Protecting client collateral in the Australian
OTC derivatives market: An examination of the
relationship between central clearing, account
structures and the client money provisions

Adamantia Velonis

The Corporations Legislation Amendment (Derivative Transactions) Act 2012
(Cth) was passed at the end of 2012 to implement major reforms to the
Australian OTC derivatives market. This was a response to the default or
near-default of a range of broker/dealers in the last five years, which alerted
regulators to the high level of counterparty risk in the OTC derivatives market.
Although losses to client collateral in a default situation cannot be entirely
eliminated, certain structural features can affect the extent of the losses. This
article will investigate the various account structures that the ASX could adopt
in order to ensure that client margin is adequately protected and suggests
additional measures to minimise the inherent operational, insolvency and
investment risks. In addition, the article argues for an amendment of the
existing Australian client money provisions (specifically, s 981D of the
Corporations Act 2001 (Cth)) in order to better protect market participants
and bring the Australian market in line with the reforms in other major
jurisdictions.

INTRODUCTION

The default or near-default of a range of broker/dealer organisations in the last five years has alerted
regulators to the high level of counterparty risk in the OTC derivatives market (both cleared and
non-cleared).¹ Although losses to client collateral in a default situation cannot be entirely eliminated,
certain structural features can affect the extent of the losses. For example, the extent to which clients
are exposed to fellow-client risk, the location and form of the client collateral, and the ability to
transfer positions or have client collateral returned post-default. However, devising such a regulatory
framework is complicated by the fact that regulators must constantly balance the need for adequate
client protection against the cost of the protective measures to the market.

The Corporations Legislation Amendment (Derivative Transactions) Act 2012 (Cth) was passed at
the end of 2012 to implement three major reforms to the Australian OTC derivatives market: trade
reporting, central clearing and trade execution obligations.² These reforms are directly linked to the
implementation of the OTC derivatives policy consensus reached at the September 2009 G-20 Summit
in Pittsburgh.³

¹ LLB (Hons), Monash University, Lawyer, Henry Davis York. The author would like to acknowledge the assistance of
Mr Andrew Godwin (University of Melbourne), Dr Colin Anderson (QUT School of Law) and the anonymous reviewer who
provided comments on drafts of this article. The views (and any errors) in this article are the author’s own.
² For example, MF Global, Sonray Capital Markets, Lehman Brothers, AIG, Peregrine Financial Group; Singh M, “Collateral,
Netting and Systemic Risk in the OTC Derivatives Market” (IMF Working Paper 10/99, International Monetary Fund,
³ Corporations Legislation Amendment (Derivative Transactions) Act 2012 (Cth); Bank of Canada, Financial System Review
Report, Access to Central Clearing Services for Over-the-Counter Derivatives (June 2011) p 39 (hereinafter Access to Central
Clearing Services for OTC Derivatives); Treasury, Consultation Paper: Implementation of Framework for Australia's G20
Over-the-Counter Derivatives Commitments (Canberra, April 2012).
⁴ G20 Pittsburgh Summit, Leaders’ Statement (24-25 September 2009); Reserve Bank of Australia, OTC Derivatives Market
Reform Considerations, A Report by the Council of Financial Regulators (March 2012) p 7 (hereinafter OTC Derivatives
Market Reform Considerations).
Central clearing has been the policy recommendation of choice because of its ability to mitigate counterparty risk. Through the process of multilateral netting or novation the central counterparty (CCP) interposes itself between all its clearing members’ (CM) trades. This reduces the size of the CMs’ outstanding obligations by creating a single net exposure to the CCP. This also reduces opacity in the financial system and provides the infrastructure for unwinding positions post counterparty default.

The explosion of the credit default swap market during the global financial crisis (GFC) revealed significant issues with unwinding bilaterally traded OTC derivatives. For example, when Lehman Brothers filed for bankruptcy in September 2008 its redundant credit default swaps needed to be closed out. This was achieved through an urgent series of compressions and the re-establishment of client positions with other dealers. This was difficult to achieve given the stressed market conditions at the time, and would have been unnecessary had the trades been centrally cleared. This is because the transactions could have been novated to alternative CCPs. In stark comparison, Lehman’s centrally cleared interest rate swaps were efficiently settled in the few days following the bankruptcy declaration.

Central clearing, while beneficial, also poses problems. It concentrates operational and counterparty risk within a single CCP or a few major CCPs. This is of concern because in the event of CCP insolvency, the market will be exposed to severe repercussions. In order for CCPs to take on the volume of OTC derivatives trading that has been suggested by regulators, there needs to be significant upgrades in the infrastructure and risk management processes of CCPs. Accordingly, on 25 October 2012 the Australian Securities Exchange (ASX) issued a market discussion document titled “Derivatives Account Segregation and Portability” which seeks market feedback on the potential changes to the account structures offered by Australian CCPs and the appropriate level of client protection arising from CCPs holding client margin. The deadline for submissions was 14 December 2012.

---


7 Chapter 3 Making OTC Derivatives Safer, n 5, p 9.

8 Chapter 3 Making OTC Derivatives Safer, n 5, p 2.

9 Chapter 3 Making OTC Derivatives Safer, n 5, p 9.

10 Chapter 3 Making OTC Derivatives Safer, n 5, p 9.

11 Chapter 3 Making OTC Derivatives Safer, n 5, p 9.

12 Chapter 3 Making OTC Derivatives Safer, n 5 p 9.


14 Singh, n 1, p 10.

15 Report 309, n 6, p 1.


In regards to the new clearing solution for OTC interest rate swap derivatives, it has been suggested that “individual segregated client accounts” (ISCAs) be mandatory and that clients will not have access to an omnibus account option. The details of the ISCA have not yet been finalised. The market document states that: “ASX Clear (Futures) is likely to need to examine several types of ISCA in order to satisfy differing client/end user demands, and possibly differing overseas regulatory requirements.”

The particular area that will be investigated in this article is the structure of CCP accounts and, more specifically, which account structure the ASX should adopt in order to ensure that client margin is adequately protected. It will be argued that the ASX should adopt “legally segregated but operationally commingled” accounts (LSOC), because this model should enhance the level of segregation and portability of client positions and collateral. This model is also optimal because it appropriately balances the benefits and costs of protecting market participants, while bringing the Australian market in line with the reforms in other major jurisdictions.

It is acknowledged that no account structure will be a cure-all. Thus, a variety of regulatory measures have been suggested to minimise the operational, bankruptcy and investment risks inherent in LSOC. These means include reconciliation, reporting, bail-outs, private insurance, a whistle blower regime and education programs. In addition it is argued that the existing Australian client money laws will need to be amended to ensure consistency with the level of segregation and portability afforded to client collateral by the recommended model.

Apart from redrafting the current client money provisions, it is also suggested that the enforcement regime for such breaches be re-evaluated. It is argued that the current regime is unable to effectively deal with the misuse of client funds. Accordingly, it is suggested that the use of self-regulation by market participants should be minimised, alternative regimes should be investigated and additional resources should be provided to regulators to deal with enforcement issues.

Regulatory responses should remain focused on mitigating real risks to the system, rather than being reactive to certain events (eg large collapses). Regulation that is not well designed may be overly deterrent, generate fear, stifle economic innovation and may have a displacing effect. An adequate policy response will seek to achieve client protection while retaining economic growth and competition. The interests of consumers, firms, insolvency practitioners and the general public need to be considered.

For consumers any structural change to the client money rules must protect collateral at a reasonable cost and efficiently return (or transfer) client assets post-default. Any changes to the rules should aim to improve consumers’ confidence in the system by improving the perceptions surrounding client money provisions and facilitating a better level of understanding of the rules. The costs of implementation should also be reasonable, otherwise firms will exit the industry and there will be less choice for customers. Any new regulations should also allow for the fair and efficient distribution of assets on insolvency. And finally, the general public should be protected from severe systemic market disruptions and losses.

With these objectives in mind, part one of this article will examine the structure of the Australian OTC derivatives market; parts two and three will examine the various account structures that the ASX

---

21 Kiff et al, n 4, p 31.
may adopt and argue that LSOC is the preferred model; part four will describe the shortfalls of LSOC and part five will suggest additional reforms to deal with those issues; part six will discuss the interaction between the current client money provisions and LSOC, before making some concluding remarks on future regulatory directions for this area.

THE STRUCTURE OF THE AUSTRALIAN OTC DERIVATIVES MARKET

First of all it is important to understand the nature of “central clearing,” “client margin,” “segregation” and “portability” as concepts before we examine the structure of the Australian OTC derivatives market.

Central clearing involves “authorised private sector clearing houses settling certain mandated derivatives transactions.” The members of a clearing house will be subject to the rules of the clearing house and the general law in relation to their transactions (as opposed to operating on an unregulated bilateral basis). Clearing members continue to contract with each other (producing a single agreement), however, once this agreement is finalised it is novated into two contracts with the clearing house. That is, each clearing member will have a separate contract with the clearing house, rather than a single agreement concluded directly between them. The clearing house will stand in the middle of the contractual relationship and act as the “central counterparty.” The clearing house will operate an account between it and its parties so as to identify the net amounts that are owed or owing between them for each calculation period. If a member becomes insolvent the exposure will be borne by the clearing system. Thus, it is important that the clearing house is able to withstand those risks. The exposure will be the net amount owed by the insolvent party, less the amount of any collateral initially posted to secure the party’s obligations (initial margin).

Client margin can come in two forms: initial margin or variation margin. Initial margin is posted at the beginning of a trade to protect against replacement cost losses due to the potential future movements in contract value or movement due to counterparty default or counterparty credit risk. Variation margin is posted over the course of the trade to account for changes in the market value of the positions. CCPs may call margin on a net or gross basis. That is, they may call margin by offsetting the CM’s different client positions and calculating the margin for the remaining exposure (net margining); or by aggregating the margin requirements of each individual client (gross margining). Net margining usually results in a lower margin being lodged with the CCP than gross margining. However, CMs will usually call for more margin than required by the CCP, as they often invest the “surplus margin” to generate interest income.

