CITYINDEX

3rd February 2012

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

Dear Sir/Madam

Handling of Client Money

We are writing to you in response to the Treasury Discussion Paper, entitled "Handling and use of client money in relation to over-the-counter derivatives transactions" issued in November 2011.

We welcome the opportunity to provide feedback on the issues and proposals set out in the Discussion Paper i.e. the proposals to improve the handling and/or treatment of client money.

We advise that our request for an extension was granted by Treasury i.e. to provide our submission by 3 February 2011. Thank you for providing this extension.

Before responding to the specific questions in the Discussion Paper, we consider it appropriate, at the outset, to summarise our view and to provide general comments based upon our experience. Thereafter, we have provided responses to the specific questions found on pages 16 to 18 and page 21 of the Discussion Paper. Hopefully, this approach will provide Treasury with a better understanding of the basis for our response.

Introduction to City Index Australia Pty Ltd

City Index Australia Pty Ltd ("CIA") is a company registered in Victoria Australia and is a holder of an AFSL issued by the Australian Securities and Investment Commission.

CIA is part of the global operation called City index that is headquartered in London UK. City Index is a global leader in the CFD trading markets with offices in London, Poland, China, USA and Singapore as well as in Australia. As a group we hold authorisations in a number of jurisdictions including with FSA, NFA, MIS and ASIC.

City Index is part of the IPGL group.

This Submission

In making this submission, CIA will or may be directly affected by the proposals contained in the Discussion Paper.

As a major participant in the local and Asian markets we will be impcted by any changes to current rules. We have also discussed these submissions with other providers both large and small and although this submission represents our position it also reflects what our colleagues are submitting to you directly or via third parties.

Response to the Discussion Paper

We have structured our submission to the matters raised in the Discussion Paper in the sections set out below:

A. Summary.

B. Comments on the objectives of the Discussion Paper.

C. Comments about general market practice and/or what we have observed in the industry.

D. Proposed options listed in the Discussion Paper.

E. Proposed alternate option

F. Responses to the issues and questions summarised on pages 16 to 18 and page 21 of the Discussion Paper.

G. Other reforms/suggestions

H. Conclusion

We request that isolated comments in this submission not be read or taken out of context, but rather the submission be considered in its entirety.

We would be happy to meet with representatives of Treasury following your consideration of this submission to discuss the issues.

We note that we have used the term "product issuer" and AFSL Holder interchangeably. We recognise that not all AFSL Holders are product issuers, but should be subject to the same client money provisions.

A. Summary

This submission identifies a number of issues which are described in greater detail below (and not all issues discussed below are included in this brief Summary).

In summary we submit:

(i) We applaud Treasury's review of this part of the legislation and welcome stronger legislation to regulate, clearly define and remove ambiguity and protect client money.

(ii) We are a strong advocate for strengthening the client money provisions for all AFSL Holders/industry participants and not limiting the changes to only OTC derivative products. If so, there will be inconsistent application or compliance with the treatment of client money if this only applies to OTC derivative products.

(iii) We are a strong advocate that the proposed legislative changes apply to all clients and not be restricted. In our submission is not appropriate to consider all wholesale clients as "sophisticated". However the subject of client definition is a topic for further consideration and although relevant to this topic needs additional consideration and be subject to future discussion papers.

(iv) We request Treasury to take this opportunity in its review of the legislation to provide clear unambiguous guidance regarding the treatment and classification of funds lodged by a client with an AFSL holder to meet margins (initial and variation margins) i.e. are such funds classified as consideration paid for the acquisition of a financial product (thus, money belonging to the issuer) or as collateral paid to secure the rights to the profit and/or loss arising from market movements in a financial product (thus, still retaining the classification of client funds and thus, a liability to clients in the accounts of the AFSL Holder).

(v) We do not consider changing the legislation to mirror protections or regulations in other jurisdictions as the appropriate way forward. Australia has a sophisticated, well regulated financial market and should make decisions in its own right and suitable for the local investment market. The reforms being considered in this paper have the capability of making Australia a leader in the global financial markets rather than someone who is merely adapting another jurisdiction chosen methodology.

(vi) We understand that a number of legal firms are making submissions and at least two separate legal firms have proposed alternate arrangements to the four reform options identified in the Discussion Paper. As such we would encourage Treasury to investigate and consider more fully the alternatives suggested rather than mirroring a system which may or may not work in the local market place.

