



**ASIC**

Australian Securities & Investments Commission

**REPORT 482**

# **Compliance review of the retail OTC derivatives sector**

June 2016

## **About this report**

This report presents the key findings of our compliance review of Australian financial services (AFS) licensees in the retail over-the-counter (OTC) derivatives sector.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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## Executive summary

- 1 The Australian Securities and Investments Commission (ASIC) is responsible for the supervisory oversight of Australian financial services (AFS) licensees that issue retail over-the-counter (OTC) derivatives. AFS licensees in this sector provide a range of financial services, including for trading in margin foreign exchange (FX) contracts, contracts for difference (CFDs) and binary options.
- 2 There are approximately 65 non-market participant AFS licensees that issue OTC derivatives to retail investors in Australia: see [ASIC Annual Report 2014–2015](#). In April 2015, we commenced a risk-based review of 55 of those AFS licensees to review their compliance across a broad range of areas.
- 3 Seven key compliance risks were the primary focus of our thematic review:
  - (a) *Risk 1*: Failure to comply with net tangible assets (NTA) requirement (see Section A).
  - (b) *Risk 2*: Failure to comply with notification requirements for changes of control and issues around new ownership compliance (see Section B).
  - (c) *Risk 3*: Failure to comply with client money provisions (see Section C).
  - (d) *Risk 4*: Poor, misleading or deceptive Product Disclosure Statements (PDS) and website disclosure (see Section D).
  - (e) *Risk 5*: Failure to comply with financial reporting obligations (see Section E).
  - (f) *Risk 6*: Failure to supervise authorised representatives and non-compliance by authorised representatives (see Section F).
  - (g) *Risk 7*: Claims that no financial services are being provided under the AFS licence (see Section G).
- 4 This report summarises the key findings of our review and identifies areas where compliance standards can be raised in the retail OTC derivatives sector.

## Who should read this report?

- 5 This report is relevant to:
  - (a) AFS licensees (and their authorised representatives) that operate a retail OTC derivatives financial services business in this jurisdiction; and
  - (b) entities that provide third-party support services, such as legal or compliance services, to these AFS licensees.

- 6 We expect AFS licensees to take note of our findings and proactively remediate any areas requiring improvement to ensure they have adequate and enduring compliance measures to fulfil their regulatory obligations.
- 7 Existing and prospective retail investors will find this report relevant to conducting initial and ongoing due diligence of their retail OTC derivatives issuers. Investors can use this report to:
- (a) ensure they are aware of some of the key features and risks of these types of financial products; and
  - (b) better understand the standards of practice they should expect from retail OTC derivative issuers.

## Background to the review

- 8 We have repeatedly stated that retail OTC derivatives are complex products, and issued a number of significant consumer/educational warnings about these types of products, including margin FX, CFDs and binary options.

Note: See, for example, the educational material on [our MoneySmart website](#) and the media releases listed in the appendix.

- 9 In August 2011, we released [Regulatory Guide 227](#) *Over-the-counter contracts for difference: Improving disclosure for retail investors* (RG 227). RG 227 contains disclosure benchmarks for issuers on key risk areas for retail clients, including how the issuer:
- (a) determines which clients qualify (i.e. are suitable) to trade retail OTC derivatives;
  - (b) manages risk by hedging market exposures and having adequate financial resources; and
  - (c) handles clients' money.
- 10 To help ensure issuers have sufficient financial resources to operate their business in a compliant manner we amended the AFS licence financial requirements that apply to issuers of retail OTC derivatives in 2012.
- 11 These financial requirements include, among other things, that issuers who have actual or contingent liability to retail investors hold NTA of \$1 million or 10% of average annual revenue, whichever is greater.
- 12 In September 2013, we observed a material increase in the number of AFS licence applications from entities seeking to operate a retail OTC derivatives financial services business in Australia. At the same time, we also observed a growth in concerns about whether existing AFS licensees were adequately complying with a number of their Australian regulatory requirements. This observation has been gathered from:

- (a) ASIC surveillances;
  - (b) domestic and international investor complaints;
  - (c) reports received from industry participants; and
  - (d) reports received from domestic and international regulatory authorities.
- 13 Australia's regulatory framework for retail OTC derivatives is different from the framework that applies in a number of other jurisdictions because of the following factors:
- (a) Australian client money rules permit AFS licensees to use client money for a very broad range of purposes (s981D or 984B of the *Corporations Act 2001* (Corporations Act)), including:
    - (i) use of the client money of one or more clients to meet the margin obligations of the AFS licensee or the margin obligations of other clients; and
    - (ii) use of client money as working capital.

