Handling and use of client money in relation to over-the-counter derivatives transactions

Discussion Paper
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FOREWORD

I am pleased to release this discussion paper on the handling and use of client money in relation to over-the-counter (OTC) derivatives transactions.

The purpose of this discussion paper is to discuss a number of issues relating to the holding of client money in connection with OTC derivatives transactions, and to review whether the client monies provisions of the *Corporations Act 2001* (the Act) provide sufficient protections for investors.

The collapse of MF Global highlights the need to examine the client money provisions in the Act with a view to determining whether they provide sufficient protection for investors.

This discussion paper broadly considers various aspects of Australia's current regulatory regime for the keeping and handling of client monies. In particular, the scope of the paper is concerned with OTC derivatives; that is, a derivative which is a financial contract negotiated bilaterally between the buyer and seller and which typically incorporates bespoke terms to allow the contracting parties either to hedge specific risks or generate tailored exposures. Examples of such OTC derivatives include swaps, contracts for difference (CFDs), margin foreign exchange and OTC options.

Although relevant, it is not proposed to cover exchange traded derivatives which are traded through a licensed market and subject to operating rules of the exchange. However, we have sought comment on whether exchange traded derivatives should be subject to any client money changes as an issue for comment.

The paper explores options of applying requirements to retail clients only. Retail clients are generally less sophisticated than wholesale clients and may lack an understanding of the risk associated with funds in a clients segregated account.

This paper provides the public, in particular the financial services industry, with the opportunity to comment on the arrangements for client money and the future direction of these arrangements to ensure the arrangements align with international best practice.

I look forward to receiving the community's views on this matter, and thank you for your engagement.

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services and Superannuation

Glossary

ACH	Australian Clearing House Pty Ltd
Act	Corporations Act 2001
ADI	Authorised deposit taking institution
AFS	Australian financial services
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange Limited
ASX 24	ASX Limited
CASS	Client Assets Sourcebook (UK)
CEA	Commodity Exchange Act (US)
CFD	Contracts for difference
CFTC	Commodity Futures Trading Commission (US)
CS facility	Clearing and settlement facility
DCO	Derivatives Clearing Organisation (US)
FAA	Financial Advisers Act 2008 (NZ)
FCM	Futures Commission Merchant (US)
FoFA	Future of Financial Advice
FSA	Financial Services Authority (UK)
MIRs	Market integrity rules
OTC	Over-the-counter
Regulations	Corporations Regulations 2001
Ripoll Report	Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia

1 INTRODUCTION

1.1 PURPOSE AND OVERVIEW

The purpose of this discussion paper is to discuss a number of issues relating to the holding of client money in connection with OTC derivatives transactions, and to review whether the client monies provisions of the Act provide sufficient protections for investors.

Potential issues include:

- the appropriateness of pooling money received by holders of Australian financial services licences (licensees) and utilising those funds in connection with derivatives transactions; and
- the adequacy of reporting arrangements between financial services licensees holding client money and clients.

To date the Government has made no decisions on the issues raised in this discussion paper. Feedback from stakeholders on these issues will be taken into account in finalising the Government's consideration of the above issues.

1.2 SCOPE

This discussion paper broadly considers various aspects of Australia's current regulatory regime for the keeping and handling of client monies. In particular, the scope of the paper is concerned with OTC derivatives; that is, a derivative which is a financial contract negotiated bilaterally between the buyer and seller and which typically incorporates bespoke terms to allow the contracting parties either to hedge specific risks or generate tailored exposures. Examples of such OTC derivatives include swaps, contracts for difference (CFDs), margin foreign exchange and OTC options.

Although relevant, it is not proposed to cover exchange traded derivatives which are traded through a licensed market and subject to operating rules of the exchange. However, we have sought comment on whether exchange traded derivatives should be subject to any client money changes as an issue for comment.

The paper explores the option of applying requirements to retail clients[1] only. Retail clients are generally less sophisticated than wholesale clients and may lack an understanding of the risk associated with funds in a clients segregated account.

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1 A retail client is a person as identified in section 761G of the Act. For the purposes of Chapter 7 of the Act, a person to whom a financial product or financial service is provided is treated as a retail client unless specifically designated a wholesale client under subsections 761G(5), (6), (6A), (7) or 761G(1). A person who acquires a financial product or financial service, and who is not a retail client, must be a wholesale client as per subsection 761G(4). This puts it beyond doubt that a person who does not acquire a financial product or service as a retail client is a wholesale client.

1.3 Background

Licensees are required to keep their clients' money in designated 'client money accounts'. A client money account is generally operated as a trust account. This means that the funds deposited on behalf of a client in the client money account are held for the benefit of that client and cannot be used to meet the obligations of another client.

