Wednesday, 1 February 2012

By Email: clientmoney@treasury.gov.au

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To the Communications Manager,

Thank you for the opportunity to comment on the Treasury Discussion Paper – 'Handling and Use of Client Money in Relation to Over-The-Counter Derivatives Transactions' ("Discussion Paper") released in November 2011.

AxiCorp is of the opinion that options canvassed in the Discussion Paper could better take into consideration the OTC derivative landscape in Australia, especially in how it differs from the approach in the United Kingdom.

In recognition that comprehensive responses have been provided by other participants to outline the issues facing CFD providers in view of the proposals outlined by Treasury, AxiCorp has limited its response to a few key observations about the rationale which should be behind any changes made to current regulations.

Since the entry of Contracts For Difference ("CFD") providers into Australia, the market has developed very quickly, and now many issues which were not previously contemplated by Australian law and regulation have come to the fore. As with all new financial products (and particularly combined with the drastic effects of the Global Financial Crisis ("GFC")), imposing new regulations needs to be examined carefully in light of what might be seen as 'over-regulating' in a way that has detrimental impact on competition, innovation and consumer requirements.

Overview of Over-The-Counter Derivative Providers in Australia

In Australia, Over-The-Counter ("OTC") derivative providers issuing CFD products can be characterised in two ways:

1. Direct Market Access ("DMA") or Straight-Through Processing ("STP") providers – DMA is where all orders placed by clients are directly hedged on the relevant exchange. DMA allows a client to trade the spread of a stock by entering the order directly, effectively negating the need to pass through a broker or dealer. STP is the equivalent of DMA for non-exchange products such as margin Foreign Exchange ("FX"). This allows clients to benefit from guaranteed underlying market prices; and

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2. Market Makers – where some risk is run against client trades. Market Makers aim to make money by buying a financial product at a lower price than the price at which they sell it or vice versa. Ordinarily, they can make money in both rising and falling markets, by taking advantage of the difference between "bid" and "offer" prices.

Risks to Client Money in OTC Derivative Trading

In preparing a response to the Discussion Paper, AxiCorp has identified four (4) key risks to client money in the trading of OTC derivatives. These are:

1. Fraud (e.g. by directors/shareholders/employees);
2. Taking speculative positions with client funds;
3. Counterparty risk; and
4. Losses on hedging one client exceeding that client's funds and eroding that of other clients.

Taking each of these risks in turn, AxiCorp will outline our view of how the Discussion Paper addresses the risk, and provide some alternative/additional approaches for consideration.

1. Fraud (e.g. by directors/shareholders/employees)

AxiCorp is of the view that the Discussion Paper proposals do not address the risk of client money fraud faced by providers in the OTC derivative market.

AxiCorp proposes that steps be taken to increase the regulatory requirements to mitigate this risk, especially given it has been a cause of several well-publicised failures of firms in the OTC derivatives market recently. The first step in this process would be to strengthen the Adjusted Surplus Liquid Funds ("ASLF") calculation and processes applying to OTC derivative providers. Monthly reporting to ASIC of ASLF with evidence (e.g. copies of bank statements) or an audit opinion on its validity is one such option. AxiCorp currently calculates its ASLF position daily to ensure the security of its overall financial position, and does not consider that monthly reporting to ASIC would impose a significant additional regulatory burden.

Any withdrawal from the AxiCorp segregated bank account (at an Australian Authorised Deposit-Taking Institution) holding client funds must be approved by two signatories, each with their own independent password. Other such measures could be imposed, along with additional measures to ensure appropriately segregated functions within OTC derivative organisations are signatories (e.g. rather than closely aligned directors).

2. Taking speculative positions with client funds

The Discussion Paper proposals effectively ban the taking of speculative positions by OTC derivative firms using client funds. However, AxiCorp is of the view that the proposals should be re-drafted to state that (rather than banning the use of client funds for hedging entirely) the use of client funds for hedging should only be for client exposures in products the client is trading. Hedging positions shouldn't be greater than client positions and not in different products to the positions clients are holding. This would afford the appropriate level of protection, without unnecessarily restricting the operation of the OTC derivative providers, for no added benefits. Similar to the suggestion above, AxiCorp proposes that regular submission to ASIC of client positions across financial products and hedging positions would be appropriate and allow ASIC to have a similar level of oversight as that applied to the Australian Stock Exchange ("ASX") products. The information submitted to ASIC would be of

a similar nature to that which AxiCorp provided previously in the requisitions that were conducted by ASIC during 2010.

3. Counterparty risk

There are several types of counterparty risk faced by clients of OTC derivative providers. The first of these is that the Prime Broker ("PB") or hedging counterparty fails, locking up client funds that have been placed with these entities for the purpose of hedging. The second of these is that the OTC derivative provider fails, compromising the unrealised profits or open positions held by clients. The Discussion Paper proposals seek to address the former, without considering how it may tend to exacerbate the latter.

AxiCorp would like to draw Treasury's attention to ASIC Regulatory Guide ("RG") 227 which comes into force on March 31, 2012. Rather than preventing OTC derivative providers from placing client funds with hedging counterparties, ASIC suggests strengthening the regulatory intention behind Benchmark 3 of RG 227. Benchmark 3 directs OTC derivative providers to disclose their counterparty risk in relation to hedging client positions. If DMA/STP providers hedge client positions with counterparties that have large balance sheets, high credit ratings and pass other due diligence processes, the risk to client funds is by no means amplified by such a process.

AxiCorp contends that a more agreeable way forward for the Australian market would be to create transparency in the selection and appropriateness of hedging counterparties. This would involve providing more guidance or prescription around hedging counterparty suitability for OTC derivative providers (e.g. stipulating the capital requirements and appropriate regulatory regimes for such counterparties), rather than relying on retail clients to make such assessments themselves when they may not be aware of the issues and parties involved.

For example, AxiTrader implements strict controls to ensure that the procedures it adopts when managing exposure to market risk are followed. AxiTrader ensures that the counterparties with which it transacts to hedge risk are of appropriate financial standing. AxiTrader only hedges its positions through Tier 1 and 2 prime brokers that hold a minimum capital of 40 million USD (equivalent). Our main PB account is with Morgan Stanley. This is used in conjunction with several Tier 2 accounts, thus spreading the risk of a default on behalf of one of the hedging companies. Further, Axicorp has enforced trading limits with its prime brokers, which are automatically applied and can only be adjusted by the CEO of AxiTrader, upon request.

To address the counterparty risk for clients of AxiCorp, the capital requirements and surplus position of AxiCorp is monitored on a daily basis by our CFO. AxiCorp suggests again, that this information be submitted to ASIC on a more regular basis. The risk exposure that our clients face is calculated by our position keeper software in real time. This software is monitored by risk management staff, 24 hours a day, 5 days a week whilst the foreign exchange markets are operating. Our free margin levels with our hedging counterparties are displayed at all times, showing how much market movement or increase in position size can be sustained with the current level of funds.

Daily stress testing is conducted and alerts have been established at pre-defined levels to ensure that appropriate remedial action is taken in the event of market movements that are adverse to AxiTrader's financial position.

4. Losses on hedging one client exceeding that client's funds and eroding that of other clients

As in point 3 above, AxiCorp contends that the Discussion Paper proposals have not dealt with the issue of losses on one client's monies eroding that of another client.

During the GFC, many OTC derivative firms were forced to take large losses to their ineffective and antiquated margin call procedures. AxiTrader suggests that rather than using

the disclosures in Benchmark 7 of RG227 which requires retail clients to make decisions about margin call policies of various OTC derivative providers (and assess these in conjunction with the other 6 Benchmarks, where all of these factors may not be equal between the providers they are assessing), ASIC adopt a more prescriptive approach.

This could include prescribing the manner in which clients are to be informed that their account is approaching negative equity, to how quickly the position must be closed out if a stop loss is not applied, to ensure that one client's funds are not used to fund the positions of other clients. Although not particularly desirable (in terms of profitability) for OTC derivative providers, ASIC may consider prescribing 'guaranteed stop losses', so that any market slippage or gapping is a risk borne by the OTC provider.

Impact of Discussion Paper Proposals

A key aspect of the DMA/STP model is the ability to use client monies to hedge client positions. If Treasury introduces regulations which prevent DMA/STP providers using client monies to hedge client positions, this will force an end to the DMA/STP model almost entirely. Subsequent to the introduction of Treasury's proposals, DMA/STP providers would be required to use their own capital to hedge client positions. In this scenario, the Return on Capital ("ROC") for monies that are hedged is relatively low. Investors seek an ROC which is higher than the cash or term deposit rate, and this is not viable for hedged monies. Without funding from investors, or being able to make interest payments on borrowed funds, the possibility for a DMA/STP model to continue is unlikely to be viable if Treasury introduces reforms in line with the Discussion Paper.

If client monies cannot be used to hedge, DMA/STP providers will be forced to begin running risk against their clients in order to generate profit from unprofitable clients, where such positions would previously have been hedged. Not being able to hedge will force DMA/STP providers to run excessive market risk. This will increase overall risk and chances of a firm's insolvency due to settlement failures, possibly impacting client positions or profits.

Running market risk in order to generate profits is a strategy that is used by Market Maker firms. Market risk positions have been the cause of previous failures such as MF Global and Sonray. MF Global and Sonray both met with difficulty as a result of speculating with client money. This is a clear example of instances where client monies should not be used to hedge the CFD provider's exposure.

Market Makers do not hedge all positions held by clients, which creates a far larger risk to a client's funds as a result. This differs greatly to the situation where a DMA/STP provider's exposure is hedged to cover 100% of client exposures and nothing else. As such, clients who have exposure or positions in the markets should cover margin requirements of their own trading from their funds at brokers, and those who do not trade should have their funds maintained in trust.

Perpetuating Conflicts of Interest and Other Key Regulatory Issues

AxiCorp believe that if the proposed amendments are approved it will result in the industry being dictated by Market Makers whose interests are not aligned with those of their clients. This is a key consideration for the development of all financial services laws in Australia since the GFC. AxiCorp notes that the conflict between product issuers, advisers and retail clients is what has driven the development of the *Future of Financial Advice* legislation which is before the Federal Parliament. It seems therefore to be an anomaly that such concepts which perpetuate a conflict between product issuer and retail clients has been put forward by Treasury in relation to the handling of client money.

Perpetuating conflicts of interest between CFD issuers and retail clients in such a manner will have a number of negative consequences. These include:

1. Incentivising Market Making CFD issuers to take on unsuitable clients as they will profit more from losing clients than better informed clients who have a higher likelihood of trading profitably (and therefore not generate any revenue for the Market Making firm). We foresee this will result in Market Making firms either declaring non-compliance with Benchmark 1 in ASIC Regulatory Guide 227 or reducing the suitability requirements for new clients.

2. An increased number of complaints to the Financial Ombudsman Services (FOS) and ASIC.

3. Deteriorating education standards provided by both independent training providers as well as CFD providers (due to Market Maker firms not being incentivised to aid clients to trade profitably).

Stifling the growth and competitiveness of the CFD industry within Australia will simply erode the government's objective of making Australia a financial services hub, particularly in Asia. Based on our knowledge of the retail client landscape, there will be a two-fold effect:

1. Knowledgeable/experienced retail clients will look to companies outside of Australia which have not adopted an approach which stifles the DMA/STP model. AxiCorp notes that there is no recommendation by Treasury to restrict the movement of retail funds out of Australia for the purpose of investing in CFDs or OTC derivatives (in comparison to such regulations being imposed on the United States of America and India). The movement of experienced traders to companies regulated outside of Australia defeats the purpose of imposing new regulation, and has the potential to expose retail clients to a host of issues beyond just client money risk.

2. Less experienced retail clients in the OTC derivative and CFD space will be left with fewer options within the Australian market.

Effectively encouraging experienced Australian traders to send their money out of Australia whilst leaving other traders to face reduced returns on their trading erodes the financial services economy in Australia, rather than improving it in the eyes of overseas investors. Since the increased client money regulatory requirements imposed by the Monetary Authority of Singapore ("MAS") and the Financial Services Agency in Japan, there has been a marked increased in enquiry from traders in these countries, looking to avoid the increased costs being passed on to them by local providers.

AxiCorp would like to see further consultation from Treasury on this issue and some other proposals which better capture the issues pertaining to client monies in the OTC derivatives market.

Please do not hesitate to be in contact with us if you would like to discuss any aspect of our submission further.

Kind regards

Quinn Perrott

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