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27th January 2012

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

Handling and use of client money in relation to over-the-counter derivatives transactions

Submission by First Prudential Markets Pty Ltd in response to November 2011 Discussion Paper

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Dear Sir/Madam,

First Prudential Markets Pty Ltd (**FP Markets**) supports a need for change with respect to the handling and use of client money in relation to over-the-counter derivatives transactions and welcomes the opportunity to make a submission in response to the *Handling and use of client money in relation to over-the-counter derivatives transaction: Discussion Paper,* November 2011 (**Discussion Paper**).

In making any changes we urge Treasury to bear in mind that there are currently three models for issuing contracts for differences (**CFDs**) in Australia — the direct market access model (**DMA**), market marker model (**MM**) and exchange traded CFDs **(ASX24 CFDs**). Some of the changes proposed in the Discussion Paper will have different impacts on the various CFD models.

While we support change, in our view it is important that change is effected in a way that not only better protects retail clients, but also enables retail clients to continue to have the benefit of access to all three CFD models. We submit that this can be achieved only by enabling the CFD industry to operate efficiently for the benefit of its clients and the market as a whole.

We submit that a complete ban on the use of client money for hedging in all circumstances will disproportionally impact the DMA model because the DMA model has higher hedging requirements. In our view, a ban on the use of client money for hedging is likely to significantly reduce competition, increase commissions paid by clients and reduce access to the many of the benefits which a DMA model offers, such a guaranteed market prices, and an alignment of interests between the CFD provider and the client will be reduced considerably.

Further, we urge Treasury, in its consideration of international best practice, to bear in mind the differences that may exist between other markets and the Australian market. In particular, the UK market is predominantly characterised by spread betting, with little DMA available, whereas the Australian market is largely characterized by DMA as the tax advantages for retail clients, which have driven the growth of spread betting in the UK, are not available to Australian clients.

We have made a number of proposals in our submission, which we believe will both provide additional protection to retail clients while enabling CFD providers to continue to operate in a competitive CFD market which offers the benefits of DMA, MM and ASX24 CFDs.

We would welcome the opportunity to further discuss any matters raised in this submission or provide additional information if required.

Yours sincerely,

Matthew Murphie
Managing Director

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1. Introduction

First Prudential Markets Pty Ltd (**FP Markets**) welcomes the opportunity to comment on Treasury's Handling and use of client money in relation to over-the-counter derivatives transactions: Discussion Paper, November 2011 (**Discussion Paper**).

As a major player in the Australian contracts for differences (**CFD**) industry, FP Markets acknowledges that changes are required in relation to the handling and use of client money in relation to over-the-counter derivatives transactions.

In this submission, FP Markets proposes some specific changes designed to both:

(a) protect investors;

(b) clarify licensee's obligations under financial services law,

but to do so in a way that also allows the CFD industry to operate efficiently for the benefit of CFD investors and the financial markets more broadly.

The CFD market in which FP Markets operates is an important market which provides both:

(a) healthy competition; and

(b) liquidity,

in relation to financial markets as a whole.

In this submission we address the Issues for comment identified in the Discussion Paper but also include some additional information which we believe relevant in context of the submission.

Industry background

There are three very different contracts for differences (**CFD**) models used in Australia — those offering CFDs via direct market access (**DMA**) (where the issuer fully hedges all CFDs), those offered via a market maker (**MM**) model (where the issuer runs some risk against client positions) and exchange traded CFDs (**ASX24 CFDs**).

We note that the proposals canvassed in the Discussion Paper are primarily concerned with the use of client monies for hedging. In our view, CFD providers offering DMA are likely to be adversely affected by these proposals as they will have difficulty hedging all orders and will require more capital in a relative basis, despite not running market risk. On the other hand, MM CFD providers would clearly benefit from such proposals, as the MM model does not require the same level of hedging. MM providers would no longer face healthy competition from DMA providers.