Section 981D of the Act details specific rules for dealings in derivatives. It provides that where the money in the account relates to derivatives, then the money concerned may also be used for the purpose of meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee (including dealings on behalf of people other than the client). This means the protections afforded by a trust account do not apply to money used in this way and that one client's funds can be used to meet obligations incurred by the licensee in connection with dealing on behalf of another client.

The collapse of MF Global highlights the need to examine the client money provisions in the Act with a view to determining whether they provide sufficient protection for investors.

The insolvency of MF Global's US parent company has implications for Australian investors and market participants. An Australian subsidiary is under administration. A UK entity that is important in the Australian marketplace is in special administration in the UK.

1.4 Overview

The Act establishes a regulatory framework governing how AFS licensees must deal with certain money and property that they receive from clients. These requirements are set out in Divisions 2 and 3 of Part 7.8 of the Act and Regulations 7.8.01 to 7.8.07 of the *Corporations Regulations 2001* (the Regulations). Importantly, these provisions do not distinguish between retail and wholesale clients.

The objective of these requirements is to ensure that money and property received by a licensee on behalf of a client relating to the provision of a financial service or product is handled in an appropriate manner by the licensee. The requirements therefore specify such details as the types of accounts into which client money can be deposited; how money can be invested; and the circumstances under which the licensee may withdraw money from the account. Money received by the licensee for certain purposes, including remuneration or reimbursement of expenses, is not covered by these requirements.

This paper deals with money and property paid to the licensee in connection with an OTC derivative (as defined in Chapter 7 of the Act) or a financial service to the client which is related to an OTC derivative.

The Government has consulted with the Australian Securities and Investments Commission (ASIC) in preparing this paper. In addition, ASIC has over the past few years taken action to make sure licensees highlight any risks associated with their treatment of client money. Examples are ASIC Regulatory Guide 212 '*Client money relating to OTC derivatives*' and Regulatory Guide 227 '*OTC Contracts for Difference: Improving disclosure for retail investors*'.

In particular, ASIC's Regulatory Guide 212 sets out the obligations on licensees in respect of client money and draws attention to clients' counterparty risks (that is, the risk to each party of a contract that the counterparty will not live up to its contractual obligations).

This paper describes briefly how these provisions apply in connection with OTC derivatives transactions and asks whether those provisions are still appropriate or should be strengthened. Section 2 of this paper asks whether the current protections for client monies should be strengthened so that a client's money cannot be used to pay another's obligations, against the background of a number of recent reviews of comparable protections overseas. Section 3 asks whether requirements for reporting to clients in respect of client monies should be strengthened.

2 POOLING OF CLIENT MONEY OR PROPERTY RELATING TO DERIVATIVES

2.1 SUMMARY OF THE EXISTING LAW

A brief summary of some of the provisions in Divisions 2 and 3 of Part 7.8 of the Act and the regulations of significance to derivatives transactions follows. ASIC Regulatory Guide 212 sets out further detail about the provisions.

Requirement to hold money in a designated account

In brief, the licensee must ensure that client money is paid into an account with an Australian authorised deposit-taking institution (ADI), an approved foreign bank, a cash management trust or a cash common fund, which is designated as an account for the purposes of section 981B of the Act.

Regulation 7.8.01 supports this section and it is supplemented by ASIC Class Order 04/1063 section 981B money in cash common funds.

ASIC Class Order 03/1112 '*Relief from obligations to hold client money on trust*' exempts an ADI, which is also a financial services licensee, from the obligation to hold wholesale client's money on trust where the parties so agree in writing. The client must be a wholesale client for those purposes. ASIC can exempt licensees who are an ADI from paragraph 981B(1)(c) of the Act if they are a wholesale client.

Holding and use of client money

Monies other than loans have certain protections against attachment (section 981E) and are taken to be held on trust for the benefit of the client (section 981H).

This is subject to the following:

- Under section 981D, where the money is paid to the licensee in connection with a derivative 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).

- Under 7.8.02(1)(a) the licensee may make a payment out of a client money account if it has obtained a written direction from a person entitled to the money – we understand that the client agreements of licensees dealing particularly in OTC derivatives may contain a broad authorisation from clients for the licensees to make withdrawals from client money for any purpose whatsoever.

- Under 7.8.02(c) the licensee may make a withdrawal from a client money account of money to which it is entitled, and a broad entitlement may be created under the terms of its client agreement (e.g. creating an entitlement when margin is due and payable).

- Sub-regulation 7.8.01(5) means that any money paid to a licensee under the licensee's obligation to call margins from clients under the rules of a licensed market or licensed clearing and settlement (CS) facility is not held on trust.

- A financial services licensee that is required to call margins from a client under the operating rules of a licensed market or a licensed CS facility may operate an account as a client's segregated account or a trust account in accordance with the operating rules (sub-regulation 7.8.01(8)).