Segregation refers to the separate holding and accounting of client assets from fellow clients, the CMs’ proprietary positions and the positions of the CCP. Thus, segregation operates at two levels. OTC derivatives clearing houses should thus implement account structures which allow them to

---

26 Hudson, n 25.
27 Hudson, n 25.
28 Hudson, n 25.
29 Hudson, n 25.
30 Hudson, n 25.
31 Hudson, n 25.
32 Hudson, n 25.
33 Chapter 3 Making OTC Derivatives Safer, n 5, pp 4-5.
34 Chapter 3 Making OTC Derivatives Safer, n 5, pp 4-5.
38 Chapter 3 Making OTC Derivatives Safer, n 5, p 14.
effectively identify and segregate collateral. This should provide clients with the greatest possibility of recovering or transferring their collateral in the event of counterparty default, and act as a means of collateral protection.\(^{40}\) Currently, Australian CCPs can have visibility of individual client positions by implementing a gross open position keeping system; or they may choose to have visibility of a single, combined position for all of the CM’s accounts under a net open position keeping system.\(^{41}\)

Portability refers to the ability to transfer client assets (positions or collateral) from one CM or CCP to another CM or CCP (usually in a default scenario).\(^{52}\) This mechanism becomes integral in insolvency because it ensures that clients can maintain continuous access to clearing, rather than have their positions closed-out or liquidated and then re-established.\(^{43}\) The timely and efficient transfer of customer accounts can promote efficient financial markets. Porting can be achieved by solvent CMs voluntarily assuming the positions or through allocation by the CCP.\(^{44}\) A variety of issues will determine whether a solvent CM will accept the client positions, some of these factors include: market conditions, the information provided regarding the client account and the complexity and size of the portfolio.\(^{45}\) Current Australian insolvency law inhibits the transfer of client positions by CCPs, as various permissions are needed that are unlikely to be secured in a timely manner post-default.\(^{46}\) However, this will be remedied by the Corporations and Financial Sector Legislation Amendment Act 2013 (Cth), which was assented to on 21 June 2013.

Given that the Australian Securities and Investments Commission (ASIC) has recommended that OTC Australian-dollar denominated interest rate swaps migrate to central clearing,\(^{47}\) it is important that Australian market participants have access to safe and efficient clearing services and remain connected to the global market.\(^{48}\) In relation to the Australian OTC derivatives market, one of the first features to note is its size. According to ASIC, “at the end of 2011 Australian-dollar denominated derivatives counted for about 2 per cent of the global market.”\(^{49}\) The majority of OTC derivatives activity occurs in the United States and United Kingdom.\(^{50}\) Australia’s market turnover is comparable to that of other G-20 countries, like Canada.\(^{51}\)

Another interesting feature of the Australian OTC derivatives market is its international scope. We may refer to an “Australian” market but in fact there is a high level of cross-border activity.\(^{52}\) For example, market participants include both foreign and Australian financial institutions, while transactions may be recorded offshore or occur between foreign parties.\(^{53}\) Other smaller economies

---


\(^{41}\) ASX Market Discussion Document, n 16, p 7.

\(^{42}\) Chapter 3 Making OTC Derivatives Safer, n 5, p 14; CSADC Consultation Paper 91-404, n 40, p 4.

\(^{43}\) ASX Market Discussion Document, n 16, p 4; Shahen et al, n 40.

\(^{44}\) CSADC Consultation Paper 91-404, n 40, p 16.

\(^{45}\) CSADC Consultation Paper 91-404, n 40, p 16.

\(^{46}\) ASX Market Discussion Document, n 16, p 3.

\(^{47}\) This has not yet been made a mandatory requirement, however ASIC will reconsider this over time; Report 309, n 6, p 2. ASX Market Discussion Document, n 16, pp 2, 5-6; OTC Derivatives Market Reform Considerations, n 3, p 27.

\(^{48}\) Chapter 3 Making OTC Derivatives Safer, n 5, p 15.

\(^{49}\) Report 309, n 6, p 31; OTC Derivatives Market Reform Considerations, n 3, p 17.

\(^{50}\) Report 309, n 6, pp 30-31.


\(^{52}\) Report 309, n 6, p 32.

\(^{53}\) Report 309, n 6, p 32.
also share these concerns. For example, Canada has a similar OTC derivatives market share to Australia and is also not home to important global CCPs. Thus, some reference will be made to the developments in Canada by way of comparison.

There are three ways in which central clearing may be facilitated: 1) by building a domestic CCP which is linked to international infrastructure; 2) negotiating direct access to global CCPs or 3) retaining indirect access to global CCPs with supervisory arrangements between regulators.

On 20 December 2012 the ASX announced that it would be developing a new OTC Interest Rate Derivatives Clearing Service. The first phase of this clearing solution is expected to be delivered by mid-2013. This new service will provide central counterparty clearing for Australian-dollar denominated OTC interest rate swap derivatives. The benefits of this model are that Australian regulators will have direct oversight of the CCP and can design a facility that is better aligned to local market conditions and risks. A domestic CCP may even facilitate international participation, as international counterparties trading in Australian-dollar denominated interest rate swaps may prefer to clear using an Australian-domiciled CCP. Cross-margining or linking agreements could also be formed between global CCPs to allow Australian clients to access a wider share of the market, while retaining local control.

The downside of a domestic CCP is that there is less risk mutualisation and netting benefits. This may impact on the desirability of large international banks to participate in the Australian market. These institutions are likely to transact where the netting and liquidity benefits are at their greatest. A domestic CCP may fragment the global market for Australian dollar-denominated interest rate swaps by only having the capacity to serve a smaller and less liquid part of the overall market. This may add to the cost and complexity of clearing and place Australian market participants at a competitive disadvantage.

55 Canada’s OTC derivatives market represents about 2% of the global market share. The Canadian OTC Derivatives Industry Advisory Group has stated that about 36% of Canada’s OTC market derivatives activity occurs outside Canada, and that 78% of its total OTC derivatives activity is traded with foreign counterparties; OTC Derivatives Working Group, Reform of Over-the-Counter (OTC) Derivatives Markets in Canada: Discussion Paper from the Canadian OTC Derivatives Working Group (26 October 2010), p 23 (hereinafter Reform of OTC Derivatives Markets in Canada).
56 For example, peer-to-peer interoperability; Access to Central Clearing Services for OTC Derivatives, n 2, p 41; Singh, n 1, p 8.
58 ASX Group, Media Alert, Domestic and International Banks to Work with ASX on OTC Derivatives Clearing (20 December 2012); Australian Securities Exchange, Consultation on Draft Operating Rules, OTC Interest Rate Derivatives Clearing (February 2013). The ASX has proposed OTC Rules 5.7 and 5.9 in order to support the bankruptcy remoteness of collateral posted as initial margin; however, the ASX is still receiving stakeholder engagement on the issue as OTC Rules 5.7 and 5.9 will not be introduced until Phase 2 begins at the end of December 2013.
59 ASX Group, Media Alert, n 38; Report 309, n 6, p 54.
60 For example, by way of acceptable collateral, operational timelines and participation requirements; Access to Central Clearing Services for OTC Derivatives, n 2, p 40; OTC Derivatives Market Reform Considerations, n 3, pp 8-9.
62 Access to Central Clearing Services for OTC Derivatives, n 2, p 44.
63 Access to Central Clearing Services for OTC Derivatives, n 2, pp 39, 43. The negative externalities that result from the use of local CCPs can be attributed to their failure to attract a broad membership. That is, they are typically membered by a narrow range of local dealers; this decreases the netting benefits available. The risk mutualisation benefits are also limited, because local dealers (who are clearing participants of local CCPs) are not typically as well-resourced as global dealers who participate in global CCPs, thus the default of a local dealer would be more costly for a local CCP to absorb.
64 OTC Derivatives Market Reform Considerations, n 3, pp 8-9.
Currently, there are only two clearing houses in Australia: (1) ASX Clear (Futures) which clears futures and contracts for difference (CFDs), and (2) ASX Clear which clears exchange traded options (ETOs). All money and assets posted to Australian Financial Services License (AFSL) holders are subject to the client money rules found in Div 2 of Pt 7.8 of the Corporations Act 2001 (Cth). Thus, CMs that hold an AFSL and participate in Australian CCPs must hold client margin subject to the CCPs’ operating rules and the client money provisions.

As noted above, there are no systemically important global CCPs located in Australia. Clients who wish to access these markets usually do so indirectly by negotiating a relationship with direct members of offshore CCPs. The two major global CCPs that clear in Australian-dollar denominated OTC interest rate derivatives are CME Group (CME) and LCH.Clearnet Ltd (LCH).

Australian-owned financial institutions have been prevented from participating directly with global CCPs. First, this is because these CCPs are not currently licensed in Australia, so Australian clients can only gain access to them through foreign financial institutions that are direct members and operate in Australia. Secondly, given that the Australian market is heavily made up of small to medium-sized institutions, many would not satisfy the resource requirements of direct membership to global CCPs.

The use of foreign CCPs by Australian entities to access central clearing was thought to pose risks to the Australian market. This is because Australian regulators are unable to oversee the protection of client collateral, the price of indirect clearing services and the level of exposure to counterparty credit risk. For example, collateral posted overseas may become subject to foreign insolvency proceedings in the event of counterparty default. CCPs may also provide different levels of protection to the collateral posted by direct members, as opposed to that of indirect clearing participants.