(vii) Treasury should also take this opportunity in its review of the legislation to consider related legislative problems, namely:

- Currently the legislation prohibits an AFSL Holder from "topping up" the client trust account (s981B Account) on the basis that it is not an authorised deposit. This has resulted in clients of participants of regulated exchanges obtaining better protection than provisions under the Law (where this "topping up" requirement is mandatory – see ASIC Market Integrity Rule ("MIR") 2.2.6(f)).

- There are old Class Orders that provide relief to Prime Brokers to hold client property and money on Trust under certain conditions. These may need to be reconsidered in the current economic environment.

B. Comments on the objectives of the Discussion Paper

We recognise and applaud that Treasury is trying to promote public confidence in the financial markets; in that Treasury is seeking to improve the treatment and handling of client money. We welcome stronger legislation to regulate and define client money and ensure client money is protected at all times together with clear guidance to participants in the industry.

We are a strong advocate of ensuring client money is treated safely and transparently i.e. to ensure it is adequately protected, from the time it is deposited with the AFSL Holder until the time it is returned to the client. At all times money lodged by a client to trade in OTC derivatives (or any financial product until such product has been acquired) should be considered and treated as money owed and belonging to the client.

OTC Derivatives versus Exchange Traded Derivatives

We understand that the Discussion Paper is only intended to apply to OTC derivatives and not to exchange traded derivative products, albeit comments are invited in relation to both instruments.

We emphatically disagree with this argument and would request Treasury to broaden the client money provisions for all industry participants and all financial products i.e. not limit its review to OTC derivatives. Client money should be protected regardless of the nature of the client, financial product and/or by the means in which it is traded. The Law is designed to protect regardless and should be applied equally.

Treasury states inter alia "the collapse of MF Global highlights the need to examine the client money provisions in the Act with a view to determining whether they provide sufficient protection for investors". We would draw to Treasury's attention the numerous examples where counterparties have client money in a Trust Account yet, when they collapsed clients lost their money (or a significant part thereof), such as Lehman Brothers, Opus Prime, Sonray and Refco.

The point we wish to make is that a counter party may have a "strong" balance sheet, hold money in a Trust Account (as defined in s981B of the Corporations Act) and separate from the company's money, but clients' money is still at risk and unprotected.

We believe that Treasury by attempting to distinguish between OTC and exchange traded derivative products has the risk of creating the perception amongst investors that exchange traded products are "safer or more secure".

The fact is all client money covering all financial products (both exchange traded and OTC) and all AFSL Holders should be subject to the same standards. We would argue Treasury should not seek to regulate by product or by a subsection of a product. All financial products should be treated in an equivalent manner.

We agree that in the case of exchange traded derivatives counterparty risk is reduced because of the regulated clearing house (where all contracts are novated and guaranteed). However, as Treasury will be aware this guarantee only extends to the participant of the clearing house and not the client. Further, we note that exchange traded derivatives traded on ASX 24 are possibly or potentially protected by virtue of the Fidelity Fund.

Treasury's stated aim is "to review whether the client monies provisions of the Act provide sufficient protection for investors." Treating exchange traded financial products differently to OTC Derivates will not in our submission achieve this. Indeed it may be misleading to the consumer in that it could potentially create a message of false security and protection. This review provides an opportunity to Treasury to provide clear and unambiguous guidance and not send a confused message to investors.

As a result we do not agree that OTC derivatives should be distinguished from any other derivative products or for that matter, any other financial product.

(C) Comments about General Market Practice

(a) Different market practices/interpretation of current legislation

We fully recognise that the Law is designed to protect the consumer and to ensure that money owed to the consumer (realised and unrealised via the market-to-market valuation process i.e. credit balance of the account) is secure and protected at all times.

In particular, clients' money or property which is held pursuant to Part 7.8 of the Corporations Act i.e. in a Clients' Trust Account or Clients' Segregated Account is not available to pay general creditors of the AFSL Holder in the event of administration, receivership or liquidation of the AFSL Holder.

Division 2 of Part 7.8 sets out the obligations of AFSL Holders in relation to client money. In short, AFSL Holders are required to establish and maintain a separate account in which to hold client money i.e. the AFSL Holder must ensure that it pays client monies received into a trust account (or trustable manner such as a clients' segregated account) and that it segregates client money from AFSL Holders money. Our argument is that the definition of client money is imprecise and ambiguous.