- A licensee who operates such an account may pay all money received by it under the relevant provisions into that account (sub-regulation 7.8.01(9)).

Insolvency of licensee

Generally, a client money account is operated as a statutory trust account. However, if a licensee is required to call margins from a client under the operating rules of a licensed market or a licensed CS facility (regulation 7.8.01(5)), the licensee may operate the client money account as either a client's segregated account or a trust account. In either case, the account is subject to the statutory protections on use, withdrawals and distribution of client money in the event of the licensee's insolvency or ceasing to carry on business (regulation 7.8.03(4)).

In summary, when a licensee becomes insolvent and in certain other specified situations, its client money account (whether it is a trust account or a segregated account) is taken to be subject to a trust in favour of each person who is entitled to be paid money from that account (sub-regulation 7.8.03(4)). Similarly, where the client money has been invested, it is taken to be subject to a trust (sub-regulation 7.8.03(5)). The protections against attachment in section 981E may also be relevant in these circumstances.

Section 981D of the Act provides that money paid to a licensee in connection with dealing in or holding a derivative may also be used to meet obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee. Removing the ability of licensees to use client money for aforementioned purposes may be preferable to imposing a prohibition on co-mingling of client money or pooling of that money.

In addition to the current provisions, a last resort scheme would be likely to attenuate the problem of a licensee becoming insolvent. Existing fidelity fund arrangements apply only to on-exchange transactions.[2]

As part of the Future of Financial Advice (FoFA) reforms announced on 26 April 2010, the Government commissioned Richard St. John to undertake a review to consider the need for, and costs and benefits of a statutory compensation scheme. This review was announced in response to recommendation 10 of the report by the Parliamentary Joint Committee on Corporations and Financial Services '*Inquiry into financial products and services in Australia'* (the Ripoll Report*).*

The Ripoll Report recommended ' … that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors' (Recommendation 10). In making this recommendation, the Ripoll Report recognised that 'deficiencies of [professional indemnity] insurance make a last resort statutory compensation fund covering licensee wrongdoing

2 See Divisions 3 and 4 of Part 7.5 of the Act.

appealing', but that more work would be required to overcome significant issues in design and to ensure that the cost on industry is fair and equitable, and is justified by the protection offered to consumers.

A paper released by Richard St. John in April 2011 indicates that this review is looking at measures to improve the professional indemnity insurance and financial adequacy of licensees, as well as the need for a scheme that provides last resort compensation payments should a licensee fail to meet their compensation obligations.

Payments out

Regulations dealing with the circumstances in which payments may be made out of an account are included in sub-regulation 7.8.02 (under section 981C). Among other things, payments may be made out of a client money account in accordance with the written direction of a client or to the licensee if it is entitled to the payment. The terms of the contract between a licensee and client may be drawn broadly so that the licensee is entitled to make extensive withdrawals from money held in the client money accounts.

Money received in connection with derivatives may be used 'for the purpose of meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee (including dealings on behalf of people other than the client)' (section 981D).

Property other than money, which is received in connection with a derivatives transaction, may also be used in this way (section 984B).

These provisions are not dependent on holding the funds in a segregated account.

Interpretation of the provisions

There appear to be a number of possible interpretations of section 981D among stakeholders:

- One view is that section 981D allows a licensee to pay from the client money account to meet margin obligations arising from contracts entered into on behalf of any of its clients, but does not allow the licensee to use the funds for hedging its own position.
- Another view is that section 981D allows a licensee to use client money to pay margin calls to its hedge counterparty, to meet its own obligations.
- Some stakeholders consider there is no valid distinction between the two models (and hence no basis for different interpretations), given that futures brokers are regarded by the operating rules of a licensed financial market as entering into transactions as principals.

These different interpretations mean that clients may not fully understand what happens with their money once they give it to a licensee to deal in OTC derivatives.

2.2 THE EFFECT OF THE RELEVANT PROVISIONS

The effect of the relevant provisions of Part 7.8 of the Act on client monies received in relation to derivatives by a licensee as they now stand is that:

- A licensee that receives funds from a client can pool this money in a segregated account.

- The money is at risk as it may, for example, be used by the licensee for the purposes of margining, guaranteeing, securing, transferring, adjusting or settling derivatives entered into on behalf of others or paid out of the client money account, under regulation 7.8.02(1)(a), on the basis of a standing direction included in the client agreement. This risk is increased if the margins set by the licensee are inadequate to cover the risks being taken or there is a concentration of risk in one large client.

- A client is exposed to a deficiency in the client money account, in the event that the licensee becomes insolvent and is unable to meet its obligations to clients.

- If a licensee becomes insolvent, clients are entitled to be paid money from the client money account in priority to any other creditors of the licensee (sub-regulation 7.8.03(6)). However, if the money in the account is not sufficient to cover all amounts owed to clients, the money must be paid in proportion to the amount of each person's entitlement. Clients will be regarded as unsecured creditors of the licensee in relation to the balance of any monies owing to them.

