllers would be mandated by statute to manage a quick resolution in line with market practice, rather than long drawn-out and expensive legal disputes. Effectively it would be a very special category of receivers, pointed from the market, rather than the liquidator profession, reflecting the senior expertise found at a distance for what has to be done on a quick basis. This is not radical, since there are already parallels with this in appointments to the takeovers panel, and market disciplinary panels, all of whom can make decisions affecting considerable financial amounts.)

Another benefit to clients of the structure is that it uses trust law, rather than securities law. The issuer as trustee, and its directors, have serious duties and are susceptible to the remit of the courts much more than found with security interests. In particular, serious breaches by the issuer as trustee could lead to disgorgement of any profits. This gives clients a potential greater degree of compensation.

Its nature facilitates the hedge contracts with the hedge counterparties, particularly without exposing them to retail clients. This concern for hedge counterparties in the Australian market is not addressed in the discussion paper, but there is a real issue for issuers. Hedge counterparties had legitimate interest in ensuring they do not have unintended exposure to retail clients, particularly after a series of cases commenced in Australia, many resolves without the benefit of any legal principle decided in court. Any legislative response dealing with client moneys ought not have an unrealistic effect upstream on the arrangements with hedge counterparties.

Conclusion

While improvements to Part 7.8D and the corresponding regulations could certainly been made, More comprehensive changes were to be made out on the basis of a clearly articulated, principled approach.

If it is intended to benefit clients, then the ramifications of that should be accepted, including dealing with the role of external administrators and accommodating hedge counterparties.

Tinkering with segregation, reporting or disclosure to clients ignores more fundamental issues about comprehensively providing protection to the client yet allowing the issuer to create the business sought by the client within the reality of the arrangements are available in the Australian market place, subject to Australian law.

It will be a considerable sub optimal legislative response if there are piecemeal solutions plugged in from overseas jurisdictions which do not have sufficient corresponding legal and financial features relevant to issuance of OTC derivatives as principal.

It would be beneficial to the retail client market for OTC derivatives to ensure that retail clients continue to have choice in selection of business models offered to them, provided those businesses are adequately capitalised and disclosed to the clients.

Yours faithfully

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