Section 981A(2)(c) of the Corporations Act states that the client money provisions does not apply to money paid to the extent that...."*the money is paid to acquire, or acquire an increased interest in, a financial product from the licensee, whether by way of issue or sale by the licensee".*

As a result, we have found that many industry participants have structured their products whereby they treat Initial Margins and/or Variation Margin payments as funds that belong to the company (product issuer). This is on the basis that they are taken as payments for 'the acquisition of the product'. Alternatively, client agreements affect the transfer of ownership to the product issuer.

Accordingly, the AFSL Holder considers that it may use the funds as its own and as it sees fit, including meeting its financial commitments with its hedging counterparties (i.e. hedging the transactions to which it has entered into with its clients).

There are two points of view on this concept and it is interesting to make the comparison in relation to buying another type of asset (other than a derivative), such as a yacht:

- One school of thought suggests that ownership in the "product" (e.g. yacht) vests with the buyer when full consideration is paid for it, not when a margin or deposit is lodged.

  In other words, just because a person pays a deposit for a product (e.g. yacht), that payment does not make the product (yacht) theirs, until it is fully paid for i.e. ownership is transferred when full payment for the product (yacht) is made and the deposit paid represents collateral.

- The other school of thought argues that the ownership of the product (yacht) does vest to the buyer (i.e. it is owned by that person). However, that person also now has a debt (financial obligation) as a result of acquiring the product (yacht).

CIA firmly considers margin payments to fall into the first school of thought i.e. it is money belonging to the client and should be treated as such.

CIA considers that the intention of the section (s981A(2)(c)) was for financial products such as an insurance policy where a customer pays a premium. In such a circumstance, CIA agrees, that such payment does not need to go into a Client Trust Account (981B Account) and can be treated as consideration paid for the acquisition for the financial product. Hence, the AFSL Holder can deposit the money straight into their operating account.

However, this does not mean that margins (deposits) can be treated in a similar fashion. Nonetheless, CIA is aware that many legal advisers have taken a different view/interpretation (and thus, so have numerous AFSL Holders acting on such advice).

Accordingly, some industry participants (product issuers) treat and/or classify funds lodged by a client with an issuer (e.g. to meet (initial and variation margins) as consideration paid for the acquisition of a financial product (thus money belonging to the issuer) as opposed to collateral paid to secure the rights to the profit and/or loss of market movements in a financial product (thus still retaining the classification of client funds and thus, a liability to clients). Alternatively, client agreements affect the transfer of ownership to the product issuer.

We believe that many participants have misinterpreted the current legislation and that the **money should remain as client money,** notwithstanding that it may be used for the purposes of meeting obligations incurred by the AFSL Holder in hedging its positions with counterparties/liquidity providers).

In other words:

- if the AFSL Holder withdraws money from the Clients' Account and pays the money to a counterparty (to hedge the risk), then the AFSL Holder should be required to advise the counterparty that the funds ultimately belong to its clients and counterparty must pay the monies into its own Clients' Trust Account or Clients' Segregated Account (or Client Account) - in this regard we refer to MIR 2.2.6(e). We submit that a similar rule should apply to all financial products and not just exchange traded derivatives

- if the counterparty then withdraws money from the Clients' Account and pays the money to its liquidity provider, then the counterparty should be required to advise the liquidity provider that the funds ultimately belong to its clients and the liquidity provider must pay the monies into its own Clients' Trust Account or Clients' Segregated Account (or Clients' Account or equivalent).

It should also be noted that this is how exchange traded derivatives flow of funds work all the way up the chain to the Clearing House where the Clearing House maintains two accounts for the Clearing Participant i.e. a House Account and a Client Account. Thus, client money (and positions) are always segregated from the participant's money (and positions).