We urge Treasury to consider the commercial interests of industry participants making submissions, in order to focus on the goal of better protection of retail clients when dealing in CFDs.

FP Markets

FP Markets is an Australian owned company which has been trading since 2005. We are an active promoter of DMA. We have in excess of 3,000 active CFD clients and currently execute more than 5,000 client trades per day, all of which are executed on an underlying exchange.

Under FP Markets' DMA model, all client orders are directly and fully hedged in the underlying market. This means we do not take any proprietary positions and do not make money from client losses. So, unlike some CFD providers, our commercial interests are aligned with those of our clients.

Research conducted from Investment Trends[1] indicates that 73% of our clients cite DMA as a reason for trading with FP Markets rather than a MM CFD provider. We are continuing to grow and experience record account openings which indicates that there is a strong demand for DMA in Australia.

FP Markets does not take any proprietary positions. We derive all our revenues from commission and financing and do not benefit from client losses. Consequently, our business model is focused on giving retail clients every opportunity to make money in the markets. This means it is in our interests for our clients to be as successful as possible, on an ongoing basis, so that they are far more likely to continue trading with us.

If, in the future, we cannot use any client money to hedge our clients' orders we will have great difficulty continuing to offer DMA.

In the case of FP Markets, because we offer CFDs via DMA, a prohibition on the use of client monies to hedge is likely to end our current business model. We understand that other DMA providers may face similar concerns.

While we support tighter regulation and / or increased capital requirements for those using client monies to hedge, we strongly believe that it is not in the best interests of retail clients, to prohibit the use of client monies for hedging purposes as this is likely to reduce competition and innovation within the industry, increase pricing to retail clients; and increase the potential for a conflict of interest between CFD providers and their clients.

Alignment with international best practice

We note the reference in the Discussion Paper to aligning client money arrangements with international best practice. In our view, it is critical to bear in mind the significant differences between the Australian CFD market and other international CFD markets.

In the Discussion Paper, Treasury canvasses the proposal to change the law in Australia to replicate the UK's client money law. However, we note that the UK market is dominated by spread betting. In the UK, spread betting provides clients with tax advantages over trading CFDs — the profits from spread betting being free from tax to the investor in the UK as it is deemed to be gambling rather than investing. Spread betting providers pay a tax (duty) of 3% calculated on the 'net stake receipts' of client losses, calculated

[1] Investment Trends Pty Ltd, Australia CFD Report 2011

without taking hedging into account.[2] The tax advantages of spread betting do not exist in Australia and CFD providers are not required to pay a duty of 3% of net client losses as spread betting providers are in the UK. This has resulted in the Australian market being shaped very differently. Spread betting clients are estimated at 83,000 in the UK, with only 16,500 CFD clients.[3] In Australia, it is estimated that there are 41,000 CFD clients and no spread betting clients.[4]

The dominance of spread betting in the UK market, and the taxation regime that applies there, has given rise to UK business models whereby risk is run against clients, which lowers hedging requirements. As a result UK CFD businesses are set up on a market maker model, and the DMA model has very little market share.

In contrast to the UK, in Australia it is estimated that direct market access CFD providers hold over 25% market share and 50% of CFD traders cite direct market access as an important feature. [5] Furthermore, from data available from the Australian Stock Exchange, we estimate that the average volume per equity CFD client for direct market access providers is twice that of market makers, as traditionally larger volume clients prefer the transparent pricing of the direct market access model. Therefore, in terms of volumes, we estimate that in Australia over 50% of equity CFD turnover is made up of retail clients opting for direct market access, whereas in the UK, from observing the Investment Trends report, this figure could be reasonably assumed to be less than 5%.

The wider use of direct market access by retail clients in Australia means that the introduction in Australia of UK-style client money laws would have a much larger impact on clients in Australia than they have had in the UK, as the market dynamics are very different.

