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

3rd February 2012

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 Lazorne Group Pty Ltd

Lazorne Group Pty Ltd ("Lazorne") is a company structured to provide professional consulting services in regulatory compliance predominantly to financial service licensees.

In addition to other services, Lazorne assists companies in making applications to the Australian Securities and Investments Commission ("ASIC") for an Australian Financial Services Licence ("AFS Licence") and preparing supporting internal policy and procedure documents to assist licensees in meeting their ongoing compliance obligations.

Established in March 2002, Lazorne has been involved with compliance related activities since the introduction of the Financial Services Reform Act. A vast number of our clients include companies that provide financial services in derivative products, and a significant number of these issue over-the-counter ("OTC") financial products, as well as exchange traded financial products. Accordingly, we are well versed with and have a strong understanding of the financial markets, including derivative products.

For further information about Lazorne and a brief description of the qualifications and/or experience of the principals, please visit our website at www.lazorne.com.au.

In particular, we note that one of the founders and principals of Lazorne (Deborah Horne) was previously the General Manager, Compliance and Surveillance with the Sydney Futures Exchange ("SFE") and thus, very familiar with the client money rules regarding clients' segregated accounts operated by futures brokers. She was employed by the SFE from 1983 to 2000. As you will be aware, prior to ASIC taking over certain supervisory responsibilities it was the role of the market operators to perform these functions. Ms Horne headed the division that performed these functions.

This Submission

In making this submission, Lazorne is representing a number of Australian Financial Services ("AFS") Licensees that will or may be directly affected by the proposals contained in the Discussion Paper.

Most of these companies have specifically requested the submission be a "white paper" and that they be listed and identified as contributors to this submission. The intention is to demonstrate to Treasury that these companies consider the proposals contained in the Discussion Paper to be significant and wish their feedback to be considered by Treasury. The contributors are listed in Annexure A of this submission. Additional contributors have asked to remain anonymous.

These contributors form part of the Australian OTC derivative market that will be most affected by any changes to the client money provisions. They vary in size, scope and maturity with some being in the earliest stages of their operations to others being part of mature international groups. Thus, we believe the comments and observations contained in this submission are broadly representative of the opinions held by some OTC derivative issuers and reflect the very deep experience of their management.

Response to the Discussion Paper

We have structured our submission to the matters in the Discussion Paper in to the following 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 options

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 AFS Licensee interchangeably. We recognise that not all AFS Licensee 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 and define client money and ensure that client money is protected at all times together with clear guidance to participants in the industry.

(ii) We are strong advocates for strengthening the client money provisions for all AFS Licensees / industry participants and not limiting the changes to 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. Many clients of MF Global traded in exchange traded derivatives only and they are also facing losses as a result of the current client money provisions.

Treasury needs to review the existing provisions in the legislation as they are currently open to interpretation. However, this applies to all derivative products and not only OTC derivatives. Moreover, it applies to all financial products and client money should be protected at all times. Legislation should not only apply to a subset of derivatives (or a subset of financial products for that matter).

(iii) We are strong advocates that the proposed legislative changes apply to all clients and not be restricted to retail clients. It is not appropriate to consider all wholesale clients as “sophisticated”. Moreover, the legislation is designed to protect all consumers and not just a subset. Again, many clients of MF Global would have been classified as wholesale and they are facing losses as a result of the current client money provisions.

(iv) We request Treasury to take this opportunity in its review of the legislation to provide clear guidance regarding the treatment and classification of funds lodged by a client with an AFS Licensee 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 AFS Licensee).

(v) We do not believe that any of the four reform options set out in the Discussion Paper are necessarily appropriate (for the reasons stated in section 4 below).

We also appreciate that there is little point simply criticising the proposed options, without proposing an alternate solution. In this regard, we wish to advise that we are aware of other alternative options that are more likely to strengthen the client money provisions in a better way and are practically being used in the market place.

We have not detailed the proposed solutions in this submission for the following reasons:

1. we may not adequately explain the proposed alternative options;
2. we feel there is little benefit duplicating submissions made by others; and
3. we do not wish to take credit for someone else's design.

We understand that two separate legal firms (and we assume others) have proposed alternate arrangements to the four reform options identified in the Discussion Paper. We have not seen these submissions, but are aware of the general content.

Neither we, nor the contributors, are implicitly endorsing these submissions. Furthermore, some of the contributors are not even aware of these alternative structures. We simply encourage that these be explored fully before implementing any reforms.

