IG MARKETS LIMITED

(AFSL No. 220440)

EXECUTIVE SUMMARY

OF

SUBMISSION ON-

Australian Securities and Investments Commission

Consultation Paper:

Client money relating to dealing in OTC Derivatives

1. Use of client money to pass through to brokers for own margining purposes currently a permitted use under *Corporations Act 2001*, ("the Act") the Regulations, and ASIC Consultation Paper.

2. This is subject to client consent, which is typically contained in PDSs.

3. Reliance seems to be on Section 981D of the Act as authorising this permitted use.

4. IG Markets Limited ("IG") an AFS Licensee, contends-

   (i) Section 981D on its proper construction does not permit this practice;
   (ii) Even if upon its proper construction it does, it should not do so, because Section 981D derives from Section 1209(5)of the old *Corporations Law*, which largely related to futures brokers and their interaction with futures exchanges and clearing houses;
   (iii) OTC CFDS are principal to principal transactions with no involvement of exchanges or clearing houses, therefore Section 1209(5) does not translate into Section 981D as it seems to have been enacted, and interpreted. Accordingly Section 981D should be clarified or amended to make it clear in respect of OTC transactions.

5. Whatever the meaning of Section 981D, use of client funds for CFD providers' own margining should not be permitted at all, even if disclosed, because the risks are too great. In a provider's corporate insolvency, those funds would in all probability be lost or at least be at substantial risk. Added to that, the entire CFD industry is at risk of reputational damage if there was client money loss in such circumstances.

6. While beneficial owners of trust money can authorise its use by a trustee, we question whether clients are sufficiently well informed of the risks.

7. IG does not, and in Australia has never used client money (trust money) for its own margining or any other purposes. It has always remained intact, as trust money should. We do not believe all CFD providers act this way.

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1. INTRODUCTION

1.1 IG Markets Limited **("IG")** is the holder of Australian Financial Services Licence No 220440 and under that Licence is authorised , inter alia, to deal in and make a market in OTC derivatives to retail and wholesale clients. The particular derivative in which IG deals and makes a market are Contracts for Difference **("CFDs").**

1.2 CFDs are now a significant financial product in the OTC landscape in Australia. CFDs are however instruments between principal and principal, are non-standardised and do not involve clearing houses.

1.3 Prior to the introduction of the *Financial Services Reform Act 2001,* which became Chapter 7 et ff of the *Corporations Act 2001* **("the Act")** and the repeal of Chapter 8 of the *Corporations Law,* OTC financial products such as CFDs were prohibited. Derivatives such as CFDs are the statutory successor in OTC form of cash settled, non-deliverable, non-standardised futures contracts. In the context of the Consultation Paper, this statutory succession has resulted, IG believes, in unintended consequences in relation to client money, referred to *poste.*

1.4 This submission by IG is confined to the regulation of client money in relation to CFD's only.

2. RESPONSE TO DRAFT GUIDE

2.1 What can be included in a client money account?

B1Q1 . Do you agree with our guidance as to the money which may be deposited and retained in a client money account ? If not, what money do you consider can be retained in a client money account?

In IG's opinion (insofar as they are not already permitted and for the avoidance of doubt) two further categories of monies may be retained in a client money trust account, until withdrawn for the licensee, (in addition to those specified in RG000.30) namely-

(i) interest accruing to the benefit of the licensee (with the express consent of the client) on trust monies; and
(ii) client money to which the licensee has become entitled by reason of crystallised losses of clients.

B1Q2. Are 'buffers' used in client money accounts? Yes.

B1Q3. Is there any aspect of our suggested guidance on 'buffers' that you consider would present difficulties for your business? If so how? No.

B1Q4. Can you foresee any additional costs associated with the following suggested guidance? If so, what will they be? No.

B1Q5. Do you agree with our guidance as to the permitted uses of client money?

Generally yes, but with one significant exception as set out in Article 3.

B1Q6. Is there any aspect of our suggested guidance on the use of client money that you consider would present difficulties for your business? If so how? No.

B1Q7. Can you foresee any additional costs associated with the following suggested guidance? If so, what will they be? No.

B1Q8. Do you agree with our interpretation of the client money provisions as set out in the draft guide? If not please describe how you interpret the provisions.
Generally yes, but with one significant exception as set out in Article 3.

B1Q9. Do you think we should deal with any other aspect of the client money provisions? If yes, please detail.

We would seek clarification of the interpretation of Section 981D so as to exclude the permitted use, or alternatively an amendment to the legislation as set out in Article 3.

3. OBJECTION TO PERMITTED USE OF CLIENT MONEY

3.1 One of the permitted uses described in the Consultation Paper is set out in RG000.12 and RG000.51, which purport to give effect to a permitted use prescribed in Section 981D of the Act.

That Section provides relevantly-

"Despite anything in regulations made for the purposes of section 981C, if:

(a) the financial service referred to in subparagraph 981A(1)(a)(i) is or relates to a dealing in a derivative); or*

(b) ...

the money concerned may also be used for the purpose of meeting ***obligations*** [our emphasis] *incurred by the licensee in connection with the margining...dealings in derivatives by the licensee (including dealings on behalf of people other than the client."*

* i.e. essentially client money deposited with the licensee in connection with trading in CFDs (being a derivative)

3.2 It is apparent to IG that CFD issuers and ASIC (and perhaps auditors) have relied upon Section 981D as specific statutory authority to issuers to use client money for their own margining purposes. Although issuers typically disclose that in Product Disclosure Statements, in the submission of IG-

(i) upon the proper construction of Section 981D, that Section does not in fact allow this practice. This matter is addressed in Clauses 4.1 – 4.5; and

(ii) the practice itself represents one of the most significant risks to the CFD industry and the majority of its clients. This is addressed in Clauses 5.1 – 5.7.

4. SECTION 981D OF THE ACT

4.1 In IG's opinion, Section 981D of the Act is entirely inconsistent with all sound principles as ought to apply to trust money. On the apparent construction given to the Section by ASIC and other CFD issuers, those issuers may utilize client money, which is otherwise impressed by Subdivision A of Division 2 of Part 7.8 of the Act with all the indicia of sacrosanct trust money, for margining in respect of their own hedging purposes. In the parlance of the industry, issuers (rather euphemistically) "pass through client money to their broker".

4.2 However in IG's view, Section 981D does not on its literal construction allow use of margining money for licensee's own purposes, for the permission is predicated on an "obligation" in connection with margining. In our opinion, the hedging by issuers is not an "obligation", but is a risk management strategy adopted by some issuers entirely at their discretion. It is never an obligation of the nature for instance of a futures broker, which appears to us to be the fundamental pre-condition of Section 981D permitting the practice.

4.3 RG000.52 rightly in our view recognises that Section 981D does not extend to an obligation incurred by the licensee's own proprietary trading in derivatives so as to make a profit, however hedging in our view is no more or less than proprietary trading to preserve or protect profits. It is itself a form of proprietary trading.

4.4 The interpretation of Section 981D, with which IG takes issue, perhaps is explicable having regard to the statutory provenance of the section. Section 981D is by and large the successor *mutatis mutandis* to Section 1209(5) of the *Corporations Law*, now repealed. That Section related to client money of futures brokers, and provides relevantly-

"Where pursuant to this section, a futures broker deposits money in respect of a client in a client's segregated account of the broker, the broker shall not withdraw any of the money except for the purpose of:

(a) ...
(b) making a payment for, or in connection with, the ...margining...of dealings in futures contracts effected by the broker on behalf of the clients only";

4.5 Of course futures brokers so called no longer exist under Part 8 of the Act, and have been descriptively replaced as AFS Licence holders. Importantly, futures brokers by reason of the nature of exchange traded futures contracts, were participants in clearing houses and futures exchanges and often acted in an agency or quasi-agency capacity, so of course futures brokers ought properly be permitted to utilize client funds for their legitimate margining obligations.

4.6 However the same does not obtain in relation to counterpart principals in the CFD transaction. There is no interpositional participation of an exchange or clearing house as part of a licensed financial market, and thus the statutory authority provided by Section 1209(5) while right and proper in respect of futures brokers, does not translate into OTC transactions between principals without such interposition as it is thought Section 981D does.

4.7 Thus in IG's view the draftsman of Section 981D of the Act, inappropriately adopted and applied Section 1209(5) *mutatis mutandis*, when the imperative as applied to futures brokers, does not obtain in relation to OTC CFD issuers. The inappropriate adoption of it however has established the statutory foundation of the practice of CFD issuers "passing client moneys through to brokers", which has been given ASIC's apparent imprimatur in the Consultation Paper (RG000.51).

4.8 However even if IG's view of the proper construction of Section 981D is not correct, in IG's submission the practice we have referred to ought not be permitted for the reasons we set out in Clauses 5.1 – 5.7.

5. RISK OF THIS SUGGESTED PERMITTED USE OF CLIENT MONEY.

5.1 IG's policy position, its interpretation of the *Corporations Act 2001*, the Regulations made thereunder and in recognition of the general law concerning the inviolability of trust accounts, have lead IG to the position, that IG never uses client trust money –

(i) for its own margining purposes, or
(ii) for any margining or related or any other of its own purposes.

That is, IG never passes client money through to brokers. IG believes this position ensures client money is never at risk in the event of IG's corporate insolvency.

5.2 IG's submission is that the practice adopted by some of the other CFD issuers in Australia poses a threat to client money – and ultimately the reputation of the entire CFD industry. This is so because the trust protections of client money are simply lost in the catastrophic event of CFD issuer insolvency, if client money has been used for a CFD issuer's own margining purposes. That the money remains trust money (for example by reason of Section 981H of the Act) is of no benefit if the money has been lost in the insolvency. The protection of client money from attachment (as provided for instance in Section 981E) also does not assist, when the funds are lost.

5.3 A recent experience in the United Kingdom related to 'Global Trader Europe (GTE)' represents a graphic example of the risks and adverse consequences we apprehend, where client money not treated as 'Trust' or 'Segregated' under a UK definition was used for margining purposes, even with client consent. (See http://www.globaltraderclients.com).

5.4 Furthermore in the submission of IG, the practice represents a fundamental conflict of interest which is met head on by Section 912A(1) (aa) of the Act. It is difficult to imagine a greater conflict, than to use client money for one's own purposes. The analogy would be for a Solicitor to use client trust funds awaiting

settlement of a property transaction, to pay the rent on the Solicitor's office. We believe it is an entirely untenable conflict.

5.5 Although RG000.55 recognises the risk, the protection offered – better disclosure in PDSs – in IG's submission is not sufficient. We believe the practice should be absolutely prohibited and to that end , (but not exhaustively) Section 981D ought be amended to eliminate what appears to be statutory authority for the practice, when in truth (for the reasons we have stated *supra*) that part of the statute is anomalous and of flawed and very dubious provenance.

5.6 IG does recognize that as is the case with all trust money, the beneficial owner may expressly permit any use of it by trustees. We question, however, whether the consents constituted by acceptance of a generic "consent" in a PDS, is a sufficiently informed consent for a matter of this significance.

5.7 IG believes that the better view is that the permitted use specified in RG000.51, for the reasons we have attempted to elucidate, ought to be comprehensively prohibited. Only then will client funds be truly protected, and potential reputational damage to the CFD market (and its regulator) be appropriately minimised.