To explain the second scenario further, we provide the following simplistic example:

Let's assume the AFSL Holder operates 2 bank accounts:

1. AFSL Holder Operating Account; and
2. AFSL Holder Clients' Trust Account.

Furthermore, let's assume the following occurs:

- Day 1 – a client deposits $5,000 into the AFSL Holder Clients' Trust Account.
- Day 2 – client enters into a derivative contract which requires an initial margin of $3,000. The AFSL Holder transfers $3,000 from the Clients' Trust Account into its Operating Account.
- The AFSL Holder then opens a position with its hedging counterparty (in its name) and transfers funds (margin as collateral) from its Operating Account to its hedging counterparty (may not necessarily be $3,000 as positions are run on a net book basis).
- Day 3 – the market moves against the client's position and a debit variation margin arises in the amount of $1,000. The AFSL holder transfers $1,000 from the Clients' Trust Account into its Operating Account.
- The AFSL Holder transfers extra funds to its hedging counterparty to cover the variation margin (assuming it is called by the hedging counterparty).
- Day 4 – the AFSL Holder goes into liquidation (for whatever reason).
- Day 5 – the Liquidator closes all open transactions and instructs the counterparty (the hedging counterparty) to return all proceeds in the manner in which they were received.
- Day 6 – the hedging counterparty returns all proceeds to the AFSL Holder Operating Account. The Liquidator then takes this money to pay the general creditors (as it is not considered client money).

However, had the money been withdrawn from the Clients' Trust Account (instead of the Operating Account), then the hedging counterparty would have been placed on notice (advised) that the funds belonged to the AFSL Holders clients. Furthermore, all proceeds would be returned in the manner in which they were received i.e. to the AFSL Holder's Clients' Trust Account. As a result, the Liquidator would not be able to use these funds to pay the general creditors.

Accordingly, in this situation, the client would only lose the market value of the contract (i.e. $1,000 which is appropriate as the market moved against the position) from the proceeds and not the initial margin ($3,000 which was provided as security for the contract).

We consider s981A(2)(b) was introduced for specific circumstances where the licensee pays for the financial product and is seeking reimbursement from the client, such as where a licensee pays for the settlement of securities on behalf of the client (for example the client does not meet the settlement time requirements of the securities exchange).

Thus, in summary, even though s981D enables client money to be used to meet obligations incurred by the AFSL Holders (and in turn so can the hedging counterparty) in connection with dealings in derivatives on behalf of itself, including dealings on behalf of people other than the client (i.e. other clients), the point is that the money remains client money notwithstanding that it may be used for the purposes of meeting obligations incurred by the licensee.

Thus, initial (and/or variation) margins do not belong to the AFSL Holder (and/or the hedging counterparty). Rather, the AFSL Holder (and in turn the hedging counterparty) is permitted to use the client funds (pursuant to section 981D) to meet its obligations with its counterparty.

Thus, a big issue is how (under what notification) the funds are transferred to the hedging counterparty from the AFSL Holder. In other words, in what capacity are the funds transferred:

- in the name of the AFSL Holder (i.e. as principal); or
- in the name of the AFSL Holder (as undisclosed principal i.e. in the name of the AFSL Holder but on behalf of undisclosed clients). In other words, the hedging counterparty is placed on notice that the funds ultimately belong to the AFSL Holders clients.

(b) ISDA Agreements

Pursuant to Section 981D of the Corporations Act, many AFSL Holders use client funds for entering into contracts, for margining, guaranteeing and/or settling transactions on behalf of clients with their hedging counterparties.

However, we have identified that these AFSL Holders are forced to enter into Agreements i.e. ISDA Agreements (with these hedging counterparties) which states that the funds are unencumbered.

The AFSL Holders also have limited ability in changing the terms of the ISDA Agreements and as such are entering into agreements that are not specifically correct.

(c) Co-mingled Funds

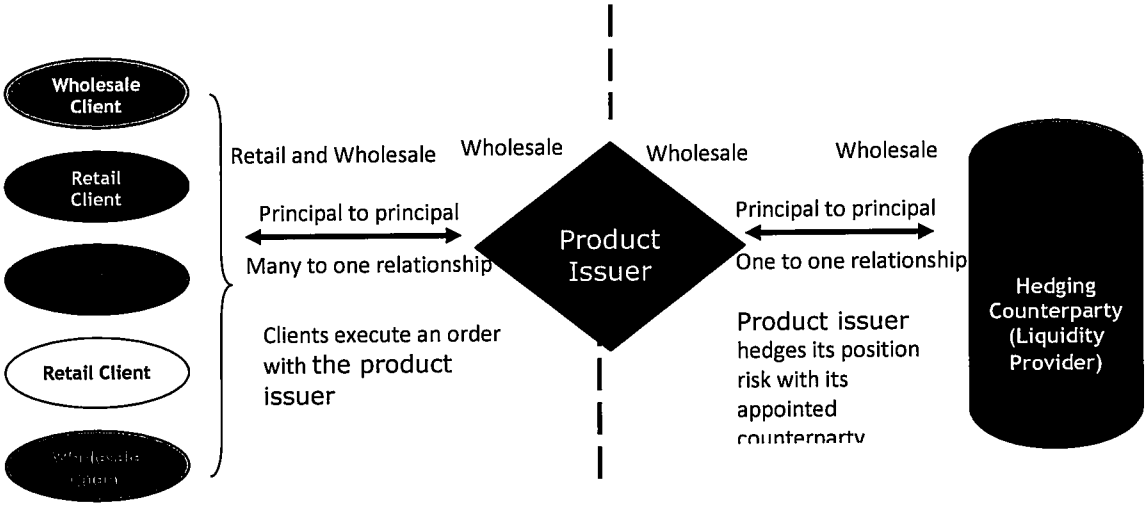
We note the Discussion Paper identifies that all client monies are combined and deposited by an AFSL Holder in a Clients' Account. However, individual client monies are not separated from each other i.e. they are co-mingled.