Note: In October 2015, the Australian Government announced that it would make legislative amendments to improve protection of client money held in relation to derivatives.
  - (b) there is currently no restriction on the amount of leverage AFS licensees can offer; and
  - (c) Australia has lower financial resource requirements than some larger jurisdictions such as the United Kingdom and United States.
- 14 Given the significant differences in regulatory frameworks, our growing concerns about compliance with key requirements, and concerns that Australia's strong regulatory reputation could be affected, we decided to review the way we assess AFS licence applications for retail OTC derivative issuers.
- 15 We have reviewed the level of scrutiny applied in assessing new AFS licence applications for retail OTC derivative issuers. In particular, we critically assessed the detailed information provided in applications for an AFS licence, including on:
- (a) business structures;
  - (b) operating business models;
  - (c) outsourcing arrangements; and
  - (d) liquidity arrangements.
- 16 In applying this increased degree of scrutiny in our assessment of new AFS licence applications for retail OTC issuers we discovered that many applicants appeared to be misrepresenting the business and operational framework underpinning their AFS licence applications. In particular, where ASIC requested evidence in support of an AFS licence application, the evidence

- provided by many applicants demonstrated material continuous changes in their business structure, and presented inconsistent information to ASIC.
- 17 We review AFS licence applications in the OTC derivatives industry on a case-by-case basis. However, we have not been able to grant an AFS licence in this industry for over two years because applicants have not been able to demonstrate that they meet the requirements for holding an AFS licence.
- 18 A small number of our AFS licence refusal decisions have undergone an independent merits review in the Administrative Appeals Tribunal (AAT). At the date of publication, none of these merits reviews have successfully reached AAT reconsideration, and most applications have been withdrawn by applicants before the first hearing date.
- 19 As a result, AFS licence applicants that wish to provide retail OTC derivatives should:
- (a) improve their readiness for the AFS licensing process; and
  - (b) ensure their business arrangements and structures are:
    - (i) consistent with any application proofs; and
    - (ii) adequately convey the applicant's ability to comply with Australian regulations.
- 20 We also note that, in response to the Financial System Inquiry, the Australian Government has agreed to strengthen ASIC's enforcement tools for the AFS and credit licensing regimes by making legislative amendments enabling ASIC to:
- (a) approve changes of licensee control;
  - (b) consider a broader range of factors when determining whether an applicant satisfies the 'fit and proper' test to be granted an AFS licence; and
  - (c) impose conditions on entities to address concerns about internal systems relating to serious or systemic conduct (including external reviews).
- 21 These additional powers will assist ASIC to ensure appropriate standards are maintained for AFS licences going forward. Even with the increased scrutiny, AFS licence application assessments are a point-in-time assessment of an entity before it begins providing financial services.
- 22 We have also focused on the activities of existing AFS licensees in the retail OTC derivative sector. We were concerned to test whether some licensees may have been granted AFS licences based on information supplied during the application process that may not be consistent with the way they are currently operating.
- 23 This report provides details of the risk-based reviews undertaken by ASIC of 55 AFS licensees in the retail OTC derivative sector. These 55 stakeholders were selected on the basis that:

- (a) they had undergone a material change of control since they were granted an AFS licence;
- (b) we received complaints about their conduct; or
- (c) the entities' past or present conduct or disclosure identified potential compliance concerns.

## Purpose

24 Retail OTC derivatives are generally considered high-risk financial products for retail investors because of the highly leveraged and principal-to-principal nature of the OTC derivative trading which contributes to counterparty risk.

25 There has been a material increase in aggressive marketing by issuers of retail OTC derivatives—particularly through cold calling and unsolicited emails—increasing the exposure of these types of products to segments of the Australian population that may not understand the associated risks.

