AliceCorporation

January 16, 2012

Manager - Financial Services Unit
Retail Investor Division
The Treasury
Langton Crescent
PARKES ACT 2600
Email: clientmoney@treasury.gov.au

Dear Sir or Madam,

RE: COMMENTS ON DISCUSSION PAPER "HANDLING AND USE OF CLIENT MONEY IN RELATION TO OVER-THE-COUNTER DERIVATIVES TRANSACTIONS"

In its discussion paper, "Handling and Use of Client Money in Relation to over-the-counter derivatives transactions", November 2011, the Australian Treasury has asked for public comment on whether the client monies provisions of the Corporations Act 2001 (the Act) provides sufficient protection for investors (referred to hereinafter as "entity" or "entities"). In particular, public comment has been sought on this question in respect of derivatives where the issuer is not a market operator under s761E(6) and where the issuer deals with a "retail" entity, as defined under s761G.

This submission is in three parts. Part 1 addresses the above question. Part 2 addresses whether the Act provides sufficient protection where the issuer is not a market operator under s761E(6) but deals with entities that are "wholesale" entities . Part 3 addresses whether the Act provides sufficient protection where the issuer *is* a market operator under s761E(6), regardless of the type of entities involved.

Part 1: Are retail clients protected when entering into contracts for over-the-counter derivatives?

The client monies provisions of the Act unambiguously do not provide sufficient protection for "retail" entities dealing with derivative issuers that are not market operators under s761E(6). The phrase in the Act that reads "to meet obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee" is too broad and allows licensees to employ client funds in ways that expose a client to loss if the licensee is stressed. This is especially true if client funds are employed by the licensee in contracts that are subject to priority claims under ISDA.

It is too easy for retail clients to be persuaded to enter into arrangements that put their funds at risk and the best approach is to strictly constrain the circumstances under which client funds may be held and used.

To provide appropriate protection to "retail" entities, s981D of the Act should be changed so that:

1. All client funds should be placed in legally segregated accounts for each client and these accounts should be maintained in Australia unless a client requests otherwise, in writing;

2. Licensees should no longer be allowed to use funds placed in a client account "to meet obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee". Furthermore, this limitation should explicitly include proprietary dealings by the licensee and dealings on behalf of people other than the client, for example, other clients of the licensee. Licensees should only use funds in connection with obligations *directly* incurred by the client, not for obligations that arise from the licensee hedging its positions with other clients. Permitted uses would include:

    a. Premium payments for options contracts entered into by the client;

    b. Where the licensee is an appointed clearing broker for the client, independent amount payments, variation margin payments and clearing fees paid to a Central Clearing Counterparty (CCP) for cleared over-the-counter derivatives contracts entered into by the client. Where the CCP or a regulator requires the licensee to collect a higher amount from the client than is payable by the clearing broker to the CCP, then the client should have the option to have the full amount be held by the CCP;

    c. Independent amount and variation margin payments to support derivatives contracts that are not cleared and to which the client remains the counterparty. Consideration should be given as to whether the client should be able to request such collateral be held by a third party custodian. Such an arrangement is likely to incur higher costs for the client but some may choose it regardless of cost;

    d. Enumerated account management fees associated with operating the client account.

3. Clients should have an agreement with a licensee enumerating the precise circumstances under which funds can be withdrawn and any other withdrawals should only be made upon direction of the client in writing.

4. Licensees should be required to conduct regular reconciliations of client funds and have a documented process in place to resolve any variances that are identified.

5. There should be express requirements regarding the segregation of funds. In particular, licensees should be required to segregate amounts that would be due to a client if a derivative position is closed.

6. There should be strict limits on how client funds collectively can be invested. As proposed in the recent ruling by the Commodity Futures Trading Commission in the U.S., restrictions should prevent investment in any instrument which does not preserve principal and should forbid the investment of funds in in-house or inter-affiliate transactions.

These changes to the Act should also apply to all derivative transactions involving an "off shore" aspect; that is: (a) Cleared derivatives that are cleared through a CCP outside of Australia; and (b) Non-cleared derivatives where the licensee "books" the transaction with an entity that is not subject to Australian regulatory jurisdiction.

Part 2: Should the protections proposed for retail clients be extended to wholesale clients dealing in over-the-counter derivatives?

In general, there does not appear to be a good public policy reason why the client monies provisions of the Act as applied to "wholesale" entities should be any different to the provisions that apply to "retail" entities. As was evident during the 2008 financial crisis, many "wholesale" entities are not capable of continually assessing their risks of loss to a licensee. This is especially true when licensees have the broad access to client funds embodied in the words "to meet obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee".

To avoid systemic risk to CCPs, the Act should, at a minimum, ensure that all funds employed for the margining and settlement of cleared OTC derivatives are legally segregated and that the allowed use of funds is restricted in the same manner as is proposed above for retail clients. It should be noted that while the United States currently proposes to require such segregation only for cleared swaps, it is examining how legal segregation may be extended to futures instruments. All cleared derivatives would thus be subject to legal segregation unless explicitly exempted.

Some jurisdictions, for example the U.S. under the Dodd-Frank Act, do not impose segregation requirements on uncleared derivatives although they require that a dealer offer segregation to a client. Whether a comparable approach should be taken in Australia should depend on the needs and preferences of wholesale clients. At a minimum, clients should be offered the option of segregation. Also, there may be certain types of entities, such as certain types of asset managers or local government entities, whose funds should be segregated by default.

Part 3: Do the client monies provisions of the Act provide sufficient protection for clients where the issuer is a financial market operator under s761E(6)?

Where the issuer is a licensed market operator and the derivatives are cleared, as is the case where the operator is an exchange, then the same provisions applicable to cleared over-the-counter derivatives should apply. Regulators and CCPs associated with futures markets internationally have varied in the degree to which they require legal segregation of client funds. Clients have sometimes

been exposed to fellow customer risk but it has traditionally been argued that this gives an incentive to intermediaries to monitor client credit risk more carefully. In the wake of MF Global where losses were associated with futures accounts, legal segregation of client funds is now being promoted.

With the growth of electronic trading of swaps and other instruments, it is possible to have a financial market operator issuing derivatives that are not cleared. These facilities should operate under the assumption of trade finality even where the market operator does not administer the contract post-trade but leaves the counterparties to margin and settle the contract bilaterally. A condition of participation should be that participant funds are legally segregated wherever they are held.

Yours faithfully,

Ian K. Shepherd

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