The operation of the Clients' Account may not protect an individual client's money in the case of default arising from the trading of any other client of the AFSL Holder.

In this event, assets in the Clients' Account of non-defaulting clients are potentially at risk as the AFSL Holder has the right to apply all clients monies held in the Clients' Account to meet any default of another client.

This treatment of client funds is common practice and applies to all AFSL Holders and all derivative products i.e. client funds are not held in separate (individual) bank accounts for each client.

This is on the basis of the business structure described below:



This means that the product issuer operates as a stand-alone company and all activities are operated **in its name (as principal)** i.e. each relationship and related transaction is agreed and entered into with clients as principal (i.e. in the name of the product issuer and not in the name of the hedging counterparty).

The product issuer then hedges its exposure (or "book") with its hedging counterparty in its name (and not in the name of its clients). In other words, the hedging counterparty has ONE client i.e. the product issuer. Hence, funds are transferred to and from one account. Operating multiple accounts for each client become untenable.

C. Proposed options listed in the Discussion Paper

The Discussion Paper has listed four proposed reform options to strengthen the classification and treatment of client funds. We believe that there is another possible alternative that acts in the best interest of clients and achieves Treasury's objectives, yet it also maintains competitive fairness i.e. it largely improves the protection of client money for all industry participants, large and small (please refer to Section 5 below for additional information).

Proposed options canvassed for comment:

(i) Restriction on the use of client money

We believe that forcing the issuer to use its own capital to meet their hedging obligations will not guarantee the protection of client funds.

This is on the basis that:

(a) This will primarily affect smaller and less capitalised product issuers and not the larger institutions such as MF Global (which apparently triggered this review).

The issue is that money held in Trust i.e. in a section 981B account is currently not adequately protected. We submit that it necessary to focus attention on where the weaknesses are which is not just using client monies for margining of hedging transactions by the AFSL Holder.

(b) This will result in the smaller and less capitalised product issuers to take more risk.

The proposed reform option punishes smaller and less capitalised product issuers for hedging their market risk. In other words, most smaller and less capitalised product issuers enter every transaction on a "matched book" basis or "back to back" basis. This means that each trade agreed and entered into with the client as principal is offset or matched immediately with a similar trade with a hedging counterparty. Hence there is no market risk to the AFSL Holder.

By restricting the use of client money as proposed, product issuers will need to use their own capital to hedge. The smaller and less capitalised product issuers will need to amend their current practices and will result in the product issuers running a "book" and either hedging the net book or taking a risk and either implement partial hedges or not hedging at all. This means that some of the transactions will not be hedged with a counterparty at all. Instead, the product issuer will prefer to manage the risk internally. Should they get this wrong, then this will have extreme detrimental implications on their continuing to maintain sufficient capital and potentially lead to more collapses.

We believe that by restricting the use of client money it will result in product issuers being required to use their own capital which will result in them taking on more risk. This is a far more undesirable consequence as client money may be far less protected.

We also make mention that the product issuer is only entering into a hedged transaction as a result of dealings with the client (as principal).

(c) The proposed change will result in far less competition. Competition has been extremely good for the consumer, bringing down the bid offer spread dramatically.

(ii) Adopt the UK approach

For the reasons listed above, we do not agree that a licensee should be prevented from using client money to hedge its own position (in derivatives) as this will result in the licensee being forced to use its own capital to hedge its positions.

