18 January 2012

Manager
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The Treasury
Langton Crescent
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(sent by post and via email to: clientmoney@treasury.gov.au)

To whom it may concern,

Collective Response to Discussion Paper: Handling and use of client money in relation to over-the-counter derivatives transactions ("CM Paper")

A like minded collective of AFSL holders who offer OTC CFDs to retail investors[1] have joined together to provide Treasury with their combined comments in response to the CM Paper. In providing this collective response we hope that Treasury will be made aware of the widespread support within the OTC CFD industry for decisive and clear client money reform.

The parties who are signatories to this response are:

1. IG Markets Limited (AFSL No' 220440)
2. CMC Markets Asia Pacific Pty Limited (AFSL No' 238054)
3. Global Futures and Forex Limited (AFSL No' 226625)
4. Saxo Capital Markets (Australia) Pty Limited (AFSL No' 280372)
5. London Capital Group Pty Limited (AFSL No' 364264)

(referred to together within this response as "the Parties")

1. The Parties and Contracts for Differences ("CFDs")

All of the Parties deal in and make a market in OTC CFDs based on a broad array of financial instruments. The Parties collectively hope to ensure the ongoing future and growth of the OTC CFD industry including maintaining sound competition within the CFD industry, adherence to the highest regulatory standards and ensuring that the overall good reputation of the CFD industry is upheld.

The Parties, who represent a combined minimum of 81% industry share[2], all strongly believe that for those objectives to be achieved then comprehensive and clear reform is needed to Australia's client money rules.

2. Executive Summary

[1] We assume the meaning of retail investor to be as defined in s961G of the *Corporations Act 2001*
[2] Investment Trends May 2011 CFD Report, primary and secondary accounts

A. The Parties support Treasury's initiative to assess the handling of retail client money by OTC derivative providers;
B. The Parties submit that retail client money is not adequately protected by the current regulations and that as a consequence the risks posed to retail client money are unacceptably high;
C. Of the options proposed by the Treasury, the Parties are in favour of change that aligns as far as possible with the client money rules in the UK, as regulated by the FSA.
D. To amend the client money rules so that they align with those adopted by the UK, the definition of what is considered client money will need to be amended to enable segregation of client money on an equity basis, rather than on a cash basis.
E. The Parties are confident that they, as well as other CFD providers, can and should meet increased client money standards and that in doing so should not reduce competition to an unacceptable level.

3. Issues for Comment

1 (i)	***Should the law be amended so that client monies held on behalf of a retail client cannot be used for meeting obligations incurred by the licensee in connection with the margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee:***	Yes. The Parties agree that the law should be so amended. The Parties submit that even with comprehensive disclosure to retail clients regarding the risks of using client money that such clients are not well placed to properly understand, compare and contrast the risk of their moneys being lost. In the event of the corporate insolvency of either an OTC CFD provider or that provider's hedging broker(s), chances are great that provider's clients' money would be lost. The Parties are conscious of the severe reputational damage this would cause to the CFD industry (as has occurred in the case of MF Global's collapse). The Parties understand that MF Global clients will not receive 100% of their client money and hope that regulatory change will ensure that retail OTC CFD clients are better protected in future.
1 (ii)	***Should the law be amended so that 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 the margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee on behalf of people other than that client?***	The Parties submit that monies deposited by a client should not be used by a provider at all until such point as it is no longer considered to be client money. To emphasise, the Parties do not think that client money should be used even for that client alone as the risks posed are still too great.
2	***Should licensees continue to be able to pay such funds into segregated client accounts, or should they be required to pay them into separate trust accounts for each client?***	The Parties understand that this question is aimed at the issue of "pooling" client money and whether the risks posed by pooling are such that separate trust accounts are required for all clients. The Parties submit that placing all client money into a pooled

