Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

2015 - 2016

Department/Agency: Australian Securities and Investment Commission
Question: AET 137-146
Topic: Derivatives Brokers
Reference: written - 17 February 2016
Senator: Dastyari, Sam

Question:

BACKGROUND

The hedging of client funds by derivatives traders is a topic that this committee has been addressing for some time.

There are allegations a consortium of four large global derivatives brokers have 'astro-turfed' a campaign, including targeting members of this committee, to change Australian laws under the guise of a body named "Australian CFD and FX Forum", and lobbyist Hugh Fraser.

As a consequence, the Government is considering adopting a regulatory regime used in the United Kingdom to protect client monies held by derivatives brokers. On 21 December 2015, the Government released exposure drafts of the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016, which proposes forcing local trading institutions to hold client money in trust.

Some 60 small trading businesses claim they will be put out of business by the big four foreign traders if the legislation passes.

Questions

137. Is ASIC aware of the allegations the Australian CFD and FX Forum is an example of 'astro-turf' lobbying campaign? (Y/N)

138. Will some 60 small trading firms be put out of business by the big four foreign traders if the legislation passes?

139. Does the UK system provide stronger protections to consumers than the current Australian legislation?

140. The UK model, which is being proposed by the Government, creates a conflict of interest between the provider and their clients. The clients want to make money, but the firm's business model revolves around the client losing. How is this in the best interests of clients?

141. The CFD and FX Forum use the example of the collapse of MF Global to support their lobbying: were UK clients worse off than Australian clients? (In the UK, the distribution payment was short 10 cents in the dollar, while in Australia clients received up to 100% of

their money back.)

142. Do you agree that the hedged model, is permitted allowed in Australia presently, flows client investments into the underlying market so the client is trading against the market, not the provider. In this model are the client and the provider's interests better aligned?

143. A number of Australian firms are concerned the proposed legislation will create a conflict of interest between firms and their clients (due to firms being prevented from hedging their clients' investments). Has ASIC considered the effect of promoting a business model whereby firms will be forced to trade against their own clients or go out of business?

144. Given the large number of firms that have indicated that their current business model will not survive in the event that the legislation is introduced, has ASIC considered the effect on competition, or referred the matter to the ACCC?

145. Is it correct that moving to the UK unhedged model will not prevent fraud?

146. Could current regulation be improved by focusing on tighter controls around client assets and liabilities, enhancing audit directives, and clearer clarification of client assets in the event of insolvency, rather than banning the use of client money for hedging?

Answer:

Question 137

ASIC is of the view that the Australian CFD and FX Forum is an industry body similar to the Australian CFD and FX Association. We are aware of the perspectives of each of these industry bodies.

Question 138

The reforms proposed by the Government in its policy paper do not prevent domestic or foreign retail OTC derivative issuers from conducting their business.

The reforms will prevent issuers from using client monies for working capital or to hedge the firm's business risks and are expected to affect both domestic and foreign issuers. Hedging and risk management strategies protect the trading and capital positions of the firm, not the client's positions. The key difference is whether the firms use their own money to hedge this business risk, or whether they use their clients' money to do so.

Transitional arrangements may be expected to allow issuers to adapt to the revised requirements. The nature of transitional arrangements would be a matter for government.

Question 139

Hedging and risk management strategies protect the trading and capital positions of the firm, not the client's positions. The key difference is whether the firms use their own money to hedge this business risk, or whether they use their clients' money to do so.

The UK regime does not permit firms to use client monies for working capital or to hedge the firm's business risk.

The Australian regime allows issuers to use client money for these purposes. This exposes retail clients to the risk, that client money may not be returned by the firm's counterparty, or that their money may have been taken out of the client trust account and loses its 'trust' status.

By comparison, under the UK regime, firms are not permitted to use client money for these purposes, so retail clients are not exposed to these risks.

ASIC notes that best practice internationally and for the majority of Australian financial firms – ranging from retail issuers to global banks – is to use their own money to hedge risk and to keep their clients' money in a trust account or segregated account.