(vi) Currently the legislation prohibits AFS Licensee 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)). **This is a major weakness in current legislation**.

In other words, if there is a shortfall in the client trust account (s981B Account) e.g. due to a loss by one client, then the AFS Licensee cannot top up the client trust account (s981B Account) as they will be seen as co-mingling company money with client funds. This forces the AFS Licensee to use other clients' funds to meet their hedging obligation.

Treasury should mandate a prompt "top up" requirement (as described and contained in the MIRs – 2.2.6(f)). This will result in the AFS Licensee using its own capital to meet the shortfall of any client funds owed as a result of adverse market movements or other client liabilities.

Strict compliance with this provision should be regularly monitored by ASIC.

(vii) Current market practice is requiring product issuers (AFS Licensees) to restructure their arrangements and the way the hold client money so that they can enter into ISDA Agreements with their hedging counterparties stating that funds transferred (by the product issuer to the hedging counterparty) are unencumbered and without a lien over them (refer section C below for additional information).

(viii) We do not consider changing the legislation to meet comparable protections implemented overseas necessarily the appropriate way forward. Australia should make decisions that are best suited to its environment / market place.

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

- Treasury should mandate a prompt "top up" requirement (as described in point (vi) above).

- Current legislation requires that client funds must be held in an Authorised Deposit Taking Institution ("ADI") i.e. Australian bank or an approved foreign bank. ASIC has not approved any foreign banks.

- 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 appreciate that Treasury is trying to promote public confidence in the financial markets, especially that Treasury is seeking to improve the treatment and handling of client money. We applaud Treasury's review of this part of the legislation and welcome stronger legislation to regulate and define client money and ensure that client money is protected at all times together with clear guidance to participants in the industry.

We are strong proponents and advocates of ensuring client money is treated safely and securely i.e. to ensure it is adequately protected, from the time it is deposited with the AFS Licensee until the time it is returned to the client. At all times money lodged by a client to trade in derivatives (or any financial product until such product has been acquired) should be considered and treated as money owed and belonging to the client. We acknowledge that there may be some exceptions e.g. where legitimate prepayments are received. However, the legislation should be clear and any exceptions clearly identified.

OTC Derivatives versus Exchange Traded Derivatives

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

We strongly disagree with this approach and encourage 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 (retail or wholesale), financial product and/or by the means in which it is traded. The Law is designed to protect the consumer and this should be maintained regardless.

Treasury states that "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". There are 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 to name a few. This includes MF Global.

The point we are trying to make is that a counter party may have a "healthy" 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 lost (and/or not protected).

We believe that Treasury's distinction between OTC and exchange traded derivative products has the risk of creating the incorrect impression amongst investors that exchange traded products are "safer".

The fact is all client money covering all financial products (both exchange traded and OTC) and all AFS Licensees should be subject to the same standards. We believe 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 substantially reduced because of the regulated clearing house (where all contracts are novated and guaranteed). However, we note this guarantee only extends to the participant of the clearing house and not to the client. Furthermore, we note that exchange traded derivatives traded on ASX 24 are potentially protected by virtue of the Fidelity Fund.

Treasury's main aim is "to review whether the client monies provisions of the Act provide sufficient protections for investors." Treating exchange traded financial products differently to OTC financial products is NOT going to achieve this objective. More so, it may be misleading to the consumer i.e. it will give them a false sense of security. Sending a message that one derivative product is more risky than another will not achieve Treasury's stated objectives.

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 and/or what we have observed in the Industry

(a) Different market practices / interpretation of current legislation

We understand and appreciate that the Law is designed to protect the consumer and to ensure that money owed to the consumer (realised and unrealised via the mark-to market valuation process i.e. credit balance of the account) is 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 AFS Licensee in the event of the receivership or liquidation of the AFS Licensee.

Division 2 of Part 7.8 sets out the obligations of Licensees in relation to client money. In short, Licensees are required to establish and maintain a separate account in which to hold client money i.e. the AFS Licensee 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 property from AFS Licensee's property. **The problem is defining what is client money.**

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 its 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 AFS Licensee 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 schools of thought 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 car or house:

- One school of thought suggests that ownership in the “product” (e.g. car) 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. car), that payment does not make the product (car) theirs, until it is fully paid for i.e. ownership is transferred when full payment for the product (car) is made and the deposit paid represents collateral.

- The other school of thought argues that the ownership of the product (car) 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 (car).