		client money trust account does not pose much risk to clients provided such money is calculated, managed and tracked in accordance with appropriate rules and parameters. First and foremost, client money should not be used for any of the purposes set out in section 981D. Secondly, client money must be calculated on a client by client basis as a sum of all positives so that if a client is in deficit to their provider then their client money balance should be considered to be zero so that no other client money is taken to top up their deficit. This calculation is illustrated in item 5 of this response. This method accords with the UK regulatory regime as set out in the Client Assets Sourcebook (CASS). Finally, all client money must be fully tracked and readily identifiable as belonging to a particular client. If segregated client money is not used by a CFD provider (until such point that it ceases to be client money) then the Parties believe pooling to be a non-issue in terms of counterparty risk. Fundamentally, separate bank accounts do not afford the client any more protection if the provider can use client money to hedge. Conversely, the Parties strongly submit that a requirement to open and maintain a separate trust account for each and every client (who, among the Parties, number in the tens of thousands) is completely impractical with an enormous cost impact and, in our view, of no additional benefit to clients. Separate bank accounts for each and every CFD client would mean as follows: • Many thousands of new bank accounts would need to be opened incurring significant costs; • Every bank account would need to be monitored, reconciled and balanced. This would create far more control risk than a single pooled account; • If client money was also to be segregated on an equity basis (see later comments) this would require a balancing adjustment to the bank accounts of every client with open positions as their running P&L changes; • The administrative and cost burden of the overhaul to banking arrangements, the systems development required, the new processes and controls together with the staffing requirements would be astronomical; • There would be increased risks of error; • The cost impact would be in the millions The Parties submit that the UK approach which allows pooling as a practical way of operating segregated client money accounts also provides effective protection to client funds. The Parties submit that any costs of implementing a

		system that equates to that adopted by the UK would be manageable and in proportion to the increased benefit to retail client money protection. A requirement for individual accounts would be overly burdensome and of no additional benefit to clients.
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)?***	The Parties submit that a retail client should get the same client money protection regardless of whether they are on-exchange or OTC. We believe that exchange providers should segregate client money on the same basis as OTC CFD providers. They may however be permitted to deduct funds held in clearing (or count them towards client funds). Ultimately retail derivatives clients should be entitled to have the same client money confidence regardless of the derivative products they choose to trade as the protection should be afforded by client type rather than financial product type.
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)?***	The Parties agree that generic or standardised client authorisations (such as those contained within a PDS) should not be permitted for matters as important as the withdrawal or use by a provider of client money belonging to a retail client. Additionally, the Parties recommend that specific client authorisation regarding matters that may cause the loss of client money protection should only be permitted for non-retail clients and never for individual retail customers. We reiterate our view that the disclosure approach currently in place is not effective because retail clients are often not able to compare risks or adequately understand the risks posed to their money. As a consequence, the Parties support a change to the law that effectively removes any discretion on CFD providers vis a vis retail client money and requires the highest standards of protection for the same. The Parties also submit that non-retail clients should be exempted from any such changes as they are able to demonstrate their understanding of the risks involved. We are of the view that non-retail clients should be entitled to sign appropriate documentation to allow their funds to be held on an unsegregated basis as their knowledge, sophistication and experience enables them to understand the risks faced. Such clients also demand far greater flexibility from a CFD provider to provide them the services they want. Standardised agreements should also be sufficient in these circumstances and specific approval for each withdrawal should not be necessary.
5	***Should licensees be required to conduct a regular reconciliation of client money and have a documented process in***	Yes. Client money reconciliations should be conducted at least daily. All CFD providers should also have clear policy and procedure in place to escalate issues such as

	place to escalate and resolve any unreconciled variances that are identified?	unreconciled variances to suitably senior levels of management.
6	***Do you consider that there is a lack of clarity as to the meaning of the law, as described above under the heading 'Interpretation of Provisions'? If not, what is in your view the correct interpretation? What should be the preferred interpretation?***	The Parties agree that the law lacks clarity and that this can be demonstrated by the differing practices of the various CFD providers.
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 client's money, or to specify the circumstances in which monies can be used? Should the right to use client money be temporary, eg. requiring that any shortfall arising from one client's money being used to cover the shortfall 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.***	The Parties support that the application of the law be altered and clarified in order to ensure that client money is considered unavailable for use by a provider for any purpose until such time as it ceases to be client money. In considering these issues, we submit that it is important for Treasury to understand the primary sources of risk to a CFD provider's financial stability. We set out our view of these below: 1. **Client default** – volatile markets lead to increased likelihood of the rate of client default given that CFDs are leveraged instruments. This in turn puts pressure on a CFD provider's financial resources. The trade off between the level of leverage offered by providers and client turnover can exacerbate this risk. Therefore providers wanting to maximise revenue who choose to offer lower margin rates may also suffer the increased likelihood of client default as part of that risk reward trade off. Please note that different business models (eg. DMA model or otherwise) adopted by providers have little if no influence on the levels of default. 2. **Misappropriation of client funds / fraud** – if legal requirements are not followed then client funds may also be lost in the case of a company default. 3. **Proprietary trading / position risk** – many CFD providers aim to internally match client positions to reduce their own hedging costs in backing off client positions. If this practice is managed poorly then the firm may expose itself to market risk. We believe that the three factors noted above are the key factors that may affect the likelihood of a firm defaulting. All CFD providers, regardless of business model (see below) or hedging policy, are exposed to some if not all of these three factors. In all such cases the full protection of client money offers a robust solution to mitigate the risks posed. The Parties are aware that some CFD providers use what is

