



5 July 2011

Martin Joy
Senior Lawyer
Investment Banks
Australian Securities and Investments Commission

By email: policy.submission@asic.gov.au

Dear Mr Joy

CP 156 - Retail OTC Derivative Issuers: Financial Requirements

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on Consultation Paper 156 (CP 156) on proposed financial requirements for retail over-the-counter (OTC) derivative issuers. AFMA represents, amongst other financial market participants, the leading CFD providers in Australia who will be primarily affected by the proposals in CP 156.

Our CFD Market Committee represents a large cross section of the industry and supports the objective of CP 156 to enhance the financial requirements for issuers of retail OTC derivative products. Our members are keen to ensure that liquidity and financial risk management are of a high standard within the industry to support the continued development of a strong and robust market.

Our response to the questions posed in CP 156 follows.

1. Proposed Financial Requirements

B1Q1 Do you agree with this proposal? If not, why not?

AFMA agrees with the objective of the proposal to require longer cash flow forecasts to assist issuers to identify potential cash flow problems at an earlier stage, qualified by our comments to B1Q3. We agree that the current cash needs requirement in Regulatory Guide 166 (RG 166) should be replaced with the proposed rolling 12-month cash flow projections. We also agree that the base level requirements in RG 166.22 (a), (b) and (d) should remain unchanged.

The key drivers of cash balances are financial market movements and client behaviour. Cash receipts from clients are driven by movements in the financial markets and the resulting margin requirements. Cash withdrawals from clients are also heavily dependent on market conditions and client decisions on where they choose to hold their funds. Movements in open position valuations impact the amount of client money that needs to be segregated and so impacts the level of funds held by issuers. In addition, hedging broker balances are also market driven. In comparison, other operating cash flows such as interest receipts, expense and investment payments, dividends and taxation are immaterial to the swings in cash balances brought about by daily market movements.

Our members manage these cash movements and liquidity risk more generally to ensure, as far as possible, that they will always have sufficient liquidity to meet their liabilities when due. Apart from complying with the current cash needs requirement as set out in RG 166, members may also take additional measures to manage liquidity risk, such as daily monitoring of available funds and periodic liquidity stress testing.

B1Q2 What additional costs will be incurred by your business as a result of these proposals?

We do not anticipate any material additional costs given cash flow forecasting is already conducted by issuers. However, as per our response to B1Q3, issuers that currently manage cash flows on a consolidated group-wide basis will be significantly impacted from a compliance and funding costs perspective.

B1Q3 Are there any drawbacks in limiting the options issuers have to meet the cash needs requirement?

Whilst the replacement of the five options in meeting the cash needs requirement currently available under RG166.22(c) with one approach generally improves clarity and promotes consistency amongst issuers, the removal of different options in managing liquidity risk may present significant compliance difficulties for some issuers. The current RG 166 recognises that liquidity risk can be appropriately managed in different ways according to a licensee's business, structure and size (RG 166.26).

We are aware that the limitation of options will present difficulties for licensees that currently manage cash flows on a consolidated group-wide basis. For these licensees, the current cash needs requirement can be met by the parent entity preparing cash flow projections on a consolidated basis, such that cash resources are managed on a group-wide basis and cash is freely transferable between all group companies. Requiring licensees that are part of a consolidated group to separately manage cash flows for regulatory purposes will have a material negative impact on potential access to group facilities, compliance costs and also funding costs. As such, the proposed cash need requirement should be amended so that licensees that are part of a consolidated group can meet the requirement at the group level.

Apart from this specific issue, we are not aware of any other drawbacks associated with limiting the options available to meet the cash needs requirement.

B1Q4 Are there any practical problems with the implementation of this proposal? Please give details.

The most significant practical problems associated with the implementation of this proposal are with regard to licensees that currently manage cash flows on a consolidated group-wide basis, as already identified.

Clarity around the proposal for cash flow forecasts to be approved by the directors of an issuer, under B1(c), is required. It is unclear how approval is to be obtained, for example, from all directors, a reduced number of directors or a quorum in accordance with the issuer's company constitution. Given that a number of issuers would have directors that are resident overseas, it would be both impractical and onerous to require approval from these directors. We therefore recommend that for companies with more than one director, that a minimum of two directors sign off on the forecasts.