- Deficiencies in the client money account may not be covered by compensation arrangements under Divisions 3 or 4 of Part 7.5. Coverage will depend on the losses covered by the particular compensation arrangements.

In addition to these legislative requirements, there are a series of rules and procedures of licensed markets and CS facilities which are relevant.

2.3 RATIONALE

The use of segregated accounts (rather than trust accounts) has a long history in the futures industry. Paragraph 200 of the Explanatory Memorandum for the *Futures Industry Bill 1986* (the precursor of Chapter 8 or the Corporations Law, and aspects of current Chapter 7 relating to derivatives) 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 to 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 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. So far as the clearing house is concerned, the mechanism for calculating deposits and margins and the procedure for dealing with such funds upon receipt will remain unchanged. However, the mechanism by which the floor member calculates and*

pays such deposits and margins and deals with funds of clients will be directly affected by cl 86 (segregation of client money and property).

The Explanatory Memorandum to an amending Bill in 1994 states that the amendment made at that time 'is intended to clarify that clients' segregated accounts are not intended to operate in the same manner as individual trust accounts. Under a clients' segregated account system monies deposited with respect to client trading are segregated generally from non-segregated monies but not in relation to each individual account'.

This treatment of accounts in connection with futures contracts was carried over into the new Chapter 7 of the Act by the *Financial Services Reform Act 2001* and the language extended to derivatives more generally.

2.4 EXCHANGE TRADED DERIVATIVES AND MARKET INTEGRITY RULES

Under section 798G of the Act, ASIC is empowered to make rules that deal with the following:

- the activities or conduct of licensed markets;
- the activities or conduct of persons in relation to licensed markets; and
- the activities or conduct of persons in relation to financial products traded on licensed markets.

These are known as market integrity rules (MIRs). They include rules governing market participant conduct, participant–client relations, general trading matters and rules governing fair, orderly and transparent markets.

Under subsection 798G(3) of the Act, ASIC requires the Minister's consent in order to make MIRs.

On 24 August 2009, the Australian Government announced its decision to transfer the responsibility for supervising Australia's domestic licensed financial markets from market operators to ASIC.

In March 2010, the *Corporations Amendment (Financial Market Supervision) Act 2010* was enacted, amending the Act to allow ASIC to make MIRs for Australian licensed markets.

As of 1 August 2010, ASIC's MIRs replaced any market operator rules which dealt with 'market integrity' matters on a licensed market (e.g. ASX or NSXA).

Segregated accounts are recognised in the ASX 24 MIR 2.2.26 (formerly ASX 24 market operating rule 2.2.26) and associated procedure. The ASX 24 has encouraged reference to them in client agreement documentation. In addition, in 2006 it issued Notice 50/06 to remind participants and end users about the operation of segregated accounts. Segregated accounts are also recognised in ASX MIR 7.11 and Australian Clearing House Pty Ltd (ACH) operating rule 4.23.4. Client monies in a segregated account on ASX 24 market cannot be used for house margins/liabilities (per ASIC MIR 2.2.6 (j)).

While MIRs that apply to market participants dealing in exchange traded products require, at paragraphs 3.5.8 to 3.5.11, that the market participant conduct reconciliations of client trust accounts, there is no equivalent, specific obligation on other licensees that hold client money.

From 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. From 1 January 2012, all ASX 24 market participants (clearing and non clearing) must complete daily reconciliation of client money. It is therefore obvious that ASX 24 market participants are required to conduct regular reconciliation of client money account.

ASIC released Consultation Paper 152 '*ASIC's conversion of ASX and SFE guidance: General operational obligations*' (CP 152) on 28 March 2011. This discussion paper sought feedback on ASIC's proposed minor modifications, and limited additions, to pre-existing ASX and SFE guidance that ASIC is converting into ASIC regulatory guides, where this guidance continues to be relevant to the ASIC MIRs (ASX Market) 2010 and the ASIC MIRs (ASX 24 Market) 2010. In particular, CP 152 focused on the general operational obligations of ASX and ASX 24 (formerly SFE) market participants. It does not propose changes to the existing obligations under the MIRs.

Furthermore, ASIC proposes to issue a regulatory guide before the end of the year which will provide guidance on co-mingling client funds, deposits and withdrawals from a clients' segregated account, maintaining additional accounting records for withdrawal and providing clients with an Information Sheet on the risks associated with co-mingling client monies. This guide will also describe the new daily client reconciliation requirement (with monthly reporting to ASIC) commencing 1 January 2012.