Further, as a result of the different landscape in the UK, market making CFD providers in Australia tend to originate from the UK while direct market access providers tend to originate in Australia. Moving Australian regulations into line with the spread betting dominated market in the UK will favour UK businesses with spread betting origins and disadvantage Australian CFD providers whose business models are more tailored to the Australian market.

Other markets of note

The Singapore CFD market is largely characterised by direct market access and allows DMA providers to use client money for hedging purposes.

We also note initiatives in the United States where a 'legally segregated, operationally comingled' (LSOC) has recently been adopted by the Commodity Futures Trading Commission (**CFTC**). This model requires

[2] Notice 451 General Betting Duty, April 2010
[3] Investment Trends Pty Ltd, UK Spread Bet and CFD Report 2010
[4] Investment Trends Lty Ltd, Australian CFD report 2011

[5] Investment Trends Pty Ltd, Australia CFD Report 2011

complete legal segregation; however client money can be used to hedge client orders and may be commingled. [6]

In considering a move in line with international best practice, we urge Treasury to consider those markets with comparable products and business models.

[6] Commodity Future Trading Commission, Billing Code 6351-01, 17 CFR Parts 22 and 190, RIN Number 3038- AC99, Protection of Cleared Swap Customer Contracts and Collateral: conforming Amendments to the Commodity Broker Bankruptcy Provisions.

2. Responses on Issues for comment

1. Should the law be amended so that:

(i) client monies held on behalf of a retail client cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee; or

While FP Markets strongly supports law reform with respect to the handling and use of client monies, we believe that a law amendment which prohibits the use of client monies for meeting obligations incurred by the licensee in connection with margining would have a negative impact on the CFD industry.

Therefore, in our view, the law should not be amended to prohibit client monies held on behalf of retail clients being used to meet obligations incurred by the licensee in connection with derivatives, as proposed above.

Why FP Markets opposes this proposed amendment

The proposed amendment would have significant negative implications for direct market access CFD providers, as they would be required to use their own funds to hedge client positions. Consequently, despite the fact that direct market access providers do not run market risk, they would be required to be significantly more capitalised, on a relative basis, than market making CFD providers who do run risks against their clients.

Direct market access CFDs providers offer retail clients many advantages — such as guaranteed market prices, no re-quotes and an alignment of interests between the providers and the clients. These advantages are likely to be largely lost, or be offered in a far less competitive environment, in the event of the proposed amendment.

Further explanation as to why direct market access businesses may be adversely affected

The below example compares the capital requirements for both a direct market access CFD provider and a market maker CFD provider, assuming that they had the same value of client open positions. Traditionally, counterparty requirements are approximately 25% of the value of positions hedged and therefore this figure has been used below.

Direct market access CFD providers do not run market risk and so hedge 100% of client orders. Market maker CFD providers do run market risk and will not be fully hedged. For this reason the example below shows client open positions and hedge open positions identical for direct market access providers, and hedge open positions as 50% of the client open positions for market maker CFD providers.[7]

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[7] 50% hedging of client positions by market maker CFD providers is our best estimate based on ASX turnover executed by Market Makers which is publicly available, correlated with market share outlined in Investment Trends Pty Ltd, Australian CFD Report 2011.

If client monies cannot be used for hedging purposes, the direct market access CFD provider would require $12,500,000 of its own funds to hedge a $50,000,000 portfolio where as a market making CFD provider would require the lesser amount of $6,250,000 for the same client exposure.

Because it has unhedged positions, the market maker has a commercial incentive to attract loss making clients, whereas a direct market access CFD provider has a commercial incentive to foster profit making clients, as it is profit making clients that continue to trade and generate commissions for the direct market access CFD provider.

	DMA Provider	MM Provider
Client Open Trades	$50,000,000	$50,000,000
Hedge Open Trades	$50,000,000	$25,000,000
Counterparty Margin Requirements @ 25%	$12,500,000	$6,250,000
Value at Risk	Zero	$25,000,000
Difference in capital requirements	$6,250,000	

Regulatory Guide 227: Over-the-counter contracts for difference: Improving disclosure for retail investors (August 2011) contains the following questions in the *Appendix: Questions a potential investor should ask a CFD provider*.