		known as a "DMA Model" which they claim to poses less or no risk to clients. DMA Model CFD providers back to back all client trades with its hedging broker. It is sometimes claimed that there is a lower market risk with this model as a CFD provider will, in theory, never have an uncovered position in the market. This claim is flawed because the moment a client cannot meet a margin obligation or a client defaults on a payment, the clients' position becomes that of the firm and the default of a client is borne by the firm, thereby posing the same risks as any other business model. If <u>all</u> CFD providers are required to segregate client money on an equity basis and none are permitted to use it for any operational or hedging purpose, then client money risks are reduced and the CFD industry will benefit in turn. The Parties support the view that client money should not be used at all and that CFD Providers should be encouraged to segregate client money (on trust) on an equity basis. To segregate on any other basis does not protect client winnings and is less beneficial to clients.
8	***What would be the impact of the possible changes identified in this paper? Please provide as much detail as possible on any costs of other impacts.***	If the client money rules are amended in line with our submissions above, being the full protection of client money to be segregated on an equity basis, then this will have significantly <u>*less*</u> impact on all CFD providers than if they are required to fully segregate all client funds (without any section 981D carveout) on a cash basis. ***Segregation on a cash basis vs equity basis:*** As Treasury is aware, current client money rules require segregation on a cash basis but allow the use of client funds for hedging. If the rules were changed so that segregation was still on a cash basis but did *not* allow the use of client funds for hedging then CFD providers would have to segregate more client money than they would have to under the UK model. Given that the UK model offers what we believe to be comprehensive client money protection, and will in itself cost most CFD providers dramatically more than they are paying currently, we believe this would be an untenable and unfair burden on the CFD industry. If CFD providers were required to segregate on a cash basis (and only permitted to use its *own* money for hedging) this would cost more than segregating on an equity basis because clients tend to keep losing positions open. If a provider hedges its positions with brokers who also measure the funds placed with them on an equity basis then if clients are running losses then the CFD provider will also be running losses with its brokers. These positions inevitably require additional funding. Therefore, if CFD providers are not allowed to segregate client funds on an equity basis there is a

		funding gap on these positions. We are aware that other regulators, including the FSA in the UK, the FSA in Japan and the MAS in Singapore all require segregation on an equity basis, rather than on a cash basis. This recognises that segregation should be based upon an amount equivalent to the funds available if all positions are realised. To require segregation in this manner mirrors the situation with hedged positions with our brokers where funds are also measured on an equity basis. Segregation on an equity basis simulates what would happen should a CFD provider (or hedging broker) be liquidated. Therefore, in our submission, it is an entirely appropriate method when considering the protection of client funds. We ask that Treasury take note that if segregation is on a cash basis this will make it difficult for many CFD providers to be able to fund their clients' running losses. We believe that this will have a detrimental effect on competition in the industry, as well as put client money at risk by the potential for over and under-segregating the amount due to clients, and creating an issue of "pollution" where the firm's funds might be co-mingled with client funds. If client money is segregated on an equity basis firms segregate the amount that is due and payable to the client if all positions were closed.
9	***Should any enhanced protection apply to the money and property of only retail clients? Why?***	Yes, the proposed changes should only apply to retail clients. Non-retail clients and wholesale clients are well placed to assess risk and do not require such additional regulatory protection. In addition, the costs of providing a competitive service to such clients are far greater to a CFD provider so additional flexibility with regards to client funds are essential.
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 costs savings this would deliver?***	No.
11	***Are there any additional protections needed for client money where the licensee holds the financial products***	Given that CFDs are a bilateral contract between provider and client (with no right to the underlying) and client money must be held in Australia we are not sure that this question