However, the Australia Prudential Regulation Authority has now published a “no action” letter in relation to Australian banks joining CCPs, in a bid to retain competitiveness in the OTC derivatives market and to promote market innovation. Australian regulators are now more comfortable with the

---

67 Report 309, n 6, p 54.
68 OTC Derivatives Market Reform Considerations, n 3, p 21.
69 Note that there are some exemptions; OTC Derivatives Market Reform Considerations, n 3, p 21.
70 OTC Derivatives Market Reform Considerations, n 3, p 21.
72 Report 309, n 6, pp 53-55.
73 Report 309, n 6, pp 53-55.
74 Report 309, n 6, pp 53-55.
75 Access to Central Clearing Services for OTC Derivatives, n 2, p 40.
77 OTC Derivatives Market Reform Considerations, n 3, p 9.
use of offshore CCPs because the recent work of the CPSS-IOSCO has improved the operational controls of CCPs and given the interests of smaller jurisdictions more weight. This is also the position of Canadian regulators.

AN OVERVIEW OF VARIOUS CLIENT MONEY ACCOUNT STRUCTURES

Given the regulatory developments described above, this article will focus on recommending an appropriate account structure for the newly developed OTC Interest Rate Derivatives Clearing Services, which achieves the appropriate level of segregation and portability.

Currently, ASX Clear and ASX Clear (Futures) offer the following account structures. For ETOs client funds are segregated from the CM’s house account and all the CM’s open positions are allocated to the individual client level. The accounts operate on a gross margining model, while the cash received by the CCP from the CM is pooled and recorded on the CCP balance sheet (but held beneficially for each client). These accounts have been structured in this way due to the high number of retail users, and thus offer the highest level of segregation. This model should facilitate the porting of client collateral in the event of default of the CM, as individual client positions are transparent to the CCP, are adequately margined, as well as segregated from the proprietary positions of the CM. This model is costly to administer, and does not generate as much interest revenue as the other models. It also fails to prevent CCPs from applying client money to deficits across the entire client portfolio.

The account structure for futures products ensures that house accounts are segregated from client funds; however, all open positions are allocated to a single omnibus client account at the CCP. Margin is calculated on a net basis and any excess margin is held by the CM. The use of netting means that these products have lower margin requirements. Surplus margin is typically invested by the CM to generate interest revenue. The cash received by the CCP from the CM is pooled and recorded on balance sheet and can be used to offset losses occurring in any client account. Ownership in the margin is transferred to the CCP. This model does not facilitate porting because the use of a single omnibus account requires another CM to accept the defaulting CM’s whole trading

---

80 However, these standards do not eliminate all risks for Australian market participants. Australian regulators should ensure that they can exercise sufficient oversight and influence over an offshore CCP’s operations, especially in the areas of risk management, pricing and holding of client margin. It will be important for Australian and foreign regulators to frequently co-ordinate their activities to minimise the possibility of regulatory arbitrage. It may even be appropriate over time for systemically important CCPs to obtain an Australian Clearing and Settlement Facility Licence pursuant to Pt 7.3 of the Corporations Act 2001 (Cth) to ensure direct oversight by ASIC and the Reserve Bank; OTC Derivatives Market Reform Considerations, n 3, pp 30-32; Access to Central Clearing Services for OTC Derivatives, n 2, p 39; Kiff et al, n 4, p 22; Chapter 3 Making OTC Derivatives Safer, n 5, p 16; OTC Derivatives Market Reform Considerations, n 3, pp 13-14, 31.

81 Reform of OTC Derivatives Markets in Canada, n 55.


89 ASX Market Discussion Document, n 16, p 10.


93 ASX Market Discussion Document, n 16, p 10.
Thus, positions are likely to be closed out in the event of counterparty default. The market has been structured in this way to accommodate for wholesale users.

CFDs operate using a hybrid account structure. The house account is segregated from client funds however unlike the futures model all open positions are allocated to the individual client level. Margin is calculated on a net basis and surplus margin is held by the CM. Margin held on the CCP’s balance sheet is pooled and ownership is transferred to the CCP. Accordingly, similar disadvantages associated with the futures model result.

ASX Clear and ASX Clear (Futures) both use the same model for cash margin investment. CMs post cash margin to CCPs which is commingled in a pooled investment account and conservatively invested. Under this model it is not possible to specify which investments belong to any individual CM or their clients.

The first point to make is that the current futures model is inappropriate for the new ASX CCP to adopt. It has been the prevailing model in the futures industry because it is operationally less intensive, entails lower margining costs, and can be efficient in porting client positions where a solvent CM is willing to accept the entire client portfolio (and there is no shortfall in the customer margin account).

However, it is problematic because it fails to effectively protect clients from fellow-client risk. Although client collateral is held separately from the assets and proprietary positions of the CM, it is pooled by both the CM and CCP. CCPs do not need to maintain records of individual client positions and collateral, and only recognise the positions and collateral that the CM intermediates on a collective basis. In the event of CM default, the CCP has access to all client collateral, including non-defaulting clients, to satisfy the overall margin shortfall. As a result, the CCP will use as much client collateral as required to cover the obligations, and has no incentive to port positions until the full claim against the account is resolved.

The ability to use non-defaulting clients’ collateral is unacceptable because it exposes low-risk clients to the risks incurred by high-risk clients. Section 981D of the Corporations Act allows CMs to “margin, guarantee, secure, transfer, adjust or settle” the derivative transactions of all clients from the client segregated account; however, clients do not have access to information regarding the level of

---

94 If client positions were to be un-netted and transferred to a non-defaulting CM, it would be likely that the collateral would be insufficient and that additional collateral would need to be posted; Singh M, “Making OTC Derivatives Safe – a Fresh Look” (IMF Working Paper 11/66, Washington, International Monetary Fund, March 2011) p 8.
95 ASX Market Discussion Document, n 16, p 10.
97 ASX Market Discussion Document, n 16, p 11.
98 ASX Market Discussion Document, n 16, p 11.
100 ASX Market Discussion Document, n 16, p 11.
101 ASX Market Discussion Document, n 16, pp 7 and 17.
102 ASX Market Discussion Document, n 16, pp 7 and 17.
103 ASX Market Discussion Document, n 16, pp 7 and 17.
104 FSA Consultation Paper 38, n 24, pp 9-10; OTC Derivatives Market Reform Considerations, n 3, p 23.
105 OTC Derivatives Market Reform Considerations, n 3, p 23.
107 CFTC Final Rule, n 106, pp 16-17.
108 Corporations Act 2001 (Cth).
counterparty risk that they are exposed to when they post collateral to the omnibus account.\textsuperscript{109} They are also in a weak position to evaluate those risks, even if they were disclosed. Thus, the futures model allows risk to be non-transparently shifted between clients, and exposes non-defaulting clients to any deficiency in the segregated account.\textsuperscript{110}

Accordingly, any model adopted by the ASX should enhance the level of segregation afforded to client margin and the ability to port client positions post-default in order to minimise the current levels of counterparty risk. Four account structures will be examined in turn below.

PROPOSED CLIENT MONEY ACCOUNT STRUCTURES

There are four account structures that may be adopted by regulators to enhance portability and segregation of client collateral. They are: 1) full physical segregation, 2) complete legal segregation, 3) legal segregation with recourse, and 4) optionality.\textsuperscript{111}

The first model which is considered is the “physical segregation model”. Under this model the CM and CCP separate client accounts from house accounts and maintain separate individual accounts for each client.\textsuperscript{112} The advantages of this model are that it prevents client collateral from being used to cover another defaulting customer’s losses; it eliminates investment risk; and it facilitates portability by ensuring that the CCP has visibility of individual client positions.\textsuperscript{113}

However, there are some significant problems with this model. First, it is the most expensive and resource intensive to operate and would result in CMs and CCPs passing on these costs to their clients.\textsuperscript{114} Ironically, keeping individual accounts may increase the opportunity for error and fraud through complicated recordkeeping.\textsuperscript{115} Finally, in the event of default, client recovery rights might still be exercised on an omnibus basis. Under the current client money regime, on insolvency, client monies are pooled and distributed on a pro rata basis. This ensures that if there are any losses, that they are shared rateably among all customers.\textsuperscript{116} However, the physical segregation model attempts to better protect the property of some clients over others. This is inconsistent with the pari passu principle, which prevents some clients from being paid a higher proportion of their net equity than others.\textsuperscript{117} Thus this model is unlikely to enhance customer collateral protection despite the higher account maintenance fees it attracts.\textsuperscript{118}

The second model considered is the “complete legal segregation” or “legal segregation with operational commingling” model (LSOC). Here the CM and CCP segregate the positions and collateral of each individual customer and ensure that such account is separate from house accounts; however, operationally each CM or CCP will commingle the client margin.\textsuperscript{119} A gross omnibus approach is maintained, so that there is no netting across client positions.\textsuperscript{120} In the event of default, a


\textsuperscript{110} CFTC Final Rule, n 106, p 43.

\textsuperscript{111} CFTC Final Rule, n 106, pp 13-17; OTC Derivatives Market Reform Considerations, n 3, pp 22-23.

\textsuperscript{112} CFTC Final Rule, n 106, pp 15-16; OTC Derivatives Market Reform Considerations, n 3, p 22.

\textsuperscript{113} CFTC Final Rule, n 106, pp 15-16.

\textsuperscript{114} CFTC Final Rule, n 106, p 38.


\textsuperscript{117} CFTC Final Rule, n 106, p 18.


\textsuperscript{119} CFTC Final Rule, n 106, pp 13-14; OTC Derivatives Market Reform Considerations, n 3, pp 22-23.

\textsuperscript{120} CFTC Final Rule, n 106, pp 13-14.
CCP will only be able to access defaulting clients’ collateral. However, any deficiency in the client account post-default will be shared rateably. The CM and CCP may also invest client collateral as permitted by the regulations.

This model is more costly to operate than the futures model due to the added transaction fees and record keeping costs, but should not be as costly or resource intensive as the full segregation model. This model does not protect against fraud-related risk, operational risk, investment risk or bankruptcy related costs. However, despite these shortcomings, this model has four main advantages: 1) it decreases fellow-customer risk; 2) it increases the likelihood of porting positions and collateral post-default; 3) it decreases systemic risk; and 4) it should have a positive impact on portfolio margining.