- *What is the financial position of the CFD provider?*
- *What is the CFD provider's policy on the use of client money?*
- *How does the CFD provider determine the prices of CFDs they offer?*
- *Can the CFD provider change or re-quote the price after you have already placed your order?*
- *When processing CFD trades, does the CFD provider enter into a corresponding position in the market for the underlying asset?*
- *If there is little or no trading going on in the underlying market for an asset, can you still trade CFDs over that asset?*
- *Does the CFD provider let you trade CFDs even if the underlying market is closed?*

We believe that the proposed amendment is likely to lead to a less favourable answer to these questions, which ASIC has identified as relevant for retail clients.

A market making CFD provider may not necessarily be in a strong financial position, but because their business model is to run market risk, and do not fully hedge their client's positions, they will be better positioned to cater for the proposed amendment than a business (which may be financially stronger) operating a direct market access model. A DMA CFD provider may not be able to meet the increased costs resulting from the proposed amendment despite running no market risk. This may result in retail clients trading with CFD providers whose business model suit the proposed amendment, rather than CFD providers that are necessarily in a stronger financial position.
Despite being in a relatively strong and profitable position, due to our DMA business model, the proposed changes would put us in an unworkable position while making relatively little difference to the position of CFD providers using the market maker model. This in turn may result in retail clients being denied the option of accessing a DMA provider.

ASIC's further questions for retail clients to ask their CFD provider (set out above) suggest that trading with a CFD provider who does not re-quote and that trades in the underlying market is important to retail clients. It is direct market access that offers these advantages for retail clients.

(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?

No, we are not in favour of this proposed amendment for practical reasons. Using only monies deposited by a client for securing their transactions, and ensuring that such money is not used to secure hedging of other clients orders, would cause difficulties for a number of reasons:

- CFD providers margin hedge contracts on a book level. This means that CFD providers receive a margin rate that is reflective of all positions held. Allocating margin requirements to underlying clients, and ensuring that only that client's money is used to hedge their position, would be difficult as this margin requirement is made up of all client hedge positions on a collective basis. The CFD provider does not receive margin on an individual position basis and the composition of the hedge positions will effect overall margining. As a result CFD providers may find it difficult to comply with this proposed amendment.

- Counterparties only have one client who is the CFD provider and margins the CFD provider according to both the counterparties risk requirements and the amalgamated positions that the CFD provider may hold. CFD providers use counterparties to hedge client orders and such counterparties are not in a position to record underlying clients as this is the function of the CFD provider. To ensure that money provided by one client is not used to hedge another clients order would require records to be kept by counterparties. Without such record keeping, counterparties would not be aware of amounts owing to the underlying (individual) client of the CFD provider and therefore difficult to ensure that they did not commingle funds.

- The following example illustrates these difficulties.

  For simplicity we have assumed that there are only four clients and four positions. The CFD provider sets margins as shown below which range from 5% for BHP through to 60% for AOH. All positions are assumed to be the same value of $100,000. The sum of the margins collected from the underlying clients is $100,000 and the average margin is 25%. The average counterparty margin is also 25%, however, this margin requirement is set equally across all stocks. From a counterparty margin perspective, BHP and AOH may be margined at the same rate, however, for risk management it is necessary for the CFD provider to vary margins offered to clients. This discrepancy makes it difficult to know what margin taken from retail clients is attributed to which positions (margin) on a counterparty level.