	outside Australia.	applies and ask for further detail of what Treasury is asking.
12	***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?***	Yes. The Parties submit that the law should be clarified to reflect that client money should be segregated on an equity basis not only so that client cash is protected (when it properly still belongs to the client) but so that their running profits are also protected[3]. Segregation on any other basis is less beneficial to a client as it does not necessarily reflect their current position.
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 Parties submit that all client money should be segregated on an equity basis so that if every client closed their position then all client money is accounted for and ready to be paid out. To segregate on any other basis does not protect the client's current position.

<u>Reporting Requirements:</u>

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?***	The Parties believe that an information gap is possible, especially in light of the different treatment of client money among providers. However, we also submit that if the FSA client money model is adopted in Australia then any such gap will largely be closed as the statement balance would equate to segregated client money. For instance, the FSA have a requirement to complete and lodge a monthly Client Money and Asset Return which might be considered here, or alternatively the requirement for an annual audit on the systems and controls of client money reconciliation and treatment. New reporting requirements may require varying levels of IT work as well as changes to processes and controls. The Parties nevertheless agree that the effort and costs of such work should be outweighed by the clarity and confidence it would give to clients.
2	***Are the items listed above information which would benefit clients?***	See question 1. above.
3	***Can you give an indication of cost of preparing monthly statements covering these items and providing them to clients electronically?***	The costs of this would be variable among the Parties depending on their current practices regarding statements. Regardless, all Parties are prepared to undertake whatever reasonable and manageable costs may be required to ensure statements remain compliant.

[3] Please note that any law change to enable the protection of running profits must equally permit the deduction of running losses. This accords with the current regulations in the UK.

4	***Please indicate if there are any other reasons why it would be inadvisable to require monthly reporting?***	We know of no reason.
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)?***	No, the right should be automatic.
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.***	Treasury might consider further alignment with the FSA regulations in relation to the requirement for Trust letters from banks to brokers in holding client money which will give further control and assurance.

4. **The Reform Options**

We also set out our specific responses to the four options listed at section 2.9 of the CM Paper that are being canvassed for comment.

Restriction on the use of client money:
The Parties would support the full protection and segregation of client money in a client money trust account with no rights to use such money until such point as it is no longer considered client money.

Adopt the UK approach:
The Parties unanimously support adoption of the UK approach including the requisite amendment this would entail to ensure client money must be segregated on an equity basis rather than a cash basis. Experience in the UK and in Australia has shown this method of segregation to be reliable, robust, reassuring and yet to still permit a well managed business to succeed.

Impose a statutory trust fund:
The Parties would like a better understanding of what Treasury envisages with this proposal before we can provide any kind of informed comment.

Adopt segregated individual accounts:
As we have noted above, the Parties do not believe that pooling segregated client money (that cannot be used by a CFD provider for its own purposes) is problematic. Conversely, we are strongly opposed to the adoption of individual segregated accounts because of the large and impractical administrative burden they would create without any additional benefit to clients.

5. Client Money Calculation

1. the sum of the balances for each client, calculated as follows:

that client's free cash, meaning money that is not currently being used by the client for any purposes

plus

margin paid by the client on open positions (because this money forms part of the client equity balance) because the firm is required to repay it to the client when the client closes his position

plus

the client's running profits

less

the client's running losses

less

any amounts owed by the client which are due and payable to the firm.

provided that, if for any client the calculation above results in a negative number, zero must be used in the client money requirement calculation for that client;

2. *plus* any unallocated client money.

A client's equity balance means the amount which the firm would be liable to pay to that client (or the client to the firm) in respect of his CFDs if each CFD was liquidated at the firms then quoted closing rate. Note that no adjustment needs to be made for "firm's equity balance" because the firm always deals as principal with clients, never as agent for clients.

6. Concluding Comments

All or any of the Parties below would be delighted to speak with any interested representatives from Treasury if they feel this would be helpful.

If Treasury has any questions about this response document or any of the matters stated within, please do not hesitate to contact any of the signatories personally on the details set out below

Yours faithfully

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For and on behalf of IG Markets Limited

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