26 In addition, trading of products such as FX has traditionally been reserved for large, well-established institutions in wholesale markets. While retail investors are not directly involved in the wholesale FX markets themselves, recent advances in technology and trading software has made it possible for retail investors to get exposure to the movement of FX. This technology has also meant that providers of these retail margin FX products may appear legitimate and substantial when this is not always the case.

27 As a result of the scope of risk posed to retail investors by these complex financial products, and consistent with ASIC's mandate to promote investor and financial consumer trust and confidence, we have sought to improve compliance standards in the retail OTC derivatives sector.

Note: See Section B of [Report 384](#) *Regulating complex products* (REP 384) for information on what we consider to be complex products.

28 The purpose of this review was to understand how AFS licensees are complying with the provisions of the Corporations Act. This review also aimed to materially raise compliance standards in the retail OTC derivatives sector and mitigate against potential risks to Australian investors.

## What we did

29 As part of our review we assessed 55 licensees against the seven key compliance risks in paragraph 3.

30 We then sent out a letter to AFS licensees covering each relevant area of concern, this communication:



- (a) outlined the applicable Australian regulatory requirements;
- (b) detailed our regulatory concerns;
- (c) discussed the penalties associated with the identified potential breaches; and
- (d) requested additional information about the identified potential breaches.

31 During the review we adopted a facilitative approach to working with the AFS licensees. Where compliance concerns were identified, we raised the matter with the AFS licensee (or other relevant parties) to give them the opportunity to respond to our concerns and implement timely remedial action, where appropriate. In most cases, AFS licensees were willing to work with ASIC to promptly rectify the concerns raised and improve their standards of compliance.

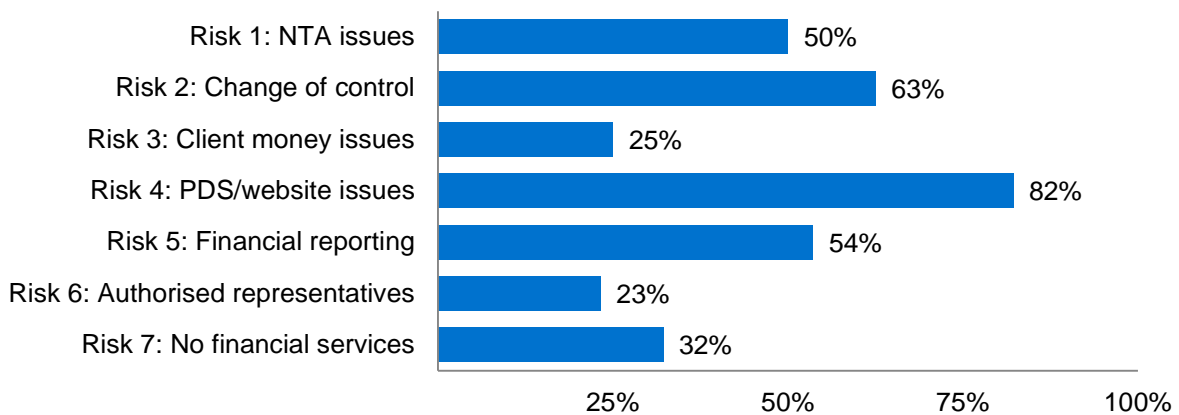
32 In some instances, where there was continued non-compliance by the AFS licensee or significant contraventions were identified, we considered additional regulatory action was necessary such as AFS licence cancellations, suspensions or infringement notices.

## What we found

33 Over 70% of AFS licensees we reviewed were found to have issues associated with three or more of the seven key compliance risks.

34 In general, our review identified a high degree of non-compliance across nearly all AFS licensees reviewed. Many of the compliance concerns we detected related to contraventions of well-established regulatory requirements or non-compliance with fundamental AFS licensing obligations.

**Figure 1: Rate of non-compliance across the key compliance risks**



35 Our initial review, which was only based on public information or information that had been previously provided to ASIC, identified the following:

- (a) over 80% of AFS licensees demonstrated issues with disclosure in their PDS or website;
- (b) over 60% of AFS licensees had undergone a change of control, with some issuers exhibiting multiple changes of control in one year;
- (c) of the 60% of AFS licensees that had undergone a change of control, 85% had failed to notify ASIC as required under the Corporations Act;
- (d) over 50% of AFS licensees had not adequately complied with their financial reporting obligations;
- (e) 50% of AFS licensees required additional detailed assessment to determine whether they adequately complied with their NTA requirement; and
- (f) nearly 30% of AFS licensees did not appear to be providing any financial service under their AFS licence, despite some being licensed for a number of years.