Margin Monies

Stock	Position Size	Client Margin Requirements	Client margin monies	Counterparty Margin
BHP	$100,000	5%	$5,000	25%
LNC	$100,000	10%	$10,000	25%
BTA	$100,000	25%	$25,000	25%
AOH	$100,000	60%	$60,000	25%
	Total Exposure = $400,000	**Average Client Margin = 25%**	**Total Client Margin = $100,000**	**Average Counterparty Margin = 25%**

In summary, FP Markets is not in favour of this proposed amendment as we believe that this is not practical due to an inability to directly reference retail margin requirements set by the CFD provider against wholesale margin requirements set on an omnibus level by counterparties and an inability for counterparties to keep records on an individual retail client basis.

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?

Yes, licensees should be able to continue to pay funds into a client segregated account, however tighter controls around client segregated accounts are required. In our view, appropriately administered trust accounts would provide protection of client money without the need for individual trust accounts for each client.

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)?

No, in our view the proposed client money changes should not be applied in either case. We are a member of the exchange and have clients who trade listed ASX24 CFDs. In our view, not being able to use client money to hedge client orders would have a similar outcome in either case.

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

We agree that general client directions should not be used inappropriately to give licensees broad authorisations to make withdrawals from s.981B accounts. However, in our view the regulations should not be changed to limit the ability of a licensee to pay money out of the client money account at the written direction of the client to instances where the client provides a specific written direction for each individual payment out of the account.

In order to mitigate our client's exposure to our hedge counterparty risk, we hold any client monies (in excess of the margin requirements) in the client trust account. In our view, this is best practice and reflects Regulatory Guide 212: Client money relating to dealing in OTC derivatives (July 2010).

At RG 212.69, ASIC states

> *The amount of client money that is used in exercise of this right [that is, the permitted use in section 981D of the Corporations Act] must also be limited to the amount necessary to meet the licensee's obligations so incurred in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives.*

As a result, daily payments are made from the client trust account to hedge counterparties and vice versa to ensure that all excess client cash above margin requirements is held in the client trust account. As complying with RG 212.69 requires daily cash movements, specific written direction for each individual payment out of the account would be unduly onerous on both clients and CFD providers.

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?

Yes, licensees should be required to conduct regular, if not daily, reconciliation of client money and have documented processes in place to escalate and resolve unreconciled variances that are identified.

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

Yes, we consider there is a lack of clarity as to the meaning of the law, as described above under the heading 'Interpretation of the provision'.

In our view, section 981D allows a licensee to pay from the client money account to meet margin obligations arising from contracts entered into on behalf of its clients.

We strongly believe that a preferred interpretation would be that 981D permits the licensee to apply client money to meet margin obligations arising from contracts entered into on behalf of its clients but does not allow the licensee to use the funds for hedging its own positions (that is, market exposure that are not related to a client positions) or for any other purpose.

Part 7.8 of the Corporations Act and Part 7.8 of the Corporations Regulations effectively allows the use of any client monies in the trust account for any other client's margin obligations or for the issuer's margin obligations. These permitted outcomes are the core reasons for any client with money in the statutory trust account still having credit exposure of the licensee.

In our view, the law should be clarified to make it clear that while client money may be used for hedging, one client's funds may not be used to support another client in the event of a negative equity position. Our current practice is that any negative equity position is immediately replaced with the CFD provider's own money. In our view, this practice should be made mandatory.

In our view, client monies should only be used for specified purposes as follows:

- to pay the licensee in accordance with a written direction from the client; and
- to pay hedging costs in accordance with client positions only

Further details see our proposal in Section 3.

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.

Yes, the general approach in law should be retained; but its application should be altered. In our view, it would be preferable to continue allowing the pooling of client money, because prohibiting this practice will be detrimental to the interests of the retail clients. (The negative effects of a prohibition are outlined in our response to Question 8 below).

We submit the following options for consideration:

- specifying the circumstances in which client monies may be used;
- limiting the scope of broad entitlements; and
- clarifying capital requirements.