With regard to the proposal for cash flow forecasts to be updated when material changes occur to the cash flow forecast assumptions, more guidance on what would constitute a 'material change', who would make this determination and whether changes to the cash flow forecast intra-quarterly would require approval from directors would be helpful.

B1Q5 Do you agree with the definition of 'issuer'? Will this capture, and only capture, all AFS licensees that are in the business of issuing OTC derivatives to retail clients?

"Issuer" is defined as an AFS licensee that makes a market in derivatives to retail clients and owes liabilities or contingent liabilities by entering into derivatives with retail clients. ASIC should ensure that the proposed financial requirements apply to issuers of over-the-counter (OTC) derivatives only, as per the objectives stated in the Consultation Paper.

B2Q1 What benefits and disadvantages do you consider will result from proposal B2(a)?

The challenge in establishing minimum financial resource requirements is the need to ensure that it meets the objectives as set out in the Consultation Paper whilst also avoiding unreasonable penalty of smaller businesses. We support the setting of a higher capital minimum in the form of the net tangible assets (NTA) proposal than that provided for in the current surplus liquid funds (SLF) and adjusted surplus liquid funds (ASLF) provisions. With regard to the proposed \$1 million minimum NTA, there are differences in opinions within the industry as to whether the proposed minimum is sufficient to ensure that the level of financial resources held by licensees is appropriate. Some issuers are of the view that the financial resources objectives, as set out in the consultation paper, are too narrow. The complexity in the task of setting an appropriate financial resources minimum is further illustrated by the fact that the level of financial resources held is only one dimension in prudent financial risk management. The overall financial risk profile for individual issuers will vary in accordance with the types of derivatives being issued and other risk management policies.

In general, we see an increase in the minimum financial resource requirement as the key benefit to this proposal. Another benefit of the proposal is that it provides a more simplified calculation, and thus, affords less opportunity for differing interpretations.

A potential disadvantage of basing the net tangible assets (NTA) calculation on revenue is that this may encourage issuers to deflate forecast revenues for the purpose of reducing the required holding of NTA. We suggest that basing the NTA measurement on actual revenues only may provide a sounder basis for financial management.

Also, for licensees structured as a branch, the proposal may have the unintended consequence of requiring the licensee to hold NTA calculated from the revenue of the whole group, which may include significant offshore businesses as well. For global groups, the proposal may also have the perverse effect of requiring the local entity to hold a significant amount of funds outside of the parent jurisdiction. It should be clarified that the requirement to hold the prescribed minimum level of NTA, for affected licensees, applies on an individual branch basis.

B2Q2 What benefits and disadvantages do you consider will result from proposal B2(b)?

Under B2(b) of the Consultation Paper, it is proposed that an issuer is required to hold 50% of the required NTA in cash and cash equivalents, which excludes cash in client segregated or trust accounts. Some issuers may voluntarily choose to allocate a greater amount of client funds into segregated or trust accounts, including client margins provided to the issuer. The effect on these issuers is that they will be holding a higher amount of financial resources. It should be clarified that cash in client segregated or trust accounts that are client margin amounts can be used in calculating the required NTA.

B2Q3 What effect will this proposal have on the capital currently held by your business? Please quantify these amounts.

No comment. Individual members may comment on the specific impacts of the proposals on their business.

B2Q4 Do you agree that this proposal will achieve our aims specified in paragraphs 3 and 6? If not, why not?

We agree that these proposals simplify the financial requirements for issuers; however it may not necessarily decrease compliance costs. This would depend on an issuer's current practice.

Further, it should be noted that with regard to the objective of encouraging compliance with obligations under the Corporations Act, adequate management of financial resources is only a small component, and ultimately, compliance will be dependent on a multitude of other factors including an issuer's compliance standards and risk frameworks.

With regard to the objective to align Australia's financial requirements for issuers with the requirements for equivalent entities in Australia's peer jurisdictions, we note that such an alignment would require a more rigorous analysis than that based purely on a comparison of quantitative financial requirements which are but one component of an effective regulatory regime.

B2Q5 Do you think there is a more appropriate method for calculating financial requirements that would meet our aims specified in paragraphs 3 and 6? Please give details.