36 We observed a significantly high number of smaller, foreign-owned or foreign-controlled AFS licensees demonstrating either a lack of awareness or understanding of their Australian regulatory obligations, or reluctance to invest resources in meeting compliance obligations for their Australian businesses. It also became evident that many of these AFS licensees were outsourcing key aspects of their financial service to third parties. Often these third parties were related to the AFS licensees and based overseas. At times, these parties were subject to little or no regulatory oversight in the jurisdiction in which they operated.

37 Many of these AFS licensees heavily promoted the safety and security of Australian regulation to their investor base, but had no real physical presence in Australia. We were concerned these AFS licensees were using their AFS licence and Australian regulation as a marketing tool while misrepresenting the jurisdictional reach of the AFS licence and the Australian regime to investors outside of this jurisdiction. Some AFS licensees operated in such a way that Australian investors were encouraged to open accounts with an unregulated-related entity rather than the AFS licensee itself.

38 In total, as a consequence of our review, we obtained over 150 regulatory outcomes across 55 AFS licensees (and other associated parties such as authorised representatives), including the following:

- (a) AFS licence cancellations and suspensions;
- (b) rectification of:
  - (i) contraventions of the NTA requirement;
  - (ii) contraventions of the client money provisions;
  - (iii) disclosure on websites or in PDSs;
  - (iv) contraventions relating to financial reporting; and

- (v) compliance concerns relating to the conduct and disclosure of authorised representatives,
- (c) update of responsible manager and key person information;
- (d) cessation of unlicensed conduct by AFS licensees or associated entities;
- (e) rectification of professional indemnity insurance compliance concerns;
- (f) rectification of external dispute membership compliance concerns;
- (g) correction of information on the ASIC share registry;
- (h) referrals made by ASIC to other Australian regulatory authorities or international regulatory authorities; and
- (i) issue of infringement notices for misleading conduct.

39 We have issued a number of media releases covering our work in this area—even before to the commencement of this review. We have found these media releases to be an important platform for informing industry of ASIC’s regulatory expectations and for encouraging better industry standards of compliance. Public media releases also educate investors about emerging risks or concerns associated with trading in retail OTC derivatives. A list of recent relevant media releases covering our work in the OTC retail derivatives industry can be found in the appendix to this report.

Note: This report reflects our conclusions and observations of industry compliance practices with existing obligations. It is not intended to imply any new regulatory requirement or standard.

## A Risk 1: Net tangible assets requirement

### Key points

Our review of AFS licensee compliance with the NTA requirement revealed the following key compliance concerns:

- general failure to comply with the NTA requirement;
- mischaracterisation of assets to meet financial resource requirements;
- inconsistencies between management accounts, formal financial reports and figures used for NTA calculations; and
- attempts to avoid complying with the NTA requirement.

### Statutory obligations

- 40 AFS licensees must have available adequate financial resources to provide financial services covered by their AFS licence and to carry out supervisory arrangements: s912A(1)(d).
- 41 [Class Order \[CO 12/752\]](#) *Financial requirements for retail OTC derivative issuers* sets out further financial requirements for retail OTC derivative issuers. Issuers of retail OTC derivatives that have an actual or contingent liability to retail investors must, at all times, have NTA that are the greater of \$1 million or 10% of average revenue.
- Note: See [Regulatory Guide 166](#) *Licensing: Financial requirements* (RG 166) at RG 166.314 and Appendix 8.
- 42 They must also have 50% of the required NTA in cash or cash equivalents (excluding any other cash or cash equivalents that are held in respect of any liability or obligation to clients) and 50% in liquid assets.

### Regulatory focus

- 43 The policy objectives of the financial requirements for AFS licensees are designed to ensure that:
- (a) AFS licensees have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act;
  - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind up if the business fails; and
  - (c) there are incentives for owners of the business to comply with the Corporations Act through risk of financial loss.