Specifying the circumstances in which client monies may be used

In our view, the law should clearly specify the circumstances in which the client monies can be used. Those circumstances should be when **both** of the following conditions are met:

1. the client agreement details how client monies are to be used and the client has agreed in writing to explicit terms with respect to the use of client monies.

   As noted in the Discussion Paper, under Corporations Regulation 7.8.02(1)(a) the licensee may make a payment out of a client money account if it has obtained a written direction from a person entitled to the money. In our view, CFD providers should be required to be specific about disclosure of the use of client monies. Licensees should not be in a position to make withdrawals for any purpose whatsoever or to use one client's money to satisfy the short fall (deficit) of another client.

2. the licensee is adequately capitalised relative to its liabilities.

   While *Regulatory Guide 166: Licensing— Financial requirements* (May 2010) (including Section H) provides an outline of capital requirements, in our view, further clarity is needed. This was made evident to us when we obtained external advice with respect to capital requirements outlined in RG 166 and we received conflicting advice.

   We believe that when the licensee holds sufficient capital relative to client liabilities, client money should be able to be used to hedge obligations incurred by the licensee in respect of client positions on a pooled basis.

Limit scope of broad entitlements

Under Corporations Regulation 7.8.02(1)(c) the licensee may make a withdrawal from a client money account of money to which it is entitled, and a broad entitlement may be created under the terms of its client agreement (e.g. creating an entitlement when margin is due and payable).

In our view, this Regulation should be amended because a broad entitlement is not appropriate for retail clients. In our view there needs to be a requirement to restrict this broad entitlement and include specific disclosure requirements with respect to the use of client money.

Clarifying capital requirements

In our view, providing clarity around the adjusted surplus liquid funds (**ASFL**) calculation provided in RG 166 for those transacting with clients as principal, and using this to set capital requirements at an appropriate level, could be a simple way to provide additional protection. Any licensee using client monies for hedging

purposes should hold a prescribed ratio of its own capital to client monies and / or exposure; in order for client monies to be used for hedging. This would provide further protection for retail and also enable the direct market access model to survive.

The current ASFL requirement is as follows:

RG 166.115 If the ASLF requirement applies to you; you must hold at least the sum of:

(a) $50,000; plus
(b) 5% of adjusted liabilities between $1 million and $100 million; plus
(c) 0.5% of adjusted liabilities for any amount of adjusted liabilities exceeding $100 million.

There is a maximum requirement of $100 million ASLF.

Providing clarity on this and setting capital requirements at a relevant level would provide considerable protection to retail clients.

The options below are for illustration purposes to highlight how simple capital ratios would clarify capital requirements and ensure that capital levels are set at an appropriate level in the event that client money is used for hedging.

One option is to alter RG 166.115 (b) above for CFD providers to define 'liability' as any client market exposure and require the licensee to hold 5% of this amount in licensee funds, all CFD providers would need to be capitalised equally on a relative basis.

We note the concern that CFD providers may currently be excessively exposed to one client posing a risk to other clients. If CFD providers were required to clearly hold 5% of all exposure in licensee funds; they would not be in a position to hold excessive single exposures covered only by other clients' money.

Another option is for a specific requirement, for CFD providers using client money to hedge, is to hold a ratio of licensee funds to client monies. If for example, RG 166 specified that a CFD provider must hold 20% of the value of client monies used for hedging in licensee funds, consumer protection for retail clients would be enhanced.

This would ensure that the licensee has considerable cash reserves in the event of a client default, reducing the risk that the CFD provider would not have enough licensee funds to top up any shortfall created by a deficit. It would also reduce the risk of excessive exposures relative to the licensee’s funds.

We urge Treasury to consider variations on the above suggested options as a means to both provide further protection to retail clients as well as continuing to offer a fully hedged direct market access CFD model.

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.

Below is a summary of what, in our view, are likely to be the major impacts of the possible changes identified in the Discussion Paper.