2.5 INTERNATIONAL COMPARISONS AND REFORMS

In September 2009, the G20 Leaders agreed to reform OTC derivatives markets. While the G20 reforms will primarily have impact on wholesale OTC derivative markets, some reforms around initial and variable margin for derivatives will also be relevant to retail clients. This will focus on the calculation of margin and the treatment of collateral posted as margin. Any reform will need to ensure that our regulatory approach to client money is consistent with arrangements being required by the G20.

OTC derivatives reforms in some overseas jurisdictions also touch on protections for client money. For example, under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act) and draft rules issued by the Commodity Futures Trading Commission (CFTC), when dealing with a non-financial end user, a swap dealer is required to put in place a credit support arrangement that specifies where any assets posted as margin will be held. The swap dealer must give the end-user the opportunity to select a custodian (who will hold any assets posted as margin) which is not affiliated with the swap dealer.

United Kingdom

Under the United Kingdom's (UK) Financial Services Authority (FSA) Principle 10, 'a firm must arrange adequate protection for clients' assets when it is responsible for them'.

In broad terms, the client money rules require companies to act as trustee in respect of client money it holds and to ensure that such money is held separately from its own funds and is provided for in the Client Assets Sourcebook (CASS). The rules dictate where firms may place client money and the steps they must take to ensure that the client money it places with third parties are held in suitable segregated facilities. These rules form an important part of the UK regulatory system, which is designed to protect consumers and other users of the financial services markets especially in the event of the failure of a regulated firm.

Recently, the FSA amended its rules to prevent investment firms from using 'title transfer collateral arrangements' with retail clients that would allow those firms to treat client money as their own working capital. The effect of this change is to stop retail OTC derivatives issuers in the UK from using client money held for retail clients in the manner currently permitted in Australia by section 981D of the Act.

In Australia, many of the larger CFD issuers in the Australian market are branches of UK companies or have UK parent companies. Therefore, these issuers are familiar with the principle of keeping client money held for retail clients on trust and not using it for hedging. They may also have existing systems in place to ensure that this occurs.

Due diligence and diversification

Section 7.4 of CASS specifies where companies are allowed to deposit any client monies, that is, with which institution. If companies do not deposit client money with a central bank, they are obliged to exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institution, bank or qualifying money market fund where the money is deposited and the arrangements for the holding of this money.

Records

CASS 6.5.1 R and 7.6.1 R provide that a firm must keep such records and accounts as necessary to enable it — at any time and without delay — to distinguish safe custody assets/client money held for one client, from safe custody assets/client money held for any other client, and from the firm's own applicable assets/client money. Compliance with these provisions is essential to equip an insolvency practitioner, appointed to a firm in the event of default, with timely information.

Acknowledgement of trust

Under CASS 5.5.49 R and CASS 7.8.1 R, when a firm opens a client bank account, it must give written notice to the bank requesting the bank to acknowledge that all money is held by the firm as trustee. The bank is not entitled to combine the account with any other account or exercise any right of set-off or counterclaim against money in that account in respect of any sum owed to it on any other account of the firm. Further, the title of the account must sufficiently distinguish that account from any account containing money that belongs to the firm.

In the event of the failure of a firm, this will clarify the difference between client money and general creditors' entitlements.

United States

The cardinal safeguard of futures customers' funds required by the relevant provisions of the *Commodity Exchange Act* (CEA), and the rules and regulations of the CFTC is that they be segregated from the funds of the futures commission merchant (FCM)/broker-dealer and may not be used to meet any obligations of the FCM/broker-dealer.

Dodd-Frank Act amendments to CEA — For all futures customers of a US FCM trading US futures or options

Section 4d(a)(2) of the CEA and related CFTC regulations require that all funds received by an FCM from a customer to margin, guarantee, or secure futures or commodity options transactions and all

accruals be accounted for separately, and not be co-mingled with the FCM's own funds or used to margin the trades of or to extend credit to any other person. Further, Section 4d(a)(2) requires that customer funds, when deposited with any bank, trust company, clearing organisation or another FCM, be available to the FCM carrying the customer account upon demand.

On 21 July 2010, United States President Obama signed the Dodd-Frank Act. Title VII — Wall Street Transparency and Accountability of the Dodd-Frank Act amended the CEA to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. The legislation was enacted to reduce risk, increase transparency and promote market integrity within the financial system.

Section 724 of the Dodd-Frank Act prescribes the manner in which cleared swaps (and related collateral) must be treated prior to and after bankruptcy. Section 724(a) of the Dodd-Frank Act amends section 4d of the CEA to add a new paragraph (f). The new section 4d(f) imposes the following requirements on an FCM:

- The FCM must treat and deal with all collateral deposited by a customer to margin its cleared swaps as belonging to such customer;
- The FCM may not co-mingle such collateral with its own property and may not, with certain exceptions, use such collateral to margin the cleared swaps of any person other than the customer depositing such collateral;
- A derivatives clearing organisation (DCO) may not hold or dispose of the collateral that an FCM receives from a customer to margin cleared swaps as belonging to the FCM or any person other than the customer; and
- The FCM and the DCO may only invest such collateral in specified investments.