Lazorne 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. Lazorne recognises that there are some exceptions e.g. where legitimate prepayments are received.

Lazorne considers that the intention of the section (s981A(2)(c)) was for financial products such as insurance policies where a customer pays a premium. In such a circumstance, Lazorne 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 AFS Licensee 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, Lazorne is aware that many legal advisers have taken a different view/interpretation (and thus, so have numerous AFS Licensees).

The difference in the treatment of client funds under these two scenarios is best highlighted in the diagrams below.

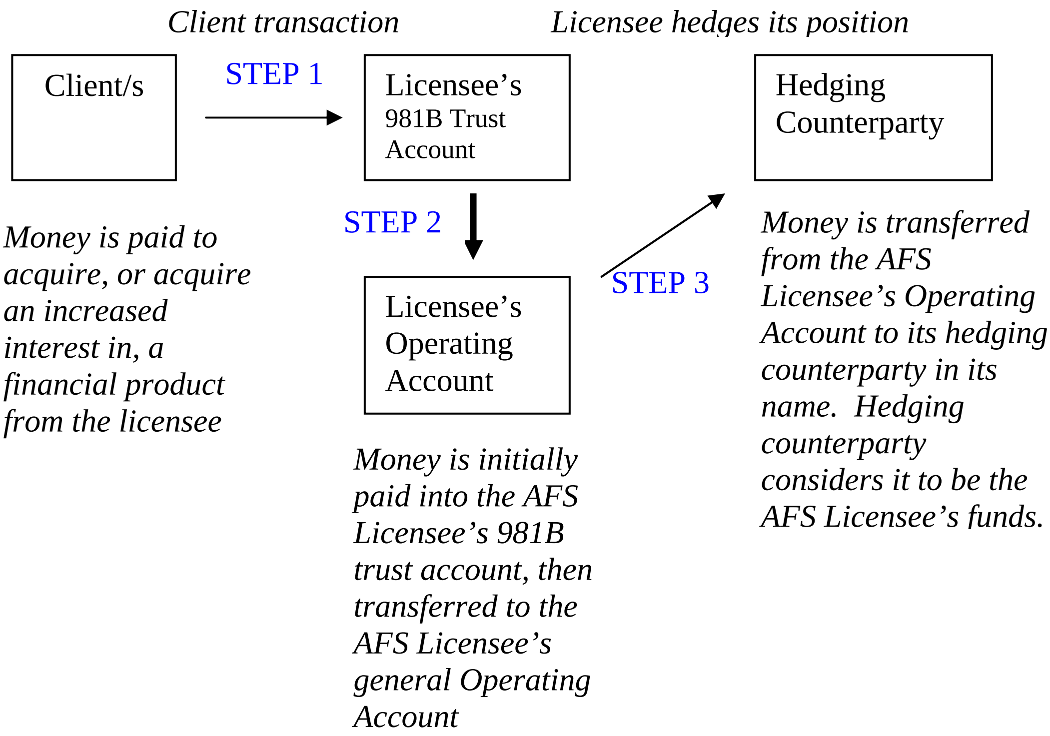
Scenario 1 - Collateral paid

	Client transaction		*Licensee hedges its position*	
Client/s	STEP 1 →	Licensee (s981B Trust Account)	STEP 2 →	Hedging Counterparty
Money is paid to acquire, or acquire an increased interest in, a financial product from the licensee		*Money is paid into the licensee's 981B trust account.*		*Money is transferred from the AFS Licensee's 981B trust account to its hedging counterparty in its name. Hedging counterparty is advised that it is money belonging to the Licensee's clients.*