CFD provider impacts

The impact of the proposed client money changes is business critical for DMA CFD providers. In our view, the DMA business model will no longer be a viable business model for CFD providers. Very few direct market access CFD providers will be able to continue to hedge 100% of client's trades if they can no longer use client monies to do so, given the large capital requirements.

Even if a CFD provider did have sufficient funds, the return on those funds, using the DMA model, would be relatively low. This means the proposed client money changes put the viability of the DMA model in question. In time, this would lead to reduced competition in the CFD market, with fewer options available to investors.

Client impacts

The lack of DMA CFD providers within the market will markedly reduce competition in the Australian CFD market. With a lack of DMA CFD providers, clients would have two remaining options — ASX24 CFDs and market maker CFD providers.

The low trading volumes on the ASX 24 CFDs indicates most clients choose not to trade this product. This may be due to the lack of products and liquidity or additional expense as a result of the wider spreads which are generally offered. So, if DMA CFD clients choose to trade the ASX24 CFD due to the DMA model no longer offered in the market, the cost of trading to the client is likely to increase significantly.

In our view, it is more likely that a lack of DMA CFD providers would result in an increased use of the market maker model.

In our opinion, the decreased competition resulting from the lack of DMA CFD providers within the market, is likely to have the following adverse affects for clients:

- OTC market rules will no longer mirror that of the underlying financial markets
- Increased Counterparty risk for clients as the unrealised profit and loss is not protected with MM business model
- Clients will not be able to participate in all market phases
- Clients will only be a price taker
- Increased conflicts of interest between providers and clients
- All OTC CFD providers will profit from client losses.

- **Increased commission costs to clients:** The lack of competition within the market will mean that the commission rates charged to clients are likely to increase.

- **The re-introduction of re-quotes**: Before the DMA business model developed in the Australian market, market maker CFD providers re-quoted prices to clients, generally in the favour of the CFD provider and to the detriment of the client.

- **Slower execution speeds**: DMA CFD trades execute as quickly as a trade does in the underlying markets as there is a simultaneous back to back hedge trade to the CFD trade. There is no dealer intervention for the DMA clients. If the MM business models are the only option for CFD clients,

CFD orders are not placed directly on the market but flow through a dealer, resulting in slower trades, especially in fast moving markets.

- **No price transparency for clients**: DMA ensures the clients trade at underlying financial products prices for their CFD trades. Under the market maker model prices are derived from the underlying market, but the MM CFD provider may add a spread.

- **No underlying market liquidity for clients:** DMA CFD providers hedge 100% of client trades in the underlying market; this means the liquidity of the underlying market is reflected in the liquidity of the DMA CFD market. Client have complete transparency to the underlying market and can monitor their trades being executed by volume and price.

- **Clients unable to participate in all market phases.** DMA CFD providers allow clients to participate in the opening and closing phases of an underlying market. MM CFD providers do not. The inability to be able to trade in the opening and closing market phases results in less liquidity for clients.

- **Price Takers only**: The DMA model enables clients to be both price makers and price takers. Under the market maker model, clients are price takers only.

- **Conflicts of interest**: The MM business model has an inherent conflict between the interests of the client and the interests of the CFD provider. This is because, under the market maker model, MM CFD providers profit from unhedged orders, so that, in some cases, it is in their commercial interest for their clients to lose money.

  It follows that it is often in the interests of MM CFD providers to:
  - re-quote prices to earn additional income on the spread price offered to clients
  - close-out client positions as the provider profits from losses
  - deal with loss making clients.

- **Limited education:** Direct market access CFD providers currently provide CFD education which helps to provide balance to the retail client's MM CFD education options.

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

We believe that any enhanced protection should only apply to retail clients because of the level of sophistication of wholesale clients.

Having said this, it is wholesale that usually adopt best practise so we suggest being mindful of changes which would make best practise only available to wholesale clients.

Our suggestions in relation to appropriate client monies protection are set out in our response to Question 7 above and Section 3 of this submission.