It is proposed that issuers are required to hold NTA equal to the greater of \$1 million and 10% of average revenue, with average revenue including aspects of actual and forecast revenue as defined. As suggested, we consider NTA based on actual rather than forecast revenue provides a sounder basis for financial management.

B2Q6 What impact will this proposal have on your business costs? How will you manage these changes?

No comment. Individual members may comment on the specific impacts of the proposals on their business.

B2Q7 Will this proposal result in increased costs for investors?

We consider it to be highly unlikely that any increased business costs would be passed onto investors through increased fees, commissions etc. Therefore we do not consider that this proposal would result in increased cost for investors.

B2Q8 What impact will this proposal have on competition?

We do not anticipate that the proposals would have any material impact on existing competition, however, the proposals may increase the barrier to entry for new market participants.

B2Q9 Will this proposal impact on issuers using different pricing models (i.e. market maker or direct market access) in different ways?

We do not anticipate that the proposals will impact on issuers using different pricing models in different ways.

B2Q10 Are there any practical problems with the implementation of this proposal?

As noted in our response to B2Q1, for consolidated group-wide entities, the proposal may have the unintended consequence of requiring the licensee to hold NTA calculated from the revenue of the group. This would be an inappropriate outcome.

B3Q1 Do you agree with this proposal? If not, why not?

We agree with the proposal in so far as it facilitates greater ease from the perspective of licensees and ASIC in monitoring the adequacy of financial resources.

B3Q2 Do you think that this proposal is likely to see issuers using their liquid NTA when required (e.g. when losses arising from operational risk factors occur)?

Yes

B3Q3 Is 110% of required NTA a reasonable level below which reporting to ASIC must occur?

Yes

B3Q4 If an issuer must use its liquid NTA to meet unexpected expenses or losses, is two months sufficient time to replenish NTA to 100% of the required NTA?

Yes

B3Q5 Do you agree with the requirement to inform clients of the deficiency in NTA? If not, why not?

While we agree that appropriate disclosure to clients is necessary, there needs to be adequate flexibility and discretion for ASIC to require disclosure to clients based on specific circumstances.

B3Q6 Setting the certification requirement at 75% allows issuers to use 25% of their required NTA before they face the risk of being unable to trade with their clients. Is 25% of required NTA a sufficient amount to allow issuers to address unexpected losses or expenses that may arise from operational risk factors?

Yes. We do not anticipate such a scenario to be commonplace, and as such, suggest that there should be sufficient flexibility and discretion for ASIC and the issuer to agree on how the requirement should be implemented when/if the situation arises.

B3Q7 What impact will this proposal have on your business costs? Please quantify your response where appropriate.

No comment. Individual members may comment on the specific impacts of the proposals on their business.

B3Q8 How will you manage any change to your business costs?

No comment. Individual members may comment on the specific impacts of the proposals on their business.

B3Q9 What impact will this proposal have on competition?

As per our response to B2Q8.

B3Q10 Are there any practical problems with the implementation of this proposal?

B3(c) would need to allow for the fact that daily calculations of NTA will be estimates that will be revised with monthly numbers. A situation may arise that, through oversight or error, a licensee may fail the 75% rule but a reasonable timeframe should be allowed to spot and rectify the problem without automatically incurring this sanction.

2. Proposed Implementation Process

C1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this consultation paper?

Some members are prepared to meet the new requirements within a shorter timeframe than that proposed. As such, these members may become fully compliant with the proposals earlier than the suggested timeframe. Others may require a longer implementation period. The final timeframe should be implemented so that there is competitive neutrality across all issuers.

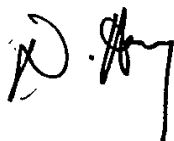
C1Q2 Do you require a staged implementation to ensure that adequate arrangements are in place to meet the proposed requirements? If so, is the level of NTA proposed to apply after 12 months appropriate? If not, what would be?

Members are generally supportive of the proposed implementation approach. As suggested, some members may seek to become fully compliant with the proposals at an earlier time than that proposed.

3. Concluding Comments

Thank you for the opportunity to comment on the proposals contained in CP 156. Please contact me at dhang@afma.com.au or (02) 9776 7994 for further clarification or elaboration as required.

Yours sincerely



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