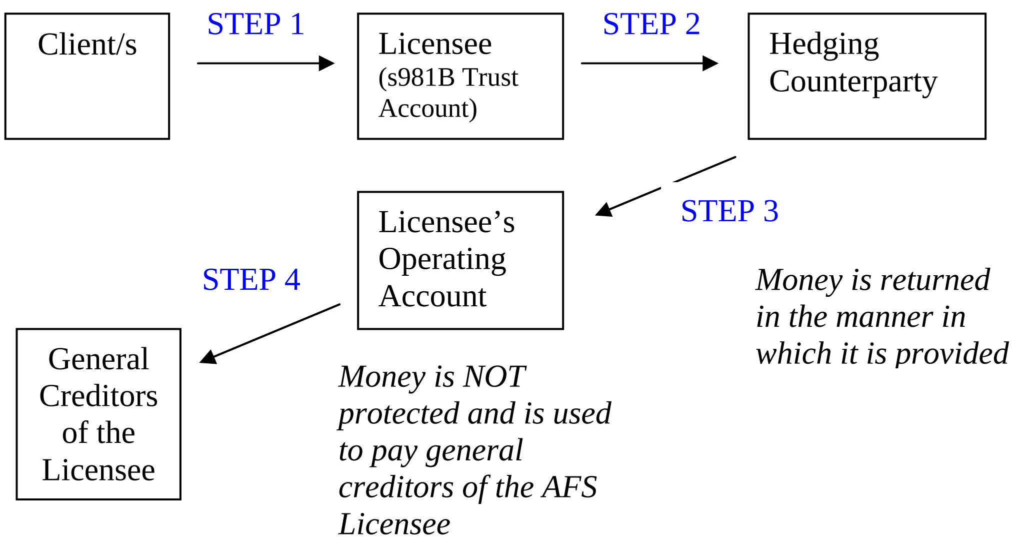
In the event of default by the AFS Licensee, money is returned in the manner (terms) in which it is paid / provided and is thus protected (it cannot be used to pay the AFS Licensee's creditors):

Client/s	← STEP 4	Licensee (s981B Trust Account)	← STEP 3	Hedging Counterparty
		Money is protected by the s981B trust account (provisions in the legislation).		*Money is returned in the manner in which it is provided*

Scenario 2 - Consideration paid for the acquisition of a financial product:



In the event of default by the Licensee, money is returned in the manner (terms) in which it is paid / provided and is thus NOT protected as it is paid into the AFS Licensees general Operating Account and thus, can be used to pay the AFS Licensee's creditors.



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 feel 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 AFS Licensee in hedging its positions with counterparties/liquidity providers).

In other words:

- if the AFS Licensee withdraws money from the Clients' Account and pays the money to a counterparty (to hedge the risk), then the AFS Licensee 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 AFS Licensee operates 2 bank accounts:

1. AFS Licensee Operating Account; and

2. AFS Licensee Clients' Trust Account.

Furthermore, let's assume the following occurs:

- Day 1 – a client deposits $5,000 into the AFS Licensee Clients' Trust Account.

- Day 2 – client enters into a derivative contract which requires an initial margin of $3,000. The AFS Licensee transfers $3,000 from the Clients' Trust Account into its Operating Account.

- The AFS Licensee 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 AFS Licensee transfers $1,000 from the Clients' Trust Account into its Operating Account.

- The AFS Licensee transfers extra funds to its hedging counterparty to cover the variation margin (assuming it is called by the hedging counterparty).

- Day 4 – the AFS Licensee 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 AFS Licensee 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 AFS Licensee's clients. Furthermore, all proceeds would be returned in the manner in which they were received i.e. to the AFS Licensee'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 AFS Licensee (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 <u>may be used</u> for the purposes of meeting obligations incurred by the licensee.

Thus, initial (and/or variation) margins do not belong to the AFS Licensee (and/or the hedging counterparty). Rather, the AFS Licensee (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 AFS Licensee. In other words, in what capacity are the funds transferred:

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

(b) ISDA Agreements

Pursuant to Section 981D of the Corporations Act, many AFS Licensee's uses 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 AFS Licensees are forced to enter into Agreements i.e. ISDA Agreements (with these hedging counterparties) which states that the funds are unencumbered.