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

No, we have developed compliance procedures around existing frameworks and are comfortable with existing regulations.

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

We make no submission on this question.

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?

Yes. In our view the law should be amended to limit the bases on which a licensee can claim an entitlement to client money. See our response to Question 7 above.

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?

Yes, the law should contain express requirements as to what money must be segregated.

In our view, the licensee should either segregate amounts that would be due to a client if a derivative position was closed on a daily basis, or have a hedge position in place to secure such amount.

3. Proposal for increased Client Protection

(a) Background

References to sections are to sections of the *Corporations Act 2001* (Cth) (**Act**) and references to regulations are references to the *Corporations Regulations 2001* (Cth) (**Regulations**).

Money received from clients in connection with a derivative of a financial product is currently paid into a trust account in accordance with section 981B.

Whilst money in this trust account is taken to be held on trust for the benefit of the client (section 8981H), the money can be used:

(i) to meet the OTC derivative issuer's obligations incurred in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives (section 981D);

(ii) by the OTC derivative issuer in accordance with a written direction from the client (Regulation 7.8.02(1)(a)); and

(iii) to meet any *other* client's margin obligations or for the issuer's margin obligations.

(b) Difficulties with current structure

Difficulties with the interpretation and application of the legislation in relation to OTC derivatives include:

(i) the limitations in the Act on the ability to withdraw money from the trust account can be overcome simply by ensuring the issuer has a right to withdraw all of the client monies - such a right can be included in an OTC derivative issuer client agreement and once the funds have been withdrawn from the trust account, the client is fully exposed as an unsecured creditor of the OTC derivative issuer; and

(ii) if the OTC derivative issuer becomes insolvent, the money in the trust account may not be enough to meet the OTC derivative issuer's obligations to its clients, in which case the client will be an unsecured creditor.

(c) Proposed solution

Amend sections 981B and 981D and regulation 7.8.02 (and other relevant provisions of the Act and Regulations) to make it clear:

(iii) that amounts paid by a client into a section 981B trust account may *only* be used to:

(A) pay the OTC derivative issuer in accordance with a written direction from the client; and

(B) pay hedging costs:

(I) in accordance with a pre-agreed hedging strategy; and

(II) in respect of part or all of the derivative book; and

(iv) that each of:

(A) the following cash amounts paid to the OTC derivative issuer out of the section 981B account:

(I) initial margin paid by clients; and

(II) later margin payments paid by clients;

(B) amounts received by the OTC derivative issuer from hedge counterparties; and

(C) the benefit of the hedge contracts,

(**Trust Property**) will, under the Act, be deemed to be held by the OTC derivative issuer on trust for clients on the occurrence of the insolvency of the OTC derivative issuer.

(d) Advantages of clarifying use of section 981B trust account

(v) From the perspective of the industry and each OTC derivative issuer:

(A) there is clarity as to how the money in a section 918B trust account can be used; and

(B) accidental misuse of money in a section 918B trust account can be prevented.

(vi) From a client's perspective, clients understand:

(A) how their money will be used by the OTC derivative issuer; and

(B) the OTC derivative issuer's hedging strategy.

(e) Advantages of certain moneys being held on trust for clients

(vii) From a client's perspective:

(A) the OTC derivative issuer and its officers would have fiduciary duties not to misuse funds;

(B) the Trust Property of the clients is protected as against other creditors;

(C) an administrator of the OTC derivative issuer may not use the Trust Property for general purposes, such as the costs of the administrator or liquidator, giving clients greater protection than they currently have; and

(D) the Trust Property is created by statute, so all potential clients are protected.

(viii) From the perspective of the industry and each OTC derivative issuer, unless an OTC derivative issuer becomes insolvent:

(A) the Trust Property is the property of the OTC derivative issuer (and the clients only have a contingent interest); and

(B) the OTC derivative issuer will be able to use the funds in the ordinary course (subject to amendments re use of funds in a section 981B trust account).