Dodd-Frank Act amendments for customers of a US FCM

CFTC Rule 30.7(a) provides that a US FCM must maintain in a separate account or accounts money, securities or property in an amount at least sufficient to cover or satisfy all of its current obligations to US customers trading foreign futures or options. This allows an FCM to employ a risk-based analysis in determining the secured amount required to be set aside. The account(s) must be denominated as the foreign futures or foreign options secured amount and may not be co-mingled with the money, securities or property of the FCM nor be used to secure or guarantee the obligations of the FCM.

Hong Kong

In Hong Kong, licensed firms (or an associated firm) must receive and hold client monies in segregated accounts established and maintained with an authorised financial institution (or approved by the Hong Kong Securities and Futures Commission). Firms cannot use client monies 'unconscionably' nor for related party transactions or to pay officers/employees.

Singapore

In Singapore, under the Securities and Futures Act, client monies must be used solely for such purposes as may be agreed to by the client (when or before the firm receives the monies from the

client). Client monies must be segregated and separate book entries for each client must be recorded and maintained. Firms cannot use client monies for payment of the firm's debts or court orders.

New Zealand

New Zealand has changed its legislative framework with the enactment of the *Financial Advisers Act 2008* (FAA). The FAA generally provides that client money or client property that is received or held by a broker on trust for a client is not available for the payment of the debts of any other creditor of the broker and is not liable to be attached or taken in execution under the order or process of any court at the instance of another creditor of the broker. This does not apply to any lawful lien or claim that a broker who holds client money has against the client money (Section 77T of the FAA).

Brazil

In Brazil, it is estimated that approximately 90 per cent of all derivatives are standardised, exchange traded and centrally cleared. Since 1994, all OTC derivatives transactions are required to be registered with trade repositories that are self-regulatory organisations.

While work is taking place to improve the quality of information reported to trade repositories, authorities do not see a need for a major legislative or regulatory initiative to achieve the G20 commitments, given the highly standardised state of the market.

Brazil does not allow omnibus accounts and collateral must be posted in the name of the entity that is posting it, with an identifier so that regulators can immediately see who has what. However, the lack of omnibus accounts means that firms cannot take advantage of any collateral efficiencies, meaning that it is more expensive to trade in Brazil than in other markets.

2.6 ASIC CONSULTATION

ASIC has identified some difficulties with the interpretation of the provisions by certain parts of industry. To address this, ASIC issued Consultation Paper 114 '*Client money relating to dealing in OTC derivatives*' seeking comments on specific issues and attaching a draft regulatory guide. Following the public consultation, ASIC finalised its guidance, and released Regulatory Guide 212 on 12 July 2010.

Regulatory Guide 212 provides an overview of the client money provisions in Division 2 of Part 7.8 of the Act generally and, in particular, the specific provisions that relate to derivatives. It also aims to promote better disclosure to help retail investors properly understand the handling of client money and associated counterparty risks when trading in OTC derivatives and it alerts investors to the potential risks associated with the current provisions in connection with trading derivative products such as CFDs.

2.7 THE PROBLEM

When Division 2 of Part 7.8 was added to the Act as part of the *Financial Services Reform Act 2001*, it was uncommon for retail clients to deal in OTC derivatives, such as CFDs and margin foreign exchange. As noted above, the ability of issuers to use client money in connection with margining,

guaranteeing, securing, transferring, adjusting or settling dealings in derivatives dealings in derivatives may result in problems for such clientsIt has been suggested that the law be amended so that the funds deposited by one client cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee on behalf of people other than that client. Licensees would therefore be required to keep client money on trust in a client money account and use its own working capital for these purposes. This would minimise the risk that, due to credit or market losses, client money held on trust would be insufficient to pay all amounts owed to clients. This is equivalent to the situation that now exists in the United Kingdom in respect of retail clients.

Should the pooling of clients money envisaged in section 981B be continued, its application may nevertheless need clarification or amendment to better protect clients.

Depending on the approach adopted, consequential amendments to provisions may also need to be made.

Risk of client loss

Changes to the client money rules are preventative and protective in nature. The broad discretion afforded to licensees by the current provisions for the use of client money may undermine the client money protections under the Act and leave clients open to the risk of loss. Scenario 1 provides a hypothetical example of how this could occur.

Scenario 1

An issuer of OTC derivatives enters into hedging transactions with a counterparty (or prime broker) to offset its market risk exposure to derivative contracts entered into with clients such that, for each change in the value of a client position, there is a corresponding change in the value of the issuer's own hedging position. The issuer uses client money to margin its hedging transactions with its counterparty on an aggregate basis. That is, the issuer pools all client money and uses those monies to provide the required margin to its counterparty based on the issuer's overall position with that counterparty. This is common practice in the industry.

