HOLLEY NETHERCOTE
commercial lawyers

7 February 2012

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

Our Ref:GH:PD:9382

By email: clientmoney@treasury.gov.au

Dear Mr Beale,

Re: Handling and use of client money in relation to over-the-counter derivatives transactions (*Discussion Paper*)

Thank you for the opportunity to make a submission in response to the Discussion Paper.

We act for a large number of OTC Derivatives providers (***Licensees)*** in Australia, and we have included some of their comments in this submission. We have not responded to every question.

1. *Q1. 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 (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?*

    1.1. A1. No. This is because:

        1.1.1. The law currently allows Licensees to pool and access client money and in turn provide a valuable service to retail investors, namely, the aggregation of liquidity and pricing which makes institutional and professional pricing accessible to individual traders. Licensees are able to aggregate and pass on better pricing, and maintain a more competitive market, giving clients access to a range of products available from many different institutions.

2. *Q2. 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?*

    2.1. A2. Licensees should continue to be able to pay such funds into client segregated accounts. This is because:

2.1.1. Opening separate client accounts is costly, and makes pooling more difficult to manage.

2.1.2. Some Licensees have reported that banks are not willing to offer segregated client account services to them, due in part to the complexities of the "Know Your Client" requirements associated with the Anti-Money Laundering and Counter-Terrorism Financing legislation.

3. *Q4. 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)?*

3.1. A4. No. Requiring a specific written direction from the client would be cumbersome and problematic – particularly considering that some clients will trade over one hundred times in a single day. However, the *Corporations Regulations 2001* (***Regulation***) should be changed to address this issue. In particular, the definition of "entitled" in Regulation 7.8.02(1) should be clarified. For example, the Licensee's liquidity provider may impose a legitimate legal requirement on the Licensee, for a certain floating margin to be maintained. This may be a reasonable obligation, creating on the Licensee a reasonable entitlement to access a minimum level of pooled client money, as it helps the Licensee wholly offset the risk of client trades. However, allowing a standing authority or other type of wide entitlement (as is common practice), is clearly an overly broad interpretation of the regulation, leaving it open to abuse. ASIC has attempted to address this in RG 212, but its commentary does not have the legal effect of a specific direction contained in the Regulations.

4. *Q5. 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?*

4.1. A5. Licensees generally conduct these practices already. Given the one business day rule with trust monies contained in Section 981B(1) of the *Corporations Act 2001* (***the Act***), as well as a Licensee's breach reporting obligations, this activity is in practice already required – and audited externally each year.

5. *Q6. 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?*

5.1. A6. Section 981D of the Act allows a licensee to use client money incurred by the licensee "in connection with margining...". What is unclear is the references in the Discussion Paper to a Licensee's "own position." There is a big difference between a licensee creating a mirrored trade, which is arguably its own trade, but which is only entered into because the client has entered into an equal/opposite trade with the Licensee. This former "own position" is very different to an un-mirrored trade conducted by the Licensee

on their own account. We are not aware of any licensee that considers the latter situation to legally justify access to client money.

6. *Q7. 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.*

   6.1. A7. Some Licensees have suggested that many of the problems highlighted in the discussion paper would be resolved if there were significant banking reforms that allow instant cash transfers. Although banks would be opposed to this, given their use of funds in the overnight money market, this would make real-time reconciliation between a Licensee's margin balances and their liquidity providers' balances possible. Until there is significant reform in this way, it is difficult to legislate that certain client money can only be used to cover certain short-term obligations. Also, it is currently expensive and cumbersome to move money back and forth between one client fund and the liquidity provider – it can take several days, which in-turn creates more risk in the financial system.

7. *Q8. 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.*

   7.1. A8. If access to client funds was completely restricted, some Licensees have suggested that:

      7.1.1. Individuals will open more accounts offshore, to access providers that can take advantage of using client funds to get better wholesale rates and lower spreads;

      7.1.2. Smaller licensees who have less access to significant financial resources will be unable to compete – there will be consolidation in the industry leading to less competition between providers in the Australian market;

      7.1.3. Some Licensees may not hedge their positions due to lack of available resources.

8. *Q9. Should any enhanced protection apply to the money and property only of retail clients? Why?*

   8.1. No. Firstly, for practical purposes, it is difficult to differentiate between retail and wholesale clients when dealing with client money. Second, the distinction between retail and wholesale clients should relate to disclosure obligations, rather than how the products themselves operate. Third, if such a distinction is implemented, then the definition of retail client should be clarified before there is consideration of protecting client money. As flagged by Treasury in its Options Paper titled "Wholesale and Retail Clients Future of Financial Advice", released January 2011, there are significant problems with these definitions.

9. *Q12. Should the law be amended to limit the bases on which a licensee can claim an entitlement to money held in a client money account?*

   A12.A12. Yes – see A4 for explanation.

10. *Q1 (page 21). A1. 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?*

    10.1. Most retail OTC derivative platforms allow clients to monitor their position in real time. Most systems can be set up to allow for daily or monthly statements.

    10.2. However, most platforms integrate multiple liquidity providers, and allow a client to conduct multiple simultaneous trades. It would therefore be extremely difficult if not impossible to allow a client to know where their money is actually being held on a daily (or monthly) basis, for as long as they are actively trading (some retail clients place hundreds of trades each day). That current sophistication is not currently available, in part due to the lack of "instant cash transfer" functionality in the Australian banking system.

If you have any questions, please do not hesitate to contact me on pauld@hnlaw.com.au.

Yours sincerely,

Paul Derham
Partner
HOLLEY NETHERCOTE
www.hnlaw.com.au
www.complianceforum.com.au
http://www.linkedin.com/in/paulderham