SUBMISSION REGARDING THE HANDLING AND USE OF CLIENT MONEY IN RELATION TO DERIVATIVES TRANSACTIONS

BY

CRAIG NEWBERRY

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General Principle of Submission

It is my view that the problems (apart from malfeasance in the US firm) at MF Global arise from one error in regulatory law, that is, that the **broker firm is currently able to use client monies to margin or deal in the firm's own positions.** A second but possibly less significant matter is whether restrictions on pooling client funds would have helped prevent the situation.

Context of Current Regulation

I note that in respect to the contract markets the best minds have looked at this a number of times both here and overseas and concluded that a trust structure is not appropriate due to the fact that only net positions are margined at the clearing house. Consequently my submission while supporting generally the idea of a trust structure in OTC markets does not make such a suggestion in relation to the contract markets.

Consequences of the General Principle of this Submission

I comment here on the four matters under consideration in the guidance document. Adopting the UK approach or imposing a statutory fund or adopting individual segregated accounts does not fix the problem. This is because the broker firm is still allowed access to client funds for margining its own positions and other related uses. This is the heart of the problem and, I contend, gives rise to a feeling within the broker firm that clients funds are available for the firm's own use.

In the case of MF Global Inc no doubt this feeling arising from regulatory uncertainty made senior employees of the firm feel they could use client funds to margin (at least temporarily) their proprietory positions in European debt, thus ultimately causing the demise of the firm. This despite the fact that under US regulatory law client funds should not be used this way.

It is my unshakeable conviction that no client funds should ever be used or be able to be used to margin the broker's own positions. Furthermore any uncertainty as to the legitimacy of this should be absolutely removed.

Submission

With this guiding principle in mind I examine each Treasury suggestion in turn.

Restriction on the Use of Client Money

It is my view that this is absolutely the right way to go. The broker firm should NEVER be able to use client money for its own purposes.

I note that although the intention of the law is to permit the firm to use client funds to enable the firm to hedge client positions and so reduce firm risk, in fact it is often very difficult to separate the firm's hedging positions from its proprietary ones. This is one major reason why other jurisdictions do not permit the use of client money for this purpose. It leads to abuse of the legal exception granting use of segregated funds to the broker firm. I contend such use of client funds **should not be permitted under any circumstances** so the temptation to abuse the law is removed. The firm should use its own capital to do this hedging.

Furthermore I believe that the **client should be unable to override the recommended provision restricting use of his segregated funds.** Otherwise the broker firm will coerce the customer to sign away protection by embedding the wording in the Client Agreement Form.

I note again that other jurisdictions mostly do NOT allow client funds to margin the brokers own positions.

Adopt the UK Approach

This certainly has merit in OTC markets. I note however that there is a worldwide movement to force OTC products to be settled through a central clearing house so caution the Treasury that too much work along these lines may not be very productive as a trust structure is not suitable for centralized clearing. Better to mandate OTC products be centrally cleared. This will offer the clients more protection in the long run. Current law relating to segregated funds offers protection close to trust law in any event. More importantly I do not believe such a structure eliminates in law the uncertainty relating to the broker firms use of client funds. It doesn't help having a fiduciary duty if the funds can be withdrawn for use by the firm for its own business. (Or indeed if the broker firm **thinks** it has that right)

Impose a Statutory Trust Fund

Please see my comments on the UK regime which apply in this case. Again I state this regulatory method fails to eliminate in law the uncertainty regarding the use of client money.

Adopt Individual Segregated Accounts

I **strongly supports this in fact and in principle**. The reason is that it acts to further make clear in the minds of the executives of the broker firm that this money is client money **not available for the ordinary business of the firm** consistent with the general principle espoused in this submission. It also has the effect that should the broker go into liquidation it sharpens the mind of the liquidator/administrator making plain that these monies are client monies and rank prior to other claims.

There is no reason for not applying individual segregation in the regulations which apply to the contract markets. These days with sophisticated computers there is no reason for not applying individual segregation. It should be a no-brainer in the same way that daily reconciliation of the clients accounts should be.

Implementation of the Principle

It is not sufficient that permission to use client monies for other purposes be eliminated from Section 981D. Uncertainty would still remain and need to be clarified by case law. **It is essential in my view that a specific provision be inserted into the Act specifically prohibiting the use of client monies for any purpose other than margining the clients own positions.**

Furthermore **provisions mandating individual client segregated accounts should be inserted.** This would eliminate pooling of clients funds where those funds can currently be used to margin other clients positions. This encourages sloppy practices by the broker firm and lack of promptness in obtaining top-up margins (variation margin) from individual clients.

Note on Fidelity Funds

Currently provisions do exist in the contract markets for the ASX Fidelity Fund providing for claims of up to $100,000 per claim by retail clients in the event of malfeasance by the broker. I **strongly propose that this fund be statutorily expanded to include the OTC markets and be available not only in the event of malfeasance, but also in the case of insolvency, where there is insufficient funds in the clients segregated accounts to make them whole**. This would be funded by a statutory levy on the broking industry. Regulations could then be modified to make it **much harder for the liquidator to be paid any amounts out of client segregated money.**

Should the Treasury wish to contact myself in relation to this submission, please contact:

Craig Newberry 0408 537 733

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