## Key concerns

### General failure to comply with the NTA requirement

44 Some AFS licensees were using assets in their calculations that were not eligible to be included, for example:

- (a) excluded assets such as receivables that originate from related parties;
- (b) loans with related parties; or
- (c) intangible assets.

Note: See RG 166.152–RG 166.158 for more information.

45 We also found incorrect classification of assets for the purposes of the ‘cash and cash equivalent’ and ‘liquid asset’ requirements, including assets that were:

- (a) funds held for the purpose of s981B or otherwise client money; or

Note: All client funds must be excluded from any NTA or cash and cash equivalent consideration: [CO 12/752].

- (b) funds used for collateral purposes such as those held with a hedge counterparty.

46 We consider funds used or held for hedging purposes are not available for use to meet the ‘cash and cash equivalents’ requirement of [CO 12/752]. The value of these funds is at risk of change because these funds are exposed to continuous fluctuations and volatility in FX markets.

47 In addition, the ability to rely on such funds in meeting the ‘liquid assets’ of the NTA requirement is also subject to the definition of ‘liquid assets’ in [CO 12/752]: see RG 166.183. In determining if funds are subject to encumbrance and can be treated as liquid assets, consideration should be given to whether funds can be used to meet margin calls or used as a deposit before trading commences.

### Considering arrangements as assets when they are liabilities

48 A number of AFS licensees were using redeemable preference share agreements and incorrectly treating securities issued under these agreements as equity when the characteristics of the securities issued meant they should have been treated as a liability.

49 Often these securities were being mischaracterised because the AFS licensees were not considering:

- (a) whether the relevant party has the right to redeem the securities;
- (b) if the AFS licensee has the obligation to pay cash in terms of principal and dividends; and
- (c) if the redemption of the securities is mandatory or optional.

- 50 We found instances of a number of AFS licensees who showed in their management accounts that preference shares were issued in the company. This information did not reconcile with the information held on our systems about the share structure of the entity holding the AFS licence.
- 51 Even where the arrangements were formally documented, we found inconsistencies with how they operated, including:
- (a) the timing of the payment of money did not reflect the timing stated under the terms of the preference share agreement; or
  - (b) the paying counterparty to the preference share arrangement was not documented as a signatory in the contractual agreement.
- 52 AFS licensees relying on preference share arrangements need to ensure the securities subject of the agreement are characterised correctly in their NTA calculation, and that these arrangements are formally documented.

### **Inconsistencies between management accounts, formal financial reports and figures used for NTA calculations**

- 53 Our review identified that information contained in financial reports lodged with ASIC were at times materially different from figures used in AFS licensee management accounts or in the licensee's calculation of their NTA requirement, and these differences were not capable of being adequately explained.
- 54 In particular, certain assets and liabilities were being considered differently between management and the company auditors. We observed examples where auditor notes contradicted explanations provided by management on certain transactions the AFS licensee had incorrectly classified as assets in their management accounts. These assets had been correctly excluded by the auditor in similar calculations.
- 55 We also identified instances where company auditors were not provided with important information that would have been relevant to their review process, for example:
- (a) a company auditor was not informed of accounts the AFS licensee was relying on to meet their NTA requirement; and
  - (b) a company auditor was not informed that money held by the licensee under a loan to meet their NTA requirement was sourced from a related party.
- 56 Our review identified some poor record-keeping practices by management. These poor compliance practices demonstrated a lack of understanding of [CO 12/752], which requires that for each quarter the directors prepare a cashflow projection based on a reasonable estimate of revenues and expenses over at least a 12-month period. The AFS licensee's directors must certify the projections are reasonable and demonstrate the licensee has sufficient funds to:

- (a) meet its liabilities over the 12-month period; and
- (b) meet the NTA requirement.

57 These statements needed to be kept up to date, the assumptions behind them need to be recorded, retained and signed-off by directors.

58 It was clear in many cases that these records were not being maintained by management and were only produced as a result of our requests during our review. Many of the records submitted as a result of our review were also not representative of the AFS licensee's financial position or business operations, or were not consistent with other financial reports produced by the licensee.