There is also the potential problem is that the industry is fast growing and prescriptive rules cannot always keep pace with an evolving and changing market.

We also make mention that the product issuer is only entering into a hedged transaction as a result of dealings with the client (as principal).

(iii) Impose a statutory trust fund

For the reasons listed above, we disagree with imposing a statutory trust fund whereby a licensee would be prevented from using client money to hedge its own position in derivatives, resulting in the licensee using its own capital to hedge its positions.

We also make mention that the product issuer is only entering into a hedged transaction as a result of dealings with the client (as principal).

(iv) Adopt segregated individual accounts

Technology may have advanced significantly, but to date this has largely been impractical for the product issuer to implement and/or manage. In other words, the product issuer has many clients but hedges using one account with its hedging counterparty (on a net basis and not gross). Refer diagram above (page 8) for further information.

The cost of opening and managing separate accounts for each client also needs to be taken into consideration.

Proposed alternate option

CIA is aware of alternate structures that have been developed by legal firms used by product issuers, including Audax Legal Pty Ltd and Gadens lawyers. We too understand that Audax Legal Pty Ltd and Gadens lawyers have lodged submissions to this Discussion Paper providing a full description of their alternate structures. The intention, we understand, is to ensure better transparency and the aim of improving client protection.

From a practical point of view, we understand that the proposed structures are logical, robust and well designed. The structures also appear to be in the best interest of the product issuer's clients. It will also enable the product issuer to sign any ISDA Agreements which require the funds to be unencumbered.

We have not duplicated the explanation of the structures in this submission but instead refer you to the detailed submission lodged by these entities.

D. Responses to the issues and questions summarised on pages 16 to 18 and page 21 of the Discussion Paper

Issues for comment:

Your feedback:

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 license?

   RESPONSE:

   No, we do not believe this will achieve the desired outcome i.e. to protect client money.

   (a) Simply because client money is held in Trust (s981B account) does not mean it is protected. There are numerous recent examples of this.

(b) We believe the law should clearly specify what is client money so there is no confusion i.e. there is still scope to classify client money as consideration paid for the acquisition of a financial product (thus, money belonging to the issuer).

As stated above, we are a strong advocate that the law should protect client money at all times. However, this is best achieved by mandating a statutory trust fund (explained above). To enhance procedures, Treasury could even consider mandating the Trustee be a separate legal entity from the product issuer.

We also do not believe that this should only apply to retail clients. It is inappropriate to consider all wholesale clients as "sophisticated". Moreover, the legislation is designed to protect all consumers and not just a subset of consumers.

(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?

RESPONSE:

No, the only way for this to operate would be to maintain separate trust accounts for each client. This is costly, a massive administrative and compliance burden and impractical.

Treasury should instead mandate a prompt "top up" requirement (as described above and contained in the MIRs – 2.2.6(f)). Currently the legislation prohibits AFSL Holders from topping up the client trust accounts (s981B Account) on the basis that it is not an authorised deposit. Compliance with this provision should be regularly monitored by ASIC.

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?*

RESPONSE:

Refer above. Licensees should continue to be able to pay such funds into clients' segregated accounts.

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)?*

RESPONSE:

This should apply to ALL derivatives, including exchange traded derivatives and all other financial products (where relevant).

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 in 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)?*

RESPONSE:

Yes, the regulations should be changed to limit the ability of an AFSL Holder to pay money out of the client money account at the written direction of the client in instances where the client provides a specific written direction for each individual payment out of the account.

We agree that the use of general and broad client directions in the client agreement of AFSL Holders from clients to enable the AFSL Holder to make withdrawals from client money for any purpose whatsoever is not I appropriate and is beyond the intent of the legislation.

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?*

RESPONSE:

Yes, we strongly recommend to all clients that they implement procedures to reconcile their Client Trust Account on a daily basis and ensure that it has sufficient funds to meet the gross client balances owed to clients.

We also note that the gross client balances must be used to calculate the liability to clients rather than the net client balances otherwise this may result in a deficiency of cash to cover liability to clients.

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?*

RESPONSE:

Yes, we agree that there must be a lack of clarity if there are different interpretations of section 981D of the Act. Our view of the correct interpretation is that a licensee is permitted to use client money to pay margin calls to its hedge counterparty i.e. to meet its own obligations (dot point number two on page 7 of the Discussion Paper). This is our preferred interpretation for the reasons listed above.