The AFS Licensee's 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

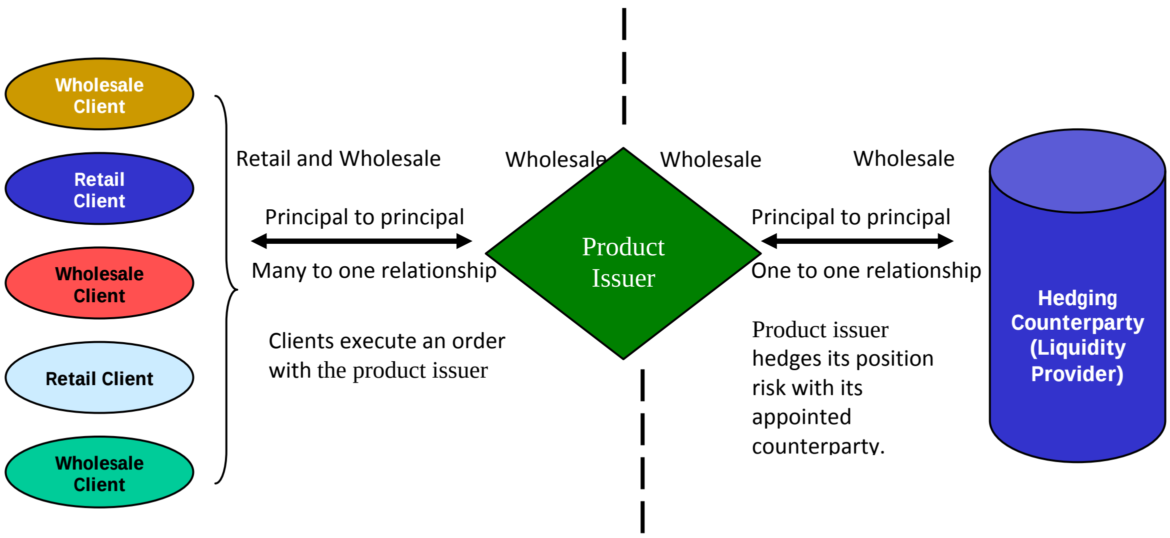
We note the Discussion Paper identifies that all client monies are combined and deposited by an AFS Licensee in a Clients' Account. However, individual client monies are not separated from each other i.e. they are co-mingled.

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 AFS Licensee.

In this event, assets in the Clients' Account of non-defaulting clients are potentially at risk as the AFS Licensee 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 AFS Licensees 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 becomes untenable.

D. 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. For the reasons listed below, we do not believe that any of the proposed reform options are necessarily appropriate. At the same time we also appreciate that there is little point simply criticising the proposed options without proposing a solution. We believe that there are other possible alternatives that act in the best interest of clients, yet they also maintain competitive fairness i.e. they largely improve the protection of client money for all industry participants, large and small (please refer to Section E 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 AFS Licensee.

(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 AFS Licensee.

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 entered into with clients 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 main 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 12) for further information.

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

E. Proposed alternate options

Lazorne 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 (and we assume others) 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.

We note that have not seen these submissions, but are aware of the general content. We thought it prudent not to duplicated the explanation of the structures in this submission, but instead refer you to the detailed submission lodged by these entities.

Neither we, nor the contributors, are implicitly endorsing these submissions. Furthermore, some of the contributors are not even aware of these alternative structures. We simply encourage that these be explored fully before implementing any reforms.

F. 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 licensee; or

   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.

We also do not believe that his 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.

As stated above, we are strong advocates that the law should protect client money at all times.

(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 AFS Licensee from topping up the client trust account (s981B Account) on the basis that it is not an authorised deposit. Compliance with this provision should be regularly monitored by ASIC. This is a major weakness in current legislation.

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 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)?

   RESPONSE:

   Yes, the regulations should be changed to limit the ability of an AFS 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.

   We agree that the use of general and broad client directions in the client agreement of licensees from clients to enable the AFS Licensee to make withdrawals from client money for any purpose whatsoever is not at all 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 AFS Licensee 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). However, we are not sure what protections are envisaged.

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?

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, AFS Licensees 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:

   No comment.

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

   RESPONSE:

   No comment.

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:

   No comment.

G. 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 give 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 AFS Licensees (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 AFS Licensees (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.

H. 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 hope Treasury finds the comments in our submission useful and we reiterate our belief that 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 sincerely

LARRY SIMON
DIRECTOR

DEBORAH HORNE
DIRECTOR

ANNEXURE A

CONTRIBUTORS TO THIS SUBMISSION

In making this submission, Lazorne is representing some AFS Licensees that will be directly affected by the proposals contained in the Discussion Paper.

Following is a list of the AFS Licensees which have contributed to and support this submission:

1. Apex Derivatives Pty Ltd – AFS Licence Number: 359820

2. Currency Online Limited – AFS Licence Number: 415643 (pending)

3. Direct FX Trading Pty Ltd – AFS Licence Number: 305539

4. First Prudential Markets Pty Ltd – AFS Licence Number: 286354

5. Gleneagle Securities (Aust) Pty Ltd – AFS Licence Number: 337985

6. Global Prime Pty Ltd - AFS Licence Number: 385620

7. HIFX Ltd – AFS Licence Number: 240914

8. HIFX Australia Pty Ltd - AFS Licence Number: 240917

In addition to the above, some contributors have asked to remain anonymous.