The decrease in fellow-customer risk is the main advantage of this model. It means that non-defaulting client collateral cannot be used to satisfy the obligations of defaulting clients. This may increase market activity as clients will no longer be concerned about being over exposed to fellow-customer risk. However, it will also result in high margin costs for end-users. Mitigating fellow-customer risk is important because end-users’ lack the ability to accurately identify the level of counterparty risk that they are exposed to by their CM. This model should alleviate the pressure from clients to monitor their CM, and shift the incentive to CCPs. This should produce more efficient monitoring of CMs, as CCPs are in a better position to access and analyse counterparty information than clients.

LSOC increases the likelihood of successfully porting client positions and collateral post-default. CCPs will have no incentive to resist transferring non-defaulting client accounts because they cannot access these accounts to satisfy the margin shortfall in any case. The CCP will also have access to individual client information which should aid in facilitating transfers.

This model should also decrease systemic risk. The ability to port positions will relieve the market of close-out costs and the need to re-establish positions in stressed market conditions, which should help protect price discovery.

Finally, LSOC should have a positive impact on portfolio margining. “ISDA has suggested that LSOC will require a 60% increase in initial margin, as compared to the futures model.” This is important because it is currently not clear to the market how much collateral is actually being posted against bilaterally traded OTC derivatives. For example, ISDA estimates that up to 22% of OTC derivatives positions are under-collateralised. ASX is of the view that the market should shift to

---

122 LSOC does not prevent pooling on insolvency because the CCP only has a direct contractual relationship with the CM and not the individual client. This is consistent with the fact that the markets operate on a principal-to-principal rather than an agency basis.
124 This will be developed further below; CFTC Final Rule, n 106, pp 34-37; Horwitz MA and Launer ZA, “CFTC Final Rule Adopts LSOC Model for Cleared Swaps Collateral”, Derivatives Alert (DLA Piper, 8 February 2012).
125 CFTC Final Rule, n 106, pp 34-37.
127 For example, confidentiality will prevent CMs from providing its clients with information about other client positions and solvency; CFTC Final Rule, n 106, pp 11-12; AFMA Submission to ASIC CP114, n 109, p 2.
128 CFTC Final Rule, n 106, pp 11-12.
129 CFTC Final Rule, n 106, p 127.
130 CFTC Final Rule, n 106, pp 136-137.
131 CFTC Final Rule, n 106, pp 117-118.
132 CFTC Final Rule, n 106, p 119.
133 Singh (2011), n 94, p 3.
gross margining, which would further facilitate the LSOC model. This view is supported as net margining often results in under-margining and hinders the porting of positions in a default situation. The importance of porting should be prioritised over the economic efficiencies obtained by netting. This position has also been maintained by Canada regulators.

The third model is the “legal segregation with recourse” account structure. Here, CMs and CCPs individually record client positions and collateral but operationally commingle the collateral. Client margin is kept separately from house accounts. In the event that the customer and CM default, the CCP can access the collateral of non-defaulting clients to satisfy their obligations. Thus, this model receives little support because it fails to adequately mitigate fellow customer risk.

The final model is “optionality”. This is where regulators do not mandate any one model but allow CCPs to offer a choice of account structures to clients. This model is intended to promote choice in the market and therefore fuel competition between market participants. The idea is to encourage a free market in which market forces identify the most efficient option over time. For example, in the European Union CMs and CCPs are required to offer a choice between omnibus client segregation and individual client segregation, and to inform clients of the costs and level of protection of each.

This model has significant disadvantages. It provides protection to clients who are willing to pay for higher account fees and transaction costs. It is also of concern because it may be unlikely to provide clients with the added protection that they are paying for. As pointed out above, clients will be classified as belonging to a certain account class for the purposes of insolvency, regardless of the account structure that they select, and will share rateably in any shortfall. Optionality should thus be avoided because it will produce undue complexity in the market, and should only be considered seriously once the market for centrally cleared OTC derivatives is well-established in Australia.

In regards to the new clearing solution for OTC interest rate swaps, ASX has suggested that the individual segregated client account (ISCA) arrangements be mandatory. It is unclear at this stage whether the proposed ISCAs will exhibit features that align them with the full physical segregation model or the LSOC model. It is strongly suggested that the ASX mandates account structures that are consistent with LSOC.

The ASX has stated its core objectives in determining an eventual solution. They are as follows: 1) that ASX CCPs must comply with their regulatory requirements relating to segregation and portability; 2) that ASX CCPs should offer account structures that reflect the risk appetite of end users;

---

135 ASX Market Discussion Document, n 16, p 12. But see, Citigroup Submission to ASX, n 17, pp 5, 8.
136 FOA CP12/22, n 115, p 7.
137 Chapter 3 Making OTC Derivatives Safer, n 5, p 9.
138 CSAD Consultation Paper 91-404, n 40, p 5.
141 CFTC Final Rule, n 106, p 45; Mirakian, Waters and Sagan, n 40.
142 CFTC Final Rule, n 106, p 17.
143 FOA CP12/22, n 115, pp 2-4.
146 CFTC Final Rule, n 106, pp 45-46; FSA Consultation Paper 38, n 24, pp 15-16; contra AFMA Submission to ASX, n 17, pp 6-7; ISDA Submission to ASX, n 17, p 2.
and 3) that ASX CCP account structures be operationally and commercially viable for CCPs, CMs and clients.\textsuperscript{148} The LSOC model satisfies these criteria while protecting the market and appropriately balancing costs and benefits.

LSOC is compatible with segregation and portability requirements as it mitigates fellow-customer risk and facilitates porting through enhanced record keeping and reconciliation processes. LSOC is likely to reflect the risk appetite of clients operating in the OTC derivatives market, as most would be prepared to weather higher operational costs in exchange for greater protection against counterparty risk and greater access to porting in the event of default. It is the most operationally and commercially viable option for CCPs, CMs and clients as it effectively mitigates fellow-customer risk and enhances portability, while minimising account fees by continuing to hold collateral in an omnibus account.

LSOC should also be the preferred model because this choice would effectively harmonise Australia’s OTC derivatives market with the global market. The largest OTC derivatives market share is held by the United States.\textsuperscript{149} The CFTC has mandated Futures Commission Merchants (CMs) and Derivatives Clearing Organisations (CCPs) to offer the LSOC account structure under the \textit{Dodd-Frank Act}.\textsuperscript{150} Canada has also followed suit.\textsuperscript{151}

As noted above, clients of ASX CCPs should not have a choice of account structures because if clients are still able to access the futures model for OTC derivatives products (even after they have received proper disclosure) Australian clients clearing locally will be less protected than clients clearing through global CCPs. This would create opportunities for regulatory arbitrage and further fragment the Australian OTC derivatives market.\textsuperscript{152}

\textbf{THE PROBLEMS ASSOCIATED WITH THE “LSOC” MODEL}

Despite the benefits of adopting the LSOC model, it does not prevent operational risk, investment risk, and bankruptcy costs. These issues will be expanded on in turn.

First, LSOC does not protect against “operational risks”. These risks include the possibility that there may be a shortfall in the client collateral account because of negligence, misuse of assets, theft, fraud, poor administration, or inadequate record keeping.\textsuperscript{153} Accordingly, LSOC may not have prevented the customer losses that occurred in MF Global,\textsuperscript{154} Sonray Capital Markets or Lehman Brothers.\textsuperscript{155}

The alleged shortfall in MF Global’s customer accounts reportedly arose due to operational failures (poor administration and misuse of assets) and was not exacerbated by client defaults.\textsuperscript{156} That is, after MF Global Holdings filed for Chapter 11 bankruptcy in the United States on 31 October 2011, a US$1.6 billion shortfall in customer segregated accounts was discovered. The shortfall arose, as a result of intra-day loans, client withdrawals and a transfer of $175 million to cover MF Global UK’s overdrawn loan facility with JP Morgan Chase.\textsuperscript{157}

\begin{itemize}
\item \textsuperscript{148}ASX Market Discussion Document, n 16, p 12.
\item \textsuperscript{149}Report 309, n 6, p 31.
\item \textsuperscript{150}CFTC Final Rule, n 106, p 5; Horwitz and Launer, n 124; CSADC Consultation Paper 91-404, n 40, p 20.
\item \textsuperscript{151}CSADC Consultation Paper 91-404, n 40, p 5.
\item \textsuperscript{152}Kiff et al, n 4, p 30.
\item \textsuperscript{153}CFTC Final Rule, n 106, p 37; Horwitz and Launer, n 124.
\item \textsuperscript{154}Horwitz and Launer, n 124.
\item \textsuperscript{155}FOA CP12/22, n 115, p 13.
\item \textsuperscript{156}Horwitz and Launer, n 124.
\end{itemize}
Lehman Brothers was another instance of poor administration and inadequate record keeping, as the firm failed to segregate client funds. On 15 September 2008 when Lehman Brothers International (Europe) was placed in administration, the liquidators identified an unsatisfied US$2.17 billion segregation obligation, which was exacerbated by an intra-day transfer of approximately US$1 billion to an affiliate company (Lehman Brothers Bankhaus AG) prior to bankruptcy. This occurred because Lehman Brothers was taking advantage of the loophole presented by “the alternative approach”.

The collapse of Sonray Capital Markets was an example of misappropriation of client funds coupled with inadequate record keeping. When Sonray entered into administration on 22 June 2010 there were insufficient funds in the client segregated accounts (CSA) to meet the client entitlements represented on its trading platforms. The liquidator’s report revealed a $45.6 million deficiency in Sonray’s CSAs and a culture of poor record-keeping practices. “The primary judge found that between 16 February 2005 and 22 June 2010 there were at least 1,049 unauthorised dealings … which directly or indirectly, affected the funds held in the ANZ AUD Segregated Account.” These deficiencies were the result of transfers from the CSA to Sonray’s general account for “commissions” (although no commissions were deposited by Sonray’s providers into the CSA); a series of unfunded transactions totalling $35.6 million; the diversion of $2 million dollars of client funds into Sonray’s house account; and $1.5 million in unfunded client rebates.