Use of directions to undermine client money protections

As well as the risks that arise from licensees' discretion under section 981D of the Act to use client money for margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives, some licensees have sought to use clauses in their client agreements, which purport to be standing directions permitted under regulation 7.8.02(1)(a). These may be a means to effectively avoid the client money rules altogether. Scenario 2 provides a hypothetical example of the effects of this.

Scenario 2

An issuer of OTC derivatives includes a clause in its standard client agreement whereby the client directs, for the purposes of regulation 7.8.02(1)(a) that their money be paid out of the client money account to be used by the issuer for its own purposes. The issuer then uses this money to pay its overheads, as well as hedging client trades. This leaves the issuer's clients at risk if the issuer becomes insolvent, as the client money remaining in the client trust account is unlikely to be sufficient to meet all clients' claims.

2.8 Alternative measures to allow pooling

If it is regarded as preferable to continue to allow pooling of clients' money and use of that money to meet obligations incurred by the licensee in connection with dealing in derivatives, there are some possible alternative measures that could be implemented to help minimise the risk to clients. These alternative measures could include:

- prompt top up requirement — shorten the timeframe in which a licensee can temporary use one client's money as margin for another client, therefore creating an incentive for the licensee to follow up payment of margin or close out relevant positions (currently, on ASX 24, top up is required after five days);
- buffers — expressly prohibit the use of 'buffers' in a clients' segregated account that may be used by a licensee to hide misuse of client funds (buffers are currently permitted on the ASX 24 market).
- individual client account reconciliation — require licensees to reconcile client segregated accounts to the individual client level (currently client money is generally reconciled to the pooled level).

2.9 Reform Options

In addition to the issues for comment set out at the end of this section, the following four reform options are canvassed for comment:

- restriction on the use of client money;
- adopt the UK approach;
- impose a statutory trust fund; and/or
- adopt segregated individual accounts.

The Government has not decided on any of the four options. These options are indicative only and merely provided to illustrate possible outcomes. The future reform could potentially be a mix of these or a single option subject to stakeholder's views and final Government policy.

Restriction on the use of client money

Under this option, a legislative requirement would be inserted into the current law which restricts or prohibits the ability of client money being used for margining of hedging transactions by the licensee. This could also limit the client money provisions, for example, to money provided for initial margin.

Adopt the UK approach

In the UK, the client money rules require companies to act as trustee in respect of client money it holds and to ensure that such money is held separately from its own funds and is provided for in the CASS. These rules are designed to protect retail consumers and other users of the financial services markets especially in the event of the failure of a regulated firm.

Impose a statutory trust fund

As explained earlier, there are differing views on the interpretation of the current law about whether a licensee is authorised to pay from the client money account to allow the licensee to use the funds for hedging its own position.

Sub-regulation 7.8.01(5) means that any money paid to a licensee 'under the financial services licensee's obligation to call margins from clients under the rules of a licensed market or licensed CS facility' is not held on trust.

In order to provide certainty, a possible reform option is to impose a comprehensive statutory trust which would mean that a licensee would be prevented from using client money to hedge its own position in derivatives.

Adopt segregated individual accounts

Another possible reform option is to adopt a requirement that individual client monies should be kept and maintained in segregated accounts. This is option is similar to the arrangement for a financial services licensee that is required to call margins from a client under the operating rules of a licensed market or a licensed CS facility may operate an account as a clients' segregated account or a trust account in accordance with the operating rules (sub-regulation 7.8.01(8)).

2.10 YOUR FEEDBACK

The purpose of this section of the paper is to initiate consultation with licensees and industry stakeholders to gain a greater understanding about how they are using client money accounts in relation to OTC derivatives transactions and what the impact of the possible change outlined above would be. For example, we consider it appropirate to explore whether not allowing the pooling of client money currently permitted by section 981D would result in more settlement failures.

The Government has made no decision on the issues referred to below.

Issues for comment:

1. Should the law be amended so that:

   (i) client monies held on behalf of a retail client cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee; or

   (ii) the monies deposited by one client in connection with a derivatives transaction cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee on behalf of people other than that client?

2. Should licensees continue to be able to pay such funds into client segregated accounts, or should they be required to pay them into separate trust accounts for each client?

3. Should the above changes to the law concerning client money be limited to derivatives issued OTC or include all derivatives, including those which are traded on an exchange (such as futures)?

4. Should the regulations be changed to limit the ability of a licensee to pay money out of the client money account at the written direction of the client to instances where the client provides a specific written direction for each individual payment out of the account (thereby restricting the use of general client directions in the form of clauses in the client agreement)?