Question 140

ASIC does not agree with the statement that the UK model creates a conflict of interest between the provider and their clients.

In the over-the-counter (OTC) markets, investors enter into contracts with the firms themselves. This can create a risk for the firms which are exposed to market movements during the life of the contract. The risk to the firm is that the market may move in a direction which is unfavourable to them (but favourable to the client). This is a business risk of the firm arising from the decision to do business with the client.

Under both the Australian and UK regimes, firms would need to manage these business risks, including by hedging and using other risk management strategies. Hedging and risk management strategies protect the trading and capital positions of the firm, not the client's positions. The key difference is whether the firms use their own money to hedge this business risk, or whether they use their clients' money to do so.

ASIC has not observed greater evidence of conflict of interest in firms that use their own capital, compared to firms that use client monies.

ASIC notes that best practice internationally and for the majority of Australian financial firms – ranging from retail issuers to global banks – is to use their own money to hedge risk and to keep their clients' money in a trust account or segregated account.

Question 141

The difference in outcomes in MF Global for UK and Australia clients appear to have been due to a range of factors not necessarily linked to the ability of the different entities to use client money for hedging.

ASIC considers that other cases illustrate that retail OTC derivatives client money is afforded a lower level of protection compared to client money for exchange-traded products.

An immediate example is outlined in a recent media release that ASIC issued on **Ironfx**.

http://asic.gov.au/about-asic/media-centre/find-a-media-release/2015-releases/15-395mr-ironfx-corrects-disclosure-about-australian-regulation-and-counterparty-arrangements/

In that case we identified that IronFX Australia hedged each transaction with its Cyprus parent and had a general policy of using all client money for the purposes of funding those positions. Investors have no recourse against a hedge counterparty and their recourse is therefore limited to IronFX Australia's actual recovery against its hedge counterparty (which is currently IronFX Cyrpus). We indicated that investors should ensure that they understand

their contractual rights and obligations and carefully assess all relevant risks. In particular, investors should understand the credit risk posed by the hedging arrangement with IronFX Cyprus before entering into any transactions with IronFX Australia

Another matter is **GTL Trade up**.

http://asic.gov.au/about-asic/media-centre/find-a-media-release/2013-releases/13-283mr-asic-warns-of-dangers-of-foreign-exchange-trading-for-retail-investors/

http://asic.gov.au/about-asic/media-centre/find-a-media-release/2015-releases/15-193mr-asic-bans-former-gtl-tradeup-pty-ltd-director/

GTL Tradeup was a retail over the counter derivatives provider that recently went into liquidation. It is understood GTL Tradeup, half of whose roughly 1500 clients are in Australia, sent more than $1 million in client money as permitted under the current law over to its hedging broker at the firm's Dubai headquarters in July, GTL Trading DMCC. GTL Trading DMCC then used the money and lost it through its hedging transactions with its own hedging counterparties. One of GTL's Australian clients, who can no longer access his funds, started a blog online following the firm's collapse. One client writing under the name Maurice Conchis, is reported to have said "There would appear to be a common misapprehension that client funds provided to a margin operator like GTL Tradeup is somehow quarantined in a trust. Indeed, I assumed this to be the case. However, it seems that is not the case at all."

Also outlined below in Schedule 1 are examples of retail OTC derivatives disclosure where we have concerns about the way in which the client money are being used.

Recovery differences for clients for exchange traded products and OTC derivatives

You might also note the difference in recoveries for client involved in exchange traded and OTC traded derivatives as illustrated in the recent BBY collapse. The table immediately below highlights the different level of protection for client money held at an exchange and off-exchange (including by retail derivatives issuers).

Table: Potential Distribution Outcomes to clients of BBY

If BBY was a market participant	**BBY was a market participant**		BBY was not a market participant				
Product	**Equities**	**ETO**	**Futures**	**FX**	**Saxo**	**Carbon**	**Interactive Brokers**
Scenario A/B	$1.00	$1.00	$0.04	$0.53	$0.02	$0.00	$0.00
Scenario C	$1.00	$1.00	$0.36	$0.60	$0.40	$0.00	$0.95
Scenario D	$1.00	$0.80	$0.36	$0.60	$0.40	$0.00	$0.95

Source: KPMG, BBY Client Monies Investigation Report, (22 December 2015), page 56

For the equities and ETO businesses, as BBY was a participant of ASX, client money was held on an exchange to which substantive additional client money protections apply. The

potential recovery for these clients is 100 cents in the dollar under most scenarios[1]. For other business lines, client money was not held at an exchange, and some of that client money was paid to third parties including hedge counterparties. These clients are likely to receive between 0 cents and 95 cents in the dollar.

Question 142

ASIC does not consider that the ability to use client money for hedging the firm's business risk results in better alignment of interest between the issuer and the client.

In the over-the-counter (OTC) markets, investors enter into contracts with the firms themselves. This can create a risk for the firms which are exposed to market movements during the life of the contract. The risk to the firm is that the market may move in a direction which is unfavourable to them (but favourable to the client). This is a business risk for the firm.

Firms need to manage these business risks, including by hedging and using other risk management strategies. Hedging and risk management strategies protect the trading and capital positions of the firm, not the position of individual clients.

The key difference is whether the firms use their own money to hedge this business risk, or whether they use their clients' money to do so.

ASIC notes that best practice internationally and for the majority of Australian financial firms – ranging from retail issuers to global banks – is to use their own money to hedge risk and to keep their clients' money in a trust account or segregated account.

Question 143

ASIC does not consider that the ability to use client money for hedging the firm's business risk creates a conflict of interest between the issuer and the client.

In the over-the-counter (OTC) markets, investors enter into contracts with the firms themselves. This can create a risk for the firms which are exposed to market movements during the life of the contract. The risk to the firm is that the market may move in a direction which is unfavourable to them (but favourable to the client). This is a business risk for the firm.

Firms need to manage these business risks, including by hedging and using other risk management strategies. Hedging and risk management strategies protect the trading and capital positions of the firm, not positions of individual clients.

The key difference is whether the firms use their own money to hedge this business risk, or whether they use their clients' money to do so.

In addition, firms that do not have sufficient capital to fund their own hedging activities and are therefore reliant on client monies to fund their hedging activities may pose additional risks. The use of client money for this purpose may suggest that they are more vulnerable to financial shocks such as the failure of a client, hedge counterparty or an operational loss of some kind.

ASIC notes that best practice internationally and for the majority of Australian financial firms – ranging from retail issuers to global banks – is to use their own money to hedge risk and to keep their clients' money in a trust account or segregated account.

[1] Details of the scenarios are in KPMG, BBY Client Monies Investigation Report, (22 December 2015), page 56

Question 144

ASIC considers that adequate transitional arrangements may allow issuers to adapt to the proposed revised requirements. The nature of transitional arrangements would be a matter for government.

Question 145

The proposals here and in the rules in the UK do not prevent hedging.

The reforms proposed in the Government's policy paper are expected to mitigate the risk of fraud. For example, the policy paper proposed more detailed record keeping and reconciliation requirements in relation to retail OTC derivatives client money. These requirements can help a firm, the clients, or the regulator, to identify potential fraud in a more timely manner.

Legislative reform for any service or industry cannot remove the risk of fraud entirely.

Question 146

ASIC considers that clearer clarification of client assets in the event of insolvency may assist with the identification and distribution of client money.

However, where client monies has been taken out of the client money trust account and used for working capital, or has not been returned by the hedge counterparty (which may be an overseas entity), there remains the risk that the money will be lost and will not be available for distribution to clients in an event of insolvency.

Preventing the use of client money to hedge business risk, or for use as working capital, would ensure that client money remains in the client money trust account, and will be available for distribution to clients in an event of insolvency.

The proposals for record keeping and reconciliation requirements in the Government policy paper, similar to enhanced audit directives, may assist the issuer, their clients, or the regulator, to identify cases of non-compliance or fraud in a more timely manner. Nonetheless these requirements would not, of themselves, remove the risk that client monies can be lost and will not be available for distribution to clients in an event of insolvency.