“Investment risk” refers to the possibility that CM or CCP will fail to return collateral because it has incurred investment losses. In Australia, CCPs are able to commingle client margin for investment purposes. However, in Australia and in other jurisdictions, the rules of investment are designed to ensure that excess margin is invested by a CCP or CM in a manner which aims to preserve principal and minimise the exposure of client collateral to credit, liquidity and market risk.

Re-hypothecation also poses further risks to client collateral. Central clearing is likely to result in a significant volume of high-quality collateral being posted to CCPs (due to gross margining), and

158 The Court of Appeal in the United Kingdom relied on the principles of equity and constructive trust law to treat the un-segregated funds as segregated funds and put all clients on an equal footing and resolve the competing claims in insolvency; Becker L, “Lehman Brothers Ruling Changes Equation for Creditors and Clients”, Risk Magazine (1 June 2012) http://www.risk.net/risk-magazine/feature/2181050/lehman-brothers-ruling-changes-equation-creditors-clients#: Haines J and Moulton R, Lehman Brothers and Client Money: The Supreme Court’s Decision (Regulatory Newsflash, Ashurst LLP, February 2012); Haines J and Small R, Lehman Client Money Appeal (Ashurst Briefing (UK), Ashurst LLP, August 2010).


160 The Client Assets Sourcebook (CASS) permits two approaches to the segregation of client funds: 1) the normal approach, where client money is segregated almost immediately, and 2) the alternative approach, where client assets are initially placed in a house account before being transferred into a segregated account at the end of the day. Thus, the client money is treated by the firm as proprietary funds prior to the daily reconciliation; James, n 159; Haines and Small, n 158.

161 These defalcations led to the chief executive officer of Sonray Capital Markets, Scott Murray, and the sole director and majority shareholder, Russell Johnson, both being charged with criminal offences. Scott Murray pleaded guilty to six counts of false accounting, two counts of theft, once count of obtaining financial advantage by deception and one count of misleading an auditor; The Queen v Scott Kenneth Murray [2011] VSC 513 at [1].

162 George v Seaborn International Pty Ltd (Trustee) in the matter of Sonray Capital Markets Pty Ltd (in liq) [2012] FCAFC 140 at [117].

163 Sonray Capital Markets (in liq) [2012] FCAFC 140 at [117].

164 Sonray Capital Markets (in liq) [2012] FCAFC 140 at [117].

165 Sonray Capital Markets (in liq) [2012] FCAFC 140 at [117].

166 For example, the value of the investment has decreased in value to less than the original value of the collateral posted; CFTC Final Rule, n 106, p 22.


168 There is a preference for investing in instruments of a predictable value and which are capable of rapid conversion to cash; ASX Market Discussion Document, n 16, p 17.
may create a relative shortage of these assets in Australia.\(^\text{169}\) Ironically, this may lead to an increase in collateral management and collateral transformation services.\(^\text{170}\) Collateral transformation or re-hypothecation is usually achieved in the interbank market through repurchase transactions.\(^\text{171}\) This allows CCPs to reuse collateral or default fund contributions posted by clients as margin.\(^\text{172}\) These collateral swaps generate income for CCPs.\(^\text{173}\)

There are significant risks inherent in these activities. The rules surrounding re-hypothecation must be carefully crafted to prevent regulatory arbitrage. For example, American firms (like MF Global) were using their European subsidiaries to take advantage of loopholes in British law which allowed collateral to be re-hypothecated an unlimited number of times, creating large amounts of liquidity with no real asset backing.\(^\text{174}\)

In an insolvency situation there may be a risk that the CM or CCP may be unable to return excess margin because it is subject to security interests or because it is held by a third party custodian who is not prepared to transfer the positions. These issues are yet to be resolved by the ASX. In Australia excess margin may be held by CCPs or CMs. However, ASX is seeking public comment on whether excess margin called by CMs should continue to be held by CMs or be passed to CCPs, and whether there are additional means of protecting surplus margin.\(^\text{175}\)

LSOC also exposes clients to “risk costs”; that is, the costs associated with the bankruptcy of the CM.\(^\text{176}\) Bankruptcy may result from financial difficulties, trading losses in proprietary accounts or due to difficulties at a corporate parent or affiliate. Accordingly, clients are exposed to the risk of CM default, as LSOC and gross margining requirements only apply to CSAs, there are no similar limits applied to CM house accounts. This is problematic because proprietary positions may be under-collateralised or if sufficiently risky, may pose a danger to the solvency to the CM. In fact, proprietary trading poses the greatest risk to the solvency of CMs and is the most likely cause of default, rather than customer losses.\(^\text{177}\) In this situation, although client positions are collateralised and should be capable of transfer, the default regulations would not guarantee that clients are paid in full because the cost of returning client collateral may create a deficit in the assets.\(^\text{178}\) The trustee’s fees will depend on the failed firm’s compliance with the client asset regime (ie availability and accuracy of records) and whether the trustee needs to seek directions from the court.\(^\text{179}\)

Thus, it is necessary for regulators to design a system where the risk of another MF Global, Lehman Brothers or Sonray Capital Markets is minimised, especially now that central clearing will concentrate risk in a few major CCPs.\(^\text{180}\) These corporate collapses highlight the fact that protecting client money is both a failure of the system and a violation of the system by market participants. Introducing LSOC only works towards improving the structure, rather than addressing the human

\(^\text{172}\) Singh, n 1, p 8.
\(^\text{174}\) Elias, n 173; Singh, n 1, p 8.
\(^\text{175}\) ASX Market Discussion Document, n 16, p 17.
\(^\text{176}\) CFTC Final Rule, e n 106, p 117.
\(^\text{177}\) Jones and Péringon, n 157, pp 3 and 17.
\(^\text{178}\) FOA CP12/22, n 115, p 15.
\(^\text{179}\) FOA CP12/22, n 115, p 15.
\(^\text{180}\) Singh (2011), n 94, pp 6 and 9.
agency problem which has also contributed to violations of the current client money provisions. The following section makes some suggestions for dealing with these risks.

**RECOMMENDATIONS TO SUPPORT THE USE OF “LSOC”**

As discussed above, there is some uncertainty regarding the costs and benefits of LSOC, however, the adoption of this model should still increase the level of collateral protection for retail clients. It is acknowledged that additional regulatory measures will be necessary to deal with the operational and investment risks posed to consumers, which LSOC does not effectively guard against. Thus, a variety of regulatory measures will be suggested to minimise the operational, bankruptcy and investment risks inherent in LSOC. These means include reconciliation, reporting, bail-outs, private insurance, a whistle blower regime and education programs.

The first recommendation is for licensees to conduct regular account reconciliations.\(^\text{181}\) As of “1 January 2012 all ASX 24 market participants (clearing and non-clearing) must lodge a monthly reconciliation of client money with ASIC, one month after the end of each month”.\(^\text{182}\) They must also complete daily reconciliation of client money.\(^\text{183}\) The use of buffers should also be expressly prohibited.\(^\text{184}\) Reconciliation will aid in the implementation of LSOC as proper record keeping is integral to this model.\(^\text{185}\)

To aid in the reconciliation process, regulators could create a set of specifications that software must meet in order to be registered for use. For example, a computer program that is able to perform various checks against regulatory requirements or to produce audit reports. These sorts of programs are designed to detect and report on non-compliance rather than to prevent it, but can obviate errors.\(^\text{186}\) ASIC also needs to enforce these reconciliation processes with stronger administrative sanctions; for example, by “issuing warnings, cautions, improvement notices, orders to disclose information or orders to publish advertisements”.\(^\text{187}\) Trust and reputation are essential to the operation of the market, so the risk of reputational harm is a powerful sanction.\(^\text{188}\)

Regular reporting to clients (as opposed to market operators and CCPs) regarding the balance of client money in CSAs may also be useful.\(^\text{189}\) The *Corporations Act* currently only requires licensees to confirm transactions.\(^\text{190}\) Since licensees now have daily reconciliation obligations, and if required to adopt LSOC, would have access to client information at the individual level, licensees would have the capacity to produce monthly individual client reports.\(^\text{191}\) The statement could set out the details of assets held by the licensee on the client’s behalf; how they are held; and any changes to the asset holdings.\(^\text{192}\) As well as assisting retail clients, this process would expose licensees’ record keeping practices to some external scrutiny.

---


\(^\text{184}\) ASIC Report 202, n 109, pp 7-8. In this context “buffers” refer to the deposit of a licensee’s funds into a client account (usually to ensure that there are adequate funds in the account).

\(^\text{185}\) ESMA Impact Assessment, n 78, p 53; FSA Consultation Paper 38, n 24, p 20.

\(^\text{186}\) Freiberg, n 22, p 163.

\(^\text{187}\) Freiberg, n 22, pp 234-257.

\(^\text{188}\) Freiberg, n 22, pp 234-257.

\(^\text{189}\) “Regulations were made for this purpose (*Corporations Amendment Regulations 2001* (No 4) 2001 No 319) but repealed before they commenced (*Corporations Amendment Regulations 2002* (No 3) 2002 No 41) because stakeholders thought that is would place a significant compliance burden on the industry with no consumer benefit.”: Treasury Discussion Paper, n 182, pp 19-20.

\(^\text{190}\) Section 1017F of the *Corporations Act 2001* (Cth); reg 7.9.63A of the *Corporations Regulations 2001* (Cth).


