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Watchdog must stop brokers using their clients' money as a piggy bank

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If a business model has to rely on client money because the trader doesn't have enough of its own capital, it is time to pack it in. *Photo: Virginia Star*

THE spectacular collapse of MF Global and the release of a consultation paper by the government flagging options to reform the client money laws for over-the-counter (OTC) derivatives could have profound consequences for the models of several operators if the government decides to ban the pooling of funds and use of client money to hedge trading positions for other clients.

Put simply, instead of using client money as their piggy bank, they would have to use their own working capital to fund margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives.

Submissions have now closed after being extended from the original deadline of January 27.

It is an issue that needs to be properly considered, particularly in light of the fiasco at MF Global, which exposed risks in the system about the pooling and use of client money and counterparty risk that this columnist has been writing about since early 2008.

On July 13, 2010, when the Australian Securities and Investments Commission came out guns blazing with a regulatory guide relating to OTC derivatives, I pointed out that in the guide it had failed to deal with the riskiest aspect of these products: that a client's money is pooled into one account, that the client money can be used for purposes unrelated to that client and if the company goes under the client becomes an unsecured creditor.

This paper is squarely aimed at contracts for difference (CFDs), but it fails to address there are two models, the market maker model and the direct market access (DMA) model. The direct market access model has more transparency particularly in the pricing but it uses client money for hedging, whereas the market maker model basically operates within the closed environment created by the market maker. Though they sometimes use external hedging in the real market, the clients are really just betting against the "house" - or each other. The risk here is obvious if the operator collapses.

In one submission, a DMA trader argued that if clients' money was no longer used for hedging, it would almost certainly lead to the closing of all DMA model providers. "Maybe one or two would still offer it as an option, but commission would increase substantially to cover the additional hedging requirements, not to mention the fact they'd basically have no competition in that sector of the industry."

However, a submission by the MF Global clients' support group argues that the problems at MF Global arise from one error in regulatory law, that is, that the broker firm is currently able to use client money to margin or deal in the firm's own positions. A second but possibly less significant matter is whether restrictions on pooling client funds would have helped prevent the situation. "It is the unshakeable conviction of the support group that no client funds should ever be used or be able to be used to margin the broker's own positions. Furthermore any uncertainty as to the legitimacy of this should be absolutely removed."

At the end of the day, if a business model has to rely on client money because the trader doesn't have enough of its own capital, it is time to pack it in. But if that means the non-transparent market maker model thrives, then that too is something that should be addressed.

THE board of Pacific Brands will be hoping like hell that KKR, TPG or even CVC does an Alan Bond and buys the company back cheaper than it did the first time around, to give shareholders the "get out of jail" card they so desperately need.

Industry talk is that at least three investment banks are doing the rounds of potential acquirers, including Steinhoff International, to try to broker a deal after the PacBrands board made it clear it was keen to put the company into play.

The confirmation by the company in January that private equity giant KKR had made an unsolicited preliminary approach looks increasingly premature and smacks of desperation by the board to create some interest or competitive tension. "There is no certainty that these discussions will lead to any agreement being reached between the parties."

For its part KKR has been radio silent and the preliminary discussions PacBrands referred to appears to have halted - for now.

It is now a waiting game. With a profit announcement due on February 24, and a share price trading at 66.5¢, everyone is waiting to see how bad the half-year earnings will be. The company's saving grace will be a debt refinancing package it brokered earlier last year as well as the strong Australian dollar. Everything else appears to be working against it, including its logistics in China, rising cotton prices, a decision by many big retailers to source their own products from China and substitute some of the PacBrands products with their own private labels. Some of the group's brands include Bonds, Berlei, Sheridan and Tontine pillows.

This is a company that has cost its investors a fortune. Ten months after floating at $2.50 in 2004 share cracks appeared when the company released a set of disappointing half-yearly results. And so began a litany of poor results, debt blowouts, capital raisings and a myriad of excuses.

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