Stockbrokers Association of Australia
Incorporating SDIA

Treasury Discussion Paper: Handling and Use of Client Money in Relation to Over-The-Counter Derivatives Transactions – November 2011

The Stockbrokers Association is pleased to provide the following comments on the matters raised in Treasury's Discussion Paper *Handling and Use of Client Money in Relation to Over-The-Counter Derivatives Transactions* dated November 11.

	Issues for comment:	Stockbrokers Association Comments:
1	Should the law be amended so that: a. 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 b. 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	a. If the law were to be amended as stated in (a) for retail clients, then there would be an inconsistent application of Corps Act (Sec 981D) between retail and wholesale clients. If there was a requirement for separate accounts akin to trust (options) or segregated (futures) account requirement for exchange-traded products, there would be an increase in compliance costs to separately maintain accounts for each retail client, and that cost may be passed on to those affected clients. The increased cost may also discourage market participants from offering financial products which require margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee, thereby inadvertently affecting competition and choice in the retail market. b. While (b) sounds fundamentally a plausible suggestion, it is unclear from the paper how this will be applied. Clearing house deals with market participants on a principal to principal basis with no distinction between principal and agency contracts. As such, segregation of client monies would need to be conducted by the market participant, and the concern of cost (as per above) may apply.

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	licensee on behalf of people other than that client?	
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?	In Exchange Traded Markets, brokers keep client funds in 'omnibus' segregated accounts (Futures trades) or trust accounts (Options trades), settle gross margining with the clearing house, and manage individual margining with their clients. Trust accounts must be reconciled daily under the Market Integrity Rule 3.5, and failures to reconcile must be reported to ASIC. This process is overseen by the relevant Exchange/Clearing House and underpinned by a strong regulatory regime, including audit. This process could be replicated for OTC derivatives. However, notwithstanding any new requirements for OTC derivatives, Market Participants should continue to be able to work on the 'omnibus' basis.
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)?	As discussed in 2, existing exchange traded processes work and provide robust protection in turbulent markets. These could probably be replicated for OTC derivatives.
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)?	Following the commencement of the AML/CTF regime, it is relatively rare for stockbrokers to make third party payments from trust, and only do so with prior written authority. However, some firms require the flexibility to make such payments on express instructions of the client. Perhaps the issue could be addressed by prohibiting standard-form (blanket) authorisations in the client agreement, in the same way that blanket instructions to trade on a certain market are not permitted by retail clients under the Best Execution rules in *Market Integrity Competition in Markets* Rule 3.1.1(3). The client should be able to choose whether or not to leave money in excess of minimum margin requirements in the account or have them returned to their regular transaction account. It works in exchange traded markets and could be replicated for OTC.
5	Should licensees be required to conduct a regular reconciliation of	Regular reconciliations are already in place for market participants, and normally subject to audit review. It would be appropriate to apply the same regime to OTC participants.

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	client money and have a documented process in place to escalate and resolve any 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?	While there appears to be different interpretations, Market Participants have been obliged to follow the Exchanges' directions, so generally there is a consistent interpretation.
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.	The UK approach where appropriate rules are in place so that firms take appropriate steps to ensure that the client money it places with third parties are held in suitable segregated facilities does appear to compliment with the existing Corps Act requirements. In addition, the proposed FSA amendments which prevent investment firms from using 'title transfer collateral arrangements' with retail clients that would allow those firms to treat client money as their own working capital, appear to be a step in the right direction. This will effectively prevent OTC derivatives issuers from using client money held for retail clients in the manner currently permitted in Australia by section 981D of the Act. As many market participants are branches of UK companies, it would therefore appear logical to explore the UK approach in greater detail. This will facilitate and ease the transition from the existing to new requirements. However, if it is being used as margin or security for enabling OTC transactions, it should rightfully be used to offset losses incurred by the client as transacted through the licensee.
8	What would be the impact of the possible changes identified in this paper? Please provide as much detail	Possible impact includes the associated increase in compliance, systems and procedural costs, and future harmonising of the propose changes with international standards (such as that of the Dodd Frank Act) where applicable.

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	as possible of any costs or other impacts.	
9	Should any enhanced protection apply to the money and property only of retail clients? Why?	Enhanced protection should be offered the retail clients as a general business rule, and not limited to segregation of retail clients' money. Market Participant's arrangements are already sufficient.
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.	-
11	Are any additional protections needed for client money where the licensee holds the financial products outside Australia?	Protection offered should ideally be consistent with international standards for segregation of client money.
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?	The law should be amended to clarify the conditions in which the licensee may make an entitlement claim, but not necessarily "limit" the bases of the claim.
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	-

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	if a derivative position was closed?	

Reporting Requirements

	Issues for comment:	Comments:
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?	A gap may exist from the perspective that since it is not a legal requirement, not all licensees are providing periodic reporting to retail clients, and not all are reporting similar information. However, this does not necessarily imply that the retail clients are misinformed.
2.	Are the items listed above information which would benefit clients?	The majority of the information suggested is generally reflected in periodic statements, with the exception of the following - '*where the licensee holds assets on behalf of clients, the licensee must provide a statement to the client setting out details of assets held and the means by which they are held*'. Further disclosures regarding the legal implications of the means by which the assets are held may be required. This should provide retail clients with relevant information of what may happen to their money in an insolvency event.
3.	Can you give an indication of the cost of preparing monthly statements covering these items and providing them to clients electronically?	Cost would depend on the extent of information provided as stated in point 2 above, but would certainly include expensive systems upgrades.
4.	Please indicate if there are any other reasons why it would be inadvisable to require monthly reporting.	-

	Issues for comment:	Comments:
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)?	As with bank account statements, licensees should, as a rule of thumb, provide retail clients with the ability to access such statements whenever they wish so. This service should be inclusive to the monthly statements.
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.	-

Thank-you for the opportunity to comment on this important Discussion Paper. Should you have any inquiries, please contact me (dhorsfield@stockbrokers.org.au) or Doug Clark, Policy Executive (dclark@stockbrokers.org.au).

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