Regulators might develop a whistleblowing regime as a source of information or use business ethics as a form of self-regulation. The use of ethics may deal with preventing some operational risks (eg fraud). This motivation towards ethical behaviour may be integral to the management of the reputation or image of the CM or CCP and thus, could be cultivated in CMs or CCPs as part of education or legal compliance programs (both internal and external).

It has also been suggested that insolvency distribution costs be paid by the insolvent firm (rather than deducted from CSAs) and that licensees could cover these costs by setting aside funds for this purpose. In Australia, Recommendation 10 of the Ripoll Report suggested that the constitution of a statutory last resort compensation fund for investors be investigated.

Private insurance may be obtained so that, over a fixed term the insurer would pay the difference between the accumulated default loss and the deductible (up to an overall payout limit). This would be in addition to capital requirements, margin and surplus funds. There is legitimate concern regarding the default risk of CCPs as many clear products which are illiquid, complex or long term. Some CCPs have already purchased insurance, while the European Central Bank in 2009 identified default insurance as a key risk management tool to prevent CCP failure. Insurance can lower the perception that a CCP can default and provides extra funds to the CCP if it does. However, insurance would be particularly expensive and there may be need for discounted premiums based on the bankruptcy remoteness of client segregated funds and the record keeping processes of CMs. Alternatively, payment may be conditional on compliance with internal risk management systems, client money regulations and audit requirements.

A related suggestion is allowing CCPs to have access to central bank funding if they are exposed to liquidity risk. Liquidity risk may arise if multiple CMs default and credit concerns arise, or if an external shock to the financial system causes CMs to attempt to liquidate collateral simultaneously and re-hypothecation prevents collateral retrieval by the CCP. In circumstances where a liquidity shortfall may cause severe market disruptions or CCP collapse, it is likely that the CCP would be bailed out by the central bank. For example, “in 1998 when the ruble crashed the Russian central

---

195 Freiberg, n 22, pp 201-204.
198 Jones and Pérignon, n 157, p 15.
199 Jones and Pérignon, n 157, p 15.
200 Jones and Pérignon, n 157, p 2.
201 For example, “Euronext.Liffe, the New York Mercantile Exchange, the Sydney Futures Exchange, the Norwegian Futures and Options Clearinghouse and OMX Nordic Exchange Stockholm;”: Jones and Pérignon, n 157, p 2.
202 Jones and Pérignon, n 157, p 2.
203 Jones and Pérignon, n 157, p 15.
204 Jones and Pérignon, n 157, pp 17-18.
205 Chapter 3 Making OTC Derivatives Safer, n 5, pp 18-19.
206 ESMA Impact Assessment, n 78, pp 100-101.
bank had to monetise the losses because the whole MICEX system was at risk”.\textsuperscript{209} However, the central bank’s provision of liquidity should be conditional upon the CCPs’ satisfaction of internal liquidity risk management processes.\textsuperscript{210}

The ASX is inquiring as to ways in which cash margins paid to ASX’s CCPs for investment purposes can be made bankruptcy remote in the event of CCP default.\textsuperscript{211} One suggestion is to pool the margin but to hold it on trust at the individual client level.\textsuperscript{212} Some jurisdictions require CCPs and CMs to disclose their investment risk strategy to clients.\textsuperscript{213} The United Kingdom banned the re-use of financial instruments through title transfer arrangements and other jurisdictions have also suggested that the rules surrounding the re-use of collateral by CCPs and the acceptability of re-hypothecated collateral should be clarified.\textsuperscript{214} It has also been suggested that CCPs should not be permitted to accept collateral from a CM that is security issued by that member.\textsuperscript{215}

These suggestions require further consideration in order to be effective at minimising the said risks and costs. Client reporting may be ineffective due to the problems with disclosure. As derivatives positions are usually actively traded, lagged reporting may be under accurate and simply add to compliance difficulties.\textsuperscript{216} For disclosure to be effective it must be well-targeted in terms of the intended audience’s understanding, level of knowledge, and receptivity.\textsuperscript{217} Given the disclosure is intended for the retail market it is important to realise that such consumers may be easily overloaded or lack confidence in their ability to weigh the information; may be influenced by their perception of the provider; may only respond to the information in so far as it allows them to make a reasonable decision and not an optimal decision; or may not impact the consumer’s behaviour or understanding at all.\textsuperscript{218}

A whistleblowing regime may be questionable in terms of its social legitimacy.\textsuperscript{219} Whistleblowers often find that turning against their employer or previous employer severely affects their legitimacy even if the matter raised is in the public interest.\textsuperscript{220} It is a regime that creates conflicts of interest as employees may struggle to reconcile their organisational identity with their individual ethical identity.\textsuperscript{221} Anti-retaliation measures may be insufficient to overcome these issues and may result in very little information being proffered to regulators.\textsuperscript{222}

\textsuperscript{209} Singh (2011), n 94, p 10.
\textsuperscript{211} ASX Market Discussion Document, n 16, p 17.
\textsuperscript{212} ASX Market Discussion Document, n 16, p 17.
\textsuperscript{213} ASX Market Discussion Document, n 16, p 17.
\textsuperscript{214} ESMA Impact Assessment, n 78, pp 106-115.
\textsuperscript{215} ESMA Impact Assessment, n 78, pp 102-103. That is, CCPs should not accept corporate bonds or equities issued by their CMs in order to prevent a situation where the value of the collateral that the CCP holds is directly linked to the credit standing of its CMs. This is important because in a default situation the CCP would be exposed to significant losses on the value of the collateral.
\textsuperscript{216} Freiberg, n 22, pp 167-169, 175-176.
\textsuperscript{217} Freiberg, n 22, pp 167-169, 175-176.
\textsuperscript{220} Chiu (Pt 2), n 220 at 293.
\textsuperscript{221} Chiu (Pt 2), n 220 at 293; Sawyer, Johnson and Holub, n 219, pp 11-15.
Education programs suffer from the same shortfalls of all self-regulatory measures: they may be under-enforced and their success will depend on the perception of the individual or organisation as to the value of ethics to the firm’s reputation and profile.223

There is some legitimate doubt as to whether private insurance would be effective in severe crisis due to the cost implications.224 There is also the concern that it would have the counterproductive effect of producing moral hazard.225 For example, CCPs may weakly enforce their risk management practices if they are insured or may reduce margin requirements because CMs would be less liable for fellow CM losses.226

Backstopping by central banks also creates moral hazard and regulatory arbitrage.227 Market participants may not post collateral with CCPs that do not have access to a central bank backstop.228 This is a real concern as the policies between jurisdictions wildly differ: the European Central Bank favours a central bank liquidity backstop; while the United Kingdom and the United States do not support a liquidity backstop.229

Accordingly, bankruptcy risks may be better dealt with by requiring CCPs to create bankruptcy remote structures which reduce the incidence of re-hypothecation, moral hazard and potential losses to taxpayers.230 For example, the recent Basel Committee’s draft proposal suggests 0% capital charge when a CM deals with CCPs via bankruptcy remote collateral structures (since there will be no loss of collateral if the CCP defaults); however a 2% capital charge applies when moving derivatives to CCPs without these structures.231

In addition, it is important that any regulatory changes do not unduly limit re-hypothecation and re-investment practices. This is because a reduction in re-hypothecation, limiting the acceptability of collateral issued by CMs,232 or reducing securities lending will negatively impact global collateral availability.233

The strongest option for alleviating the operational risks inherent in LSOC is reconciliation; while the other options may pose some benefit, they would require significant development to ensure that they are not counterproductive. That is, while regulation can be used to reduce risks; risk reduction can come with added costs or unintended consequences and can never be entirely eliminated.

**THE RELATIONSHIP BETWEEN “LSOC” AND THE CLIENT MONEY RULES**

So far it has been contended that the ASX should adopt the LSOC model for Australian-dollar denominated interest rate swaps. However, if this account structure is adopted changes may need to be made to the client money provisions in the *Corporations Act* to make them consistent.

The provisions governing how client margin is to be dealt with by Australian Financial Services licensees (licensees) are Divs 2 and 3 of Pt 7.8 of the *Corporations Act* and regs 7.8.01 to 7.8.07 of the *Corporations Regulations 2001* (Cth). Licensees who receive client margin are to hold the assets in a

---

223 Freiberg, n 22, p 273; Chiu, n 194 at 180.
224 Jones and Péringon, n 157, pp 15-16.
225 Jones and Péringon, n 157, pp 17-18.
226 Jones and Péringon, n 157, pp 17-18.
229 However ss 802-806 of the *Dodd-Frank Act* authorise liquidity support to CCPs under extreme circumstances; Singh (2011), n 94, pp 11-12; Scalcione, n 193, p 395.
231 ASX Market Discussion Document, n 16, p 16. See also, AFMA Submission to ASX, n 17, p 3; ISDA Submission to ASX, n 17, p 14.
232 For example, limiting cross-collateralisation.
This account may be a “trust account” or “segregated account” and can be operated from an Australian authorised deposit-taking institution, approved foreign bank, cash management trust or cash common fund. Once client funds are deposited into a designated account, the assets are held beneficially for that client. The funds are protected against attachment and are taken to be held on trust. Thus, in the event of licensee insolvency, clients are paid from the client money accounts in priority to the licensee’s other creditors.

These protections are subject to some significant statutory carve-outs for derivatives products. “Money posted to a licensee under the licensee’s obligation to call margins under the rules of a licensed market or licensed clearing and settlement facility are taken to be held on trust.” Licensees are able to withdraw money from designated accounts if they have obtained a written direction from the client or have an entitlement to the money. And most significantly, s 981D states that “where the money is paid to the licensee in connection with a derivatives or a financial service to the client which is related to a derivative, then the licensee may use that money to meet its obligations incurred in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives (including dealings on behalf of people other than the client)” This exposes client money to additional counterparty risks, as the margins set by licensees may be inadequate to cover the positions being taken, or a large amount of risk may be concentrated in one major client.

These provisions have the following implications for the treatment of client money by licensees: 1) there is no distinction between the treatment of collateral posted by wholesale clients and retail clients; 2) client margin can be pooled in CSAs; 3) licensees may use client monies to meet their own obligations or those of other clients; 4) client agreements may give the licensee broad authority to withdraw client collateral for any purpose whatsoever; 5) s 981D is subject to inconsistent interpretations within the industry, which at their broadest allow licensees to use client funds to support their working capital requirements; 6) if there is a shortfall in the CSA (post-default) the funds are distributed between clients on a pro rata basis and any outstanding entitlements are pursued by clients as unsecured creditors of the licensee; and finally a shortfall in the CSA may not be covered by the compensation arrangements found in Divs 3 or 4 of Pt 7.5 of the Corporations Act. To expand on the above, it has been widely disputed across the industry whether s 981D should be given a narrow or wide interpretation. It has been argued that s 981D should be interpreted narrowly so that it does not allow for the use of margined money for an AFS licensee’s own purposes. It is contended that the permission granted by the section is predicated on an “obligation”

---

234 Regulation 7.8.01 of the Corporations Regulations 2001 (Cth); ASIC Class Order 04/1063; s 981B of the Corporations Act 2001 (Cth).
235 Regulation 7.8.01(8) of the Corporations Regulations 2001 (Cth).
236 Section 981E of the Corporations Act 2001 (Cth).
237 Section 981H of the Corporations Act 2001 (Cth).
238 Regulation 7.8.03(6) of the Corporations Regulations 2001 (Cth).
239 Regulation 7.8.01(5) of the Corporations Regulations 2001 (Cth). However, in insolvency the client money account will be treated as a trust account; regs 7.8.03(4) and 7.8.03(5) of the Corporations Regulations 2001 (Cth).
240 Regulation 7.8.02(1)(a) of the Corporations Regulations 2001 (Cth).
241 Regulation 7.8.02(c) of the Corporations Regulations 2001 (Cth).
242 Corporations Act 2001 (Cth).
244 ASIC Regulatory Guide 212, n 116, p 17.
in connection with margining and that the hedging by issuers is not an “obligation” but a discretionary risk management strategy adopted by some licensees.\textsuperscript{248}

This issue was judicially considered in \textit{MF Global Australia} by Black J.\textsuperscript{249} “His Honour was required to decide whether payments received, or to be received by the liquidators under agreements between MF Global Australia (MFGA) and its hedge counterparties were beneficially owned by MFGA or held on trust for clients of MFGA. A matter for determination was whether monies paid from CSAs by MFGA to counterparties for hedging purposes were a breach of trust, given that MFGA generally maintained its hedge positions on a net basis.”\textsuperscript{250} That is, MFGA would hedge its exposure to its clients’ positions by entering into separate contracts on a principal-to-principal basis with OTC counterparties. MFGA then applied the funds from CSAs to fund their margin obligations with their OTC derivatives counterparties.\textsuperscript{251}

His Honour held that this was authorised by s 981D and in accordance with the relevant client agreement, and was not a breach of the statutory trust that arose in insolvency.\textsuperscript{252} His Honour adopted the liberal approach to interpreting s 981D and took the view that the payment of margins by MFGA from client accounts in respect of hedging was authorised by s 981D, as was the use of client funds to hedge other clients’ positions.\textsuperscript{253}

Unlike the United Kingdom Court of Appeal, Black J did not accept the submission that a constructive trust arose from a breach of s 981B: the constructive trust in the United Kingdom only arose as a result of the FSA’s rules which espouse total segregation of client funds, as opposed to the Australian framework which permits pooling and the use of client monies in certain situations. Thus, in Australia a constructive trust does not arise when a licensee removes client funds for hedging purposes.\textsuperscript{254} Accordingly, “it is artificial to read down the concluding paragraph of s 981D so that it applies only to money used for the margining or other appropriate dealings with monies of any client as the use of the word ‘including’ in the bracketed phrase is an impediment to such a narrow construction”.\textsuperscript{255}

This section has been subject to much regulatory debate. In July 2010 ASIC published Regulatory Guide 212 \textit{Client Money Relating to Dealing in OTC Derivatives}\textsuperscript{256} which dealt with the interpretative difficulties inherent in s 981D. Subsequently, Consultation Paper 114 \textit{Client Money Relating to Dealing in OTC Derivatives}\textsuperscript{257} was released in July 2010. Then in August 2011 ASIC published Regulatory Guide 227 \textit{Over-the-Counter Contracts for Difference: Improving Disclosure for Retail Investors}\textsuperscript{258} which dealt with the issue of improved disclosure within the retail OTC derivatives market. Treasury released a Discussion Paper in November 2011 titled \textit{Handling and Use of Client Money in Relation to OTC Derivatives Transactions}\textsuperscript{259} which explored some structural options for reform to the system. Some options included repealing s 981D; imposing a statutory trust on CSAs to prevent the use of client collateral to satisfy the licensee’s own margin obligations; and the adoption of

\begin{footnotesize}
\bibitem{248} IG Markets Limited, Submission to ASIC, \textit{Client Money relating to Dealing in OTC Derivatives} (undated) p 6 (hereinafter IG Markets Submission).

\bibitem{249} In re \textit{MF Global Australia Ltd} (in liq) [2012] NSWSC 994.

\bibitem{250} In re \textit{MF Global Australia Ltd} (in liq) [2012] NSWSC 994 at [203].

\bibitem{251} In re \textit{MF Global Australia Ltd} (in liq) [2012] NSWSC 994 at [214].

\bibitem{252} In re \textit{MF Global Australia Ltd} (in liq) [2012] NSWSC 994 at [217]-[222].

\bibitem{253} In re \textit{MF Global Australia Ltd} (in liq) [2012] NSWSC 994 at [208], [216].

\bibitem{254} McGregor R and Ratnam DK, “Does a Constructive Trust Arise when a Licensed Derivatives Trader Removes Clients’ Funds for Hedging Purposes” \textit{Insolvency Law Bulletin} (October 2012) p 64.

\bibitem{255} HDY Submission, n 39, p 5.

\bibitem{256} ASIC Regulatory Guide 212, n 116.

\bibitem{257} ASIC Report 202, n 109.


\bibitem{259} Treasury Discussion Paper, n 182.
\end{footnotesize}
the United Kingdom trust regime (this is where the licensee acts as a trustee in relation to client assets and maintains individual segregated accounts for clients).260

Despite these consultations, the client money reforms were placed on the back burner while ASIC considered how best to overhaul the derivatives market in line with its G-20 Commitments. This led to the publication of Report 309 Report on the Australian OTC Derivatives Market261 in October 2012 and the enactment of the Corporations Legislation Amendment (Derivative Transactions) Act. In the meantime the industry has continued to self-regulate, with some licensees adopting the Australian CFD Forum Best Practice Standards.262

The Cosy Consultation in 2010 which formed the basis for the current client money rules and which informed Regulatory Guide 212 show that in the past ASIC has been fairly unconcerned with minimising the level of counterparty risk that clients have been exposed to by s 981D.263 Instead ASIC has focussed on investors becoming fully aware of the risks in the system and on licensees becoming fully aware of their obligations.264 This resulted in Regulatory Guide 227 being issued, which focuses mainly on disclosure.265

The reliance on disclosure in this context is inadequate. The regulations may put the onus on CMs to make full disclosure of risks to clients, but they do not prevent CMs from taking those risks.266 This is seen as industry standards have not improved as a result of the consultations run by ASIC in 2010.267 ASIC reported in June 2012 that “more than 30 per cent of derivatives brokers have failed to comply with client money laws”268 and “that eight out of 40 OTC CFD and margin FX derivatives issuers have failed to pay client money into a properly designated trust account”.269

As discussed above, LSOC prohibits the application of client money to meet the CM’s obligations or those incurred by the CM’s other clients. The fact that monies remain physically pooled should not be a problem so long as there are adequate legal protections of the funds. This means that there must be appropriately defined limits on the use of client money. Accordingly, changes to the current client money provisions will be necessary to create consistency between the rules and the proposed account structure.

The following amendments are suggested to create this consistency: 1) that s 981D is redrafted to remove the current interpretative ambiguities;270 2) that s 981D and reg 7.8.01(5) be amended so that licensees can only use client money for margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives on behalf of that particular client;271 3) that an express prohibition is added to prevent licensees from using client money in the CSA to meet a licensee’s own obligations or those of their other clients;272 4) that reg 7.8.02(1)(a) is narrowed so that any written direction provided by the client cannot authorise the use of client money in the CSA to meet a licensee’s own obligations or those of

---

265 ASIC Regulatory Guide 227, n 258.
266 Scalcione, n 193, pp 230, 239, 252, 258, 266; IG Markets Submission, n 248, p 9.
268 HDY Submission, n 39, pp 4-5.
269 HDY Submission, n 39, pp 4-5.
270 HDY Submission, n 39, pp 4-5.
its other clients;\textsuperscript{273} 5) that individual client account reconciliation requirements are added;\textsuperscript{274} 6) that an express prohibition on the use of buffers in CSAs is added; and 7) that reg 7.8.01(5) is amended to require all monies paid into the CSA to be held beneficially for clients.\textsuperscript{275}

Apart from creating consistency with LSOC, these changes are necessary because the policy rational for s 981D is no longer relevant. To explain the change, it is important to recognise the reason why s 981D and its predecessor provision (s 1209 of the \textit{Corporations Law}, now repealed\textsuperscript{276}) were inserted.

First of all, there are two basic models of central clearing: the principal model and the agency model. The market mainly uses the principal model.\textsuperscript{277} This is where the customer enters into a bilateral trade with a CM who enters into a mirror transaction with a CCP.\textsuperscript{278} The client will post collateral to the CM for the original transaction, while the CM will deliver margin to the CCP under its separate obligation established by the mirror transaction.\textsuperscript{279} However, the CM will use the client collateral to discharge its principal obligations to the CCP.\textsuperscript{280} This exposes the client to the risk of CM default, but insulates them from the risk of CCP default.\textsuperscript{281}

By way of comparison, the agency model requires the CM to enter into a transaction with the CCP on the client’s behalf.\textsuperscript{282} The client will owe its obligations to the CCP directly, because the CM has entered into a bilateral trade with the CCP as the client’s agent.\textsuperscript{283} The CM is still required to guarantee the client’s obligations and pay margin owed; however, the CM is not responsible to the client for the CCP’s failure to make payments or return margin.\textsuperscript{284} This model exposes the customer to the risk of CCP default, but protects them from the risk associated with CM default.\textsuperscript{285}

The predecessor of s 981D originally related to the holding and use of client money by futures brokers.\textsuperscript{286} The \textit{Futures Industry Bill 1986} was the forerunner for certain derivatives provisions found in the current Ch 7 of the \textit{Corporations Act}.\textsuperscript{287} Paragraph 200 of the Explanatory Memorandum for the \textit{Futures Industry Bill 1986} explains the rationale for the widespread use of segregated accounts (rather than trust accounts) in the futures industry.\textsuperscript{288} It states:

The practices of the SFE and the International Commodities Clearing House Limited (ICCH) make the trust account an impracticable method of protecting clients’ monies. The clearing house deals with the floor member on a principal basis and makes no distinction between contracts of the floor member and contracts of the floor member’s clients. Accordingly, when the clearing house calculates the deposit and margin calls with respect to any floor member, it has regard to the net position of all contracts registered

\textsuperscript{273} HDY Submission, n 39, 4-5; Australian Bankers’ Association, Submission to ASIC, \textit{Client Money Relating to Dealing in OTC Derivatives} (23 September 2009) p 4.
\textsuperscript{274} Similar to those for exchange traded products; Treasury Discussion Paper, n 182, p 9.
\textsuperscript{275} HDY Submission, n 39, pp 4-5.
\textsuperscript{276} \textit{In re MF Global Australia Ltd (in liq)} [2012] NSWSC 994 at [26].
\textsuperscript{277} Mirakian, Waters and Sagan, n 40; CSADC Consultation Paper 91-404, n 40, pp 10-11.
\textsuperscript{278} Mirakian, Waters and Sagan, n 40; CSADC Consultation Paper 91-404, n 40, pp 10-11.
\textsuperscript{279} Mirakian, Waters and Sagan, n 40.
\textsuperscript{280} Mirakian, Waters and Sagan, n 40.
\textsuperscript{281} Mirakian, Waters and Sagan, n 40.
\textsuperscript{282} Mirakian, Waters and Sagan, n 40.
\textsuperscript{283} Mirakian, Waters and Sagan, n 40; CSADC Consultation Paper 91-404, n 40, p 11.
\textsuperscript{284} Mirakian, Waters and Sagan, n 40.
\textsuperscript{285} Mirakian, Waters and Sagan, n 40. ISDA Submission to ASX, n17, p 3. The agency model is used in the United States and is supported by specific regulatory protections. For further analysis regarding the potential application of the agency model to clearing in Australia please refer to Appendix 1 of ISDA Submission to ASX.
\textsuperscript{286} HDY Submission, n 39, p 6; IG Markets Submission, n 248, p 7.
\textsuperscript{287} Treasury Discussion Paper, n 182, pp 8-9.
\textsuperscript{288} Treasury Discussion Paper, n 182, pp 8-9.
with it by that floor member. When funds are paid by the floor member to the clearing house in response to deposit and margin calls it is not possible to trace funds received from any particular client as passing to the clearing house.289

As futures brokers are participants in clearing houses they are permitted to use client funds to satisfy their margining obligations and thus facilitate the principal model of trading.290 (CCPs have generally regarded futures brokers as owing their trading obligations to the CCP as principals).291 This rationale was extended to derivatives trading more generally by the new Ch 7 of the Corporations Act, introduced by the Financial Services Reform Act 2001 (Cth).292 However, it is argued that this rationale should not apply now, because clearing practices have changed significantly: first, CCPs now recognise the individual client positions that CMs hold through individual client segregated accounts (LSOC and other models) and second, CCPs are now calculating margin on a gross basis (as opposed to a net basis). These changes have all facilitated the recognition of end-user positions by CCPs.

In addition, the penalty or enforcement regime surrounding the misuse of client money needs to be re-evaluated as it is relatively fragmented. ASIC can apply to the court for orders restricting a licensee’s dealings with CSAs.293 ASIC also has the power to prosecute a licensee that fails to pay money into a client money account or which fails to comply with the client money provisions.294 These offences are deemed to be strict liability offences, but only carry a penalty of five penalty units.

Thus, compliance is predominately self-regulated, with regulators becoming involved in the enforcement process once firms have entered administration (in which case the Crimes Act 1958 (Vic) is likely to be used where there has been a misuse of funds, rather than the Corporations Act). This is problematic because there is a large amount of prosecutorial discretion in this area and because the Crimes Act is not designed to deal with or deter the operational risks inherent in OTC derivatives collateral management.295

Reliance on self-regulation also poses problems for compliance and enforcement because the information asymmetry in this area is so great that the ability of regulators to identify, monitor, assess and remedy non-compliance is severely compromised.296 For self-regulation to work adequate coverage of the industry needs to be achieved and there must also be evidence that voluntary participation is effective.297 This has not been the case as self-regulation has failed to deliver results by way of client money protection, and has resulted in under enforcement and decreased accountability.

It is argued that the current enforcement regime is not adequately structured to deal with the misuse of client funds, because it has a weak deterrent effect and fails to alter firm culture. This may be because there is a level of discretion in the way in which regulators handle such breaches,298 which may neutralise the significance of the misconduct.299 This is evidenced by the tendency of perpetrators to legitimise their actions by pointing to firm or industry practice, and even unclear regulatory

292 HDY Submission, n 39, p 6; Financial Services Reform Act 2001 (Cth).
293 Section 983A-983E of the Corporations Act 2001 (Cth); ASIC Regulatory Guide 212, n 116, pp 8, 23.
294 Section 993B-993C of the Corporations Act 2001 (Cth); ASIC Regulatory Guide 212, n 116, pp 8, 23.
295 For example, the lack of prosecutions as a result of the collapse of MF Global; Neugebauer Report, n 157, pp 74-75.
296 Freiberg, n 22, pp 26-31, 86; Chiu, n 194 at 173; Kiff et al, n 4, p 16.
297 Freiberg, n 22, pp 26-31, 86.
299 Gilligan, n 298.
structures. For example, in MF Global and Sonray Capital Markets the risks surrounding the holding of client money were exacerbated by a firm culture which allowed senior management to act above operational requirements.

This is alarming because these kinds of risks may not only be indicative of the culture of certain firms, but also indicative of the culture prevalent in the industry. After broker/dealer collapses there is a tendency for market participants to apply the “bad apple metaphor” and separate themselves from their failed colleagues. However, given the ambiguity surrounding the application of the client money provisions, there is a risk that these activities are effectively normalised. The industry is able to use a couple of failed market participants as scapegoats for the effects produced by systemic conduct. This is concerning because altering the account structures for holding client funds will not deal with the aspect of human and organisational agency which lead to these operational risks.

It is suggested that to improve compliance, regulatory architecture may need to be selected which is more centred on creating incentives for compliance, than sanctions for non-compliance. This is because the finance industry is inherently opportunistic and tolerant of excessive risk: the possibility of incurring civil penalties (or even criminal prosecution) may not be as psychologically powerful in altering market participants’ behaviour as incentive-based regulation. However, more empirical work is needed in this area.

CONCLUSION

It has been contended that ASX CCPs should adopt LSOC account structures for Australian-dollar denominated interest rate swaps. However, while the adoption of LSOC may enhance the segregation and portability of client positions and collateral, it does not protect end-users against all risks. Accordingly, further reforms are needed. Enhanced reconciliation and record keeping practices seem to be the best regulatory options for minimising operational risks, however further options need to be explored to deal with investment risk and bankruptcy costs. In addition, significant reforms will also need to be made to the client money rules to ensure full compatibility with LSOC, specifically amendments to s 981D.

The enforcement and penal regime surrounding the misuse of client money also needs to be re-evaluated. Reliance on disclosure requirements in this area has proven ineffective because of information asymmetries which exist between licensees and clients. ASIC is better placed than retail clients to assess a licensee’s solvency and risk management compliance, thus, ASIC must take more responsibility for the oversight of CMs rather than relying on disclosure requirements which do not enhance client protection or mitigate risk.

The current penal regime is also not adequately structured to deal with the nature of the offender because it fails to deter or alter the behaviour of regulated firms and their organisational cultures. Introducing LSOC will only improve the structure of the system; it will not address the human agency problem which has also contributed to violations of the current client money provisions.

It is necessary for regulators to design a system that minimises the danger of another MF Global, Lehman Brothers or Sonray Capital Markets occurring again. To do this, regulators need to have access to more resources to ensure compliance. They also need to treat the problem more holistically. For example, while regulators have been focussing on the structure of client accounts, house accounts have remained unaffected. This is despite the fact that proprietary trading in house accounts pose the greatest source of default risk to the market. Thus, over time regulators may also need to address these activities.


301 Gilligan, n 298 at 355-362.

302 Gilligan, n 298 at 358-360.

303 Gilligan, n 298 at 358-360.

304 Gilligan, n 298 at 358-360; Sarra, n 210 at 802.

305 Freiberg, n 22, p 273; Sarra, n 210 at 795.
In conclusion, while some inroads have been made in protecting client collateral and improving the resilience of the OTC derivatives market in Australia against CCP or CM default, there is still much work to be done.