### **Attempts to avoid complying with the NTA requirement**

59 When prompted for information about their NTA compliance, a number of AFS licensees simply stated that they did not need to hold the minimum \$1 million NTA required amount because they did not have any actual or contingent liability to investors, as required under [CO 12/752]. Contrary to this claim, these licensees were actively marketing and offering their services to investors through group websites. In some instances, investors were able to obtain and fund client trading accounts through the licensee website.

60 It was unclear to ASIC how these AFS licensees were able to actively market a service they would not be in a position to provide. We were concerned there was a high risk of retail investors being misled, and asked issuers to either cease marketing their financial services or take steps to become compliant under [CO 12/752].

### **Claims that services are provided to wholesale investors only**

61 Some AFS licensees claimed that they were not required to meet the NTA requirement because the liabilities they had were to wholesale investors only.

62 Although [CO 12/752] applies to AFS licensees that have an actual or contingent liability to retail investors, licensees that continue to be authorised to deal with retail investors under the conditions of their AFS licence—but chose to only offer services to wholesale investors—must be aware of the following:

- (a) they have a general obligation that requires them to have adequate financial resources to provide *all* financial services covered by their AFS licence and to carry out supervisory arrangements; and
- (b) wholesale investors may expect that AFS licensees are complying with the financial resource requirements under [CO 12/752] given their authorisation to offer services to retail investors.

63 Where an AFS licensee has chosen not to meet the minimum standards under the financial resource requirements in [CO 12/752], it will not be able

to provide OTC derivatives to retail investors. Licensees must clearly disclose this information on any website and in any marketing material. They will also need to take active steps to ensure clients signing up for their services are not retail investors.

- 64 In addition, there is a risk wholesale investors could be misled because they are likely to assume an entity authorised to provide services to retail investors is compliant with the financial resource requirements in [CO 12/752].

## General observations

- 65 AFS licensees must give careful consideration to the accounting and regulatory treatment of various commercial arrangements before relying on those arrangements to comply with their financial resource requirements.
- 66 We have provided guidance about the things AFS licensees should be considering in RG 166 (particularly Appendix 8) to meet the NTA requirement. However, professional legal and accounting advice may be warranted where the licensee is unsure of its obligations.
- 67 There are a number of reporting and record-keeping requirements outlined in [CO 12/752]. Failure to comply with these obligations would amount to a breach of financial services laws and could lead to administrative action against AFS licensees.
- 68 As a reminder, where an AFS licensee's NTA falls below the required amount, the licensee must cease taking on new liabilities for clients until its board certifies that, having made reasonable enquiries:
- (a) there is no reason to believe that, except for insufficient NTA, the licensee will fail to meet other AFS licence conditions or obligations under [CO 12/752]; and
  - (b) there is no evidence of a deficiency in any client account (i.e. an account maintained for the purposes of s981B).
- 69 If an AFS licensee's NTA remains below the required NTA for two months, it must disclose the deficiency to investors in the form provided in RG 166. Where a licensee has 75% or less of the required NTA it must not, under any circumstances, enter into any transactions with investors that could give rise to further liabilities, contingent or otherwise.



## B Risk 2: Change of control and ownership

### Key points

Our review of change of control and ownership for AFS licensees revealed the following key compliance concerns:

- failure to notify ASIC of a change of control as required through [Form FS20](#) *Change of details for an Australian financial services licence*;
- failure to undertake adequate due diligence of past compliance by new AFS licensees; and
- lack of awareness of new AFS licensees of their Australian regulatory requirements.

### Statutory obligations

- 70 Under s912A (1)(b), an AFS licensee must comply with the conditions of their AFS licence. Section 914A(8) states that the AFS licence is subject to conditions as prescribed by regulations. Under reg 7.6.04(1)(i) of the Corporations Regulations 2001 (Corporations Regulations), an AFS licensee that becomes aware of any change in control of the licensee must notify ASIC of the particulars of the change not later than 10 business days after the change.
- 71 Control is defined in reg 7.6.04(2)(b) and includes:
- (a) having the capacity to cast, or control the casting of, more than half of the votes that might be cast at a general meeting of the AFS licensee;
  - (b) directly or indirectly holding more than half of the issued share capital of the AFS licensee;
  - (c) the capacity to control the composition of the AFS licensee's board or governing body; or
  - