Forex Financial Services Pty Ltd

AFSL: 323193

Response to treasury paper regarding the handling of client money in relation to over-the-counter derivatives transactions

Forex Financial Services Pty Ltd (Forex FS) is an Australian based company specialising in providing margin Forex trading to wholesale and retail clients. Forex FS utilises the direct market access (DMA) business model.

There are two main business models used by CFD and Forex providers in Australia, these are DMA and Market Making. DMA providers usually hedge 100% of their client transactions via prime brokers who link them to the major liquidity providers, namely the major investment banks. In our opinion, the true source of pricing and liquidity for Forex and CFD does emanate from the major investment banks. These banks have capital requirements and hold adequate amounts of the underlying physical commodities or currency. Market makers that physically hold none or only small portions of the underlying commodity are speculating on their clients losing money in order to be profitable.

Market Makers keep open proprietary positions and only occasionally use hedging.

The major underlying issue of the market making approach is the conflict of interest between the provider (licensee) and their client. Even though market makers are attempting to net off client positions, there is still significant risk that the market could move in favour of the client and effectively create a substantial loss for the provider. This can lead to a situation where a provider cannot honour its obligations towards its clients and is therefore exposed to insolvency.

The DMA model allows CFD and Forex providers to eliminate this conflict of interest.

DMA providers are required to use client money to hedge with its counterparties (prime brokers). To implement hedging, DMA providers have to keep sufficient balances with their liquidity providers (LPs). Since clients have constant access to the market and are able to facilitate transactions via the provider's online trading platforms, providers need to be able to withdraw funds from the segregated client trust account for margin and hedging purposes. However, providers can only access client funds and make transfers from the segregated client account during business hours. In addition, major LPs are usually based overseas and therefore international fund transfers are required. This is why DMA providers need to be able to withdraw client money in advance from the client segregated account for hedging purposes.

The proposed changes will create a situation where DMA providers are either forced to stop their operations and cease business or switch to the Market Making model and take on all the risks associated with this model.

In our opinion, clients should have a choice with whom they want to deal – DMA providers or Market Makers.

We agree that the current law should be changed in order to better protect client funds. However, such protection should be based on requirements, which will not allow providers to use client funds for anything except margining and hedging and keeping an adequate amount of Adjusted Surplus Liquid Funds.

Response to Issues for Comment

1. Should the law be amended so that:

   (i) 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

   (ii) 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 licensee on behalf of people other than that client?

We don't support the above proposed amendments.

If the law was amended to option (i), then it will force many licensees who currently use the DMA model to adopt the market making model on retail clients. This will see the majority of licensees profit directly from client losses and these licensees will be exposed to market risk. Currently DMA providers are not exposed to market risk. In our opinion, market making has been the main reason for the collapse of brokers such as MF Global. Market making ultimately increases the trading risk for the licensee and therefore increases risk for clients.

If the law is amended to option (ii), then it will effectively force many licensees to make a market for all clients. This is because technically it will be very difficult if not impossible to implement such restrictions. Clients have constant 24 hour access to the market and are able to facilitate transactions via the provider's online trading platforms. When clients open positions at night (Australian time), then licensees cannot physically transfer funds for margin and hedging purposes from the client trust account to the counterparties. Most hedging counterparties are located overseas and funds have to be transferred to them in advance in order to be able to hedge client transactions.

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?

Licensees should be able to continue to pay such funds into client segregated accounts.
Separate trust accounts for each client will have no added benefit in regards to client money safety, but will create substantial additional and costly work for licensees.

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)?

We think the above changes should not be applied to all derivatives whether OTC or Exchange traded but there should be broader consultation with market participants.

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)?

In our opinion the regulations should be changed to limit the ability of the licensee to pay money out of the client money account for the sole purpose of hedging positions arising from client's transactions. Licensees should not be allowed to use client funds for hedging their own positions.

5. Should licensees be required to conduct a regular reconciliation of client money and have a documented process in place to escalate and resolve any unreconciled variances that are identified?

Yes we agree that the above processes should be implemented.

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?

We see no lack of clarity regarding the interpretation of provisions. In our opinion, licensees should only be allowed to utilise client money to meet margin obligations that have arisen from client's dealings.

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.

In our opinion it would be preferable for the current approach to be retained and continue to permit the pooling of client money by licensees. However, we think that the law should specify the circumstances in which monies can be used. Client funds should only be allowed to be used for margin and hedging purposes arising from client's transactions. Licensees should be allowed to transfer funds in advance as clients have constant 24 hour access to the market and are able to facilitate transactions via the provider's online trading platforms.

8. What would be the impact of the possible changes identified in this paper? Please provide as much detail as possible of any costs or other impacts.

We believe that the proposed changes will have a dramatic effect for the whole industry as they will force many licensees who currently utilise DMA business models to switch to market making.

DMA models allow for licensees not to have any proprietary positions and effectively to be riskless brokers. DMA brokers do not have any conflict of interest with their clients as they derive profit from commissions or mark ups on price. Accordingly, they are not exposed to becoming insolvent should the majority of clients have winning positions as they remove market risk by hedging all client transactions.

In contrast, the market making model, towards which these proposed changes are directed, will create significant risk. The risks for clients will be greatly increased, as they will have limited choice between different business models and will be forced to trade with market makers. In our opinion, market making has been the main reason for the collapse of brokers such as MF Global.

9. Should any enhanced protection apply to the money and property only of retail clients? Why?

The use of client funds should be restricted for any other purpose except for hedging positions arising from client's transactions regardless of whether it is a retail or wholesale client. Any other use should be prohibited and this will remove the need for any enhanced protection.

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.

We think the law should remain in its current form. We don't think that any other regulations should be improved or removed in regards to these changes.

11. Are any additional protections needed for client money where the licensee holds the financial products outside Australia?

No, the requirements pertaining to the handling and maintenance of client monies should apply equally to all AFSL holders. No additional protections should be required.

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?

Yes, the law should be amended and clarify under what circumstances a licensee can claim entitlements to the money held in trust.

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 if a derivative position was closed?

Segregating amounts in the event a client closed a derivative position, could be applied to CFD products where the market closes. However, this would be difficult in regards to Forex given that the market remains open for 24 hours and clients margins are constantly changing.

Reporting Requirements

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?

   Yes there is a gap in the Act. However, all licensees provide clients trading CFDs and Forex with statements which are made available from within the trading platform and also receive statements monthly. It should be mandatory that all brokers provide monthly reporting.

2. Are the items listed above information which would benefit clients?

   Yes the information would be of benefit to clients.

3. Can you give an indication of the cost of preparing monthly statements covering these items and providing them to clients electronically?

   Most CFD and Forex providers already provide monthly statements electronically.

4. Please indicate if there are any other reasons why it would be inadvisable to require monthly reporting.

   There is no reason that clients should not receive regular monthly reporting.

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)?

   No it should be a requirement for licensees to provide monthly statements to clients.

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.

   We don’t think that any other regulations should be improved or removed in regards to these changes.