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

6. Do you consider there is a lack of clarity as to the meaning of the law, as described above under the heading 'Interpretation of the provisions'? If not, what is in your view the correct interpretation? What should be the preferred interpretation?

7. If the current general approach in the law is retained, should its application be altered? If so, would it be preferable to continue to allow pooling of clients' money, or to specify the circumstances in which monies can be used? Should the right to use client money be temporary, e.g. requiring that any shortfall arising from one client's money being used to cover the obligations arising from another client's trading is topped up by the licensee within a short period of time? Please provide any other options you would like us to consider.

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

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

10. Given that changes could impose additional compliance costs, are there any other regulations in this area that you would like to see improved or removed to reduce compliance costs? If so, please explain what they are, how they could be improved or removed and what cost savings this would deliver.

11. Are any additional protections needed for client money where the licensee holds the financial

products outside Australia?

12. Should the law be amended to limit the bases on which a licensee can claim an entitlement to money held in a client money account?

13. Should the law contain express requirements as to what money must be segregated? Specifically, should licensees be required to segregate amounts that would be due to a client if a derivative position was closed?

3 REPORTING REQUIREMENTS

3.1 INTRODUCTION

This section relates to reporting to clients. It does not relate to reporting to the market operator or clearing house; nor does it relate to record-keeping, except insofar as record keeping is necessary to prepare reports.

The Act currently requires:

- the confirmation of transactions (section 1017F and regulation 7.9.63A);
- that periodic statements are to be provided to retail clients for financial products that have an investment component including deposit, superannuation and managed investment products (section 1017D); and
- that financial services licensees keep financial records and prepare audited financial statements (Divisions 5 and 6 of Part 7.8).

The Act does not require financial services licensees to report to clients on a regular basis about client money balances in the licensees' trust or segregated accounts, and this may cause accounting difficulties in practice. It includes a power to make regulations which impose reporting requirements to be complied with by a financial services licensee in relation to dealings in derivatives on behalf of other people (section 986B). This follows from:

- recommendation 35 of the Report of the then Companies and Securities Advisory Committee (now the Corporations and Markets Advisory Committee) on Regulation of On-Exchange and OTC Derivatives Markets in June 1997, which recommended that monthly statements be sent to clients where money is held for that client;
- the commentary on the draft *Financial Services Reform Bill* indicated (at para 7.17-7.18) the matters expected to be addressed in these regulations.

Regulations were made for this purpose (see *Corporations Amendment Regulations 2001* (No. 4) 2001 No. 319) but repealed before they commenced (Corporations Amendment Regulations 2002 (No. 3) 2002 No. 41). According to the explanatory statement, consultation with stakeholders had revealed that the regulations imposed significant compliance burdens on industry with no corresponding consumer protection benefit.

There are currently no regulations under section 986B.

ASIC's MIR 3.5.8 requires market participants to reconcile the amounts held in various accounts, including client monies accounts.

3.2 THE PROBLEM

The requirements outlined above do not provide a comprehensive reporting regime to clients on whose behalf licensees undertake OTC derivatives transactions. It is not clear that all relevant

licensed derivatives markets/clearing facilities require monthly reporting of money and property held in connection with OTC derivatives to clients.

It is arguable that:

- clients need the information which a monthly report would provide to help them make informed decisions;
    - This information would be in addition to ASIC's Regulatory Guide 212 which will help clients understand the processes.
- licensees now regularly undertake electronic communication with their clients and the objections raised in 2001 to requiring monthly statements may no longer be justified.

3.3 Possible solutions to the problem

The information which could be required to be included in a monthly report could include:

- the name of the licensee and the address of the principal place of business;
- the opening cash balance of the client's account for the month;
- all transactions affecting the account in the particular month (including fees and charges);
- the cash balance of the account at the end of the month;
- any open positions held at the end of the month;
- details of each outstanding call for a deposit or margin in respect of a contract that the licensee has acquired on behalf of a client; and
- where the licensee holds assets on behalf of clients, the licensee must provide a statement to the client setting out details of assets held and the means by which they are held. The statement would need to show details of any changes in asset holdings within the month.

Any increased reporting requirements imposed on financial services licensees would need to take account of existing requirements on market and clearing participants, and allow for the statement to be provided electronically.

Before such a requirement could be imposed, a regulation impact statement would need to be developed.

Issues for comment:

1. Do you agree that there is a gap in the information being provided to OTC derivatives clients by the Act not requiring monthly reporting of money and property held on their behalf?

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

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

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

5. Would it be preferable to give the client a statutory right to ask for such a statement (rather than requiring it to be provided monthly)?

6. Given that these changes could impose additional compliance costs, are there any other regulations in this area that you would like to see improved or removed to reduce your compliance costs? If so, please explain what they are, how they could be improved or removed and what cost savings this would deliver.