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.*

RESPONSE:

If the current approach is retained, yes we believe that the application should be altered. Clear guidance should be given as to the treatment and classification of funds lodged by a client with an issuer to meet margins (initial and variation margins).

Pooling of clients' money should be permitted only on the premise that:

(a) Currently the legislation prohibits AFSL Holder from topping up the client trust account (s981B Account) on the basis that it is not an authorised deposit (in contrast to participants of the ASX 24 where it is mandatory to top up within 5 days).

(b) Treasury should mandate a speedy and prompt top up requirement by the product issuer. If the client does meet their obligations, then the product issuer should be required to do so using their own capital.

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.*

RESPONSE:

Refer above.

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

RESPONSE:

No, this should apply to all clients.

It is inappropriate to consider all wholesale clients as "sophisticated". Moreover, the legislation is designed to protect all consumers and not just a subset.

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.*

RESPONSE:

The current legislation requires that client funds must be held in an ADI (i.e. Australian bank) or an approved foreign bank. ASIC has not approved any foreign banks and should consider doing so.

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

RESPONSE:

Yes, as that entity would be subject to the legislation in that jurisdiction (e.g. where MF Global Australia transferred funds to MF Global USA).

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

RESPONSE:

Yes, the law should make it clear in what circumstances a licensee can claim entitlements to the money held in trust. At the moment, it is open to interpretation.

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?*

RESPONSE:

Yes, AFSL Holders should be required to segregate amounts that would be due to a client if a derivative position was closed. Where a client has closed all open positions the resultant account balance should not be exposed to risk at all to other clients which have open positions and which have counterparty risk (as well as market risk).

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?*

RESPONSE:

No comment, other than to say the Act applies to all consumers, not just OTC derivatives clients.

In our experience, most OTC derivatives product issuers actually send daily statements to their clients identifying the cash balance in their account together with margin obligations and the resultant excess cash position.

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

RESPONSE:

Yes. However, as noted in response to Question 1, most OTC derivatives product issuers actually send daily statements to their clients.

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

RESPONSE:

Most providers issue daily statements to clients.

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

RESPONSE:

It is done daily in most situations.

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)?*

RESPONSE:

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.*

RESPONSE:

We do not believe that the proposed changes we have suggested (i.e. to operate a statutory trust significantly add to the compliance costs to operate a financial services business (assuming any external trustee services are commercial and reasonably priced).

E. Other reforms/suggestions

Whilst this section of the Law is being reviewed, can we also suggest Treasury liaise with ASIC and review previous ASIC Class Orders and in particular the Class Orders giving relief to Prime Brokers that are ADIs relief to hold client property and money on Trust under certain conditions.

In particular we refer to:

- Class Order 03/1110 gives relief to Prime Brokers from the obligation to hold client property on trust (specific conditions apply i.e. the property consists of securities, the licensee holds the securities under a prime brokerage agreement, the client is a wholesale client and the licensee and client agree in writing);
- Class order 03/111 gives relief to AFSL Holders (e.g. Prime Brokers) who are an Australian ADI from the obligation to hold scheme property separately; and
- Class order 03/1112 gives relief to AFSL Holders (e.g. Prime Brokers) who are an Australian ADI from the obligation to hold a client's money on trust where the client is a wholesale client and the licensee and client agree in writing.

This means that money is being co-mingled on the Prime Brokers balance sheet and is largely at risk.

We recommend that these be reconsidered in the current economic environment.

F. Conclusion

We reiterate our admiration for Treasury reviewing this section in the legislation and welcome stronger provisions to:

(i) define client money; and

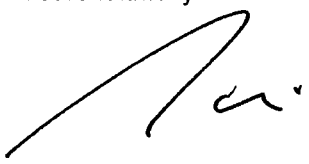
(ii) ensure that client money is protected at all times.

We believe an alternate solution to those proposed in the Discussion Paper is the most suitable reform option and requires due consideration (refer section 5 above).

We also believe that Treasury should take a broad brush approach and any changes to client money provisions should impact all financial products i.e. derivatives and/or other, they should apply to exchange traded and OTC financial products and apply to all client types (i.e. retail and wholesale).

We would welcome the opportunity to discuss the issues raised in this submission with you. If you consider this would be of benefit, please contact us to arrange a mutually convenient time to meet.

Yours faithfully



IAN MAKIN
Legal and Compliance Manager
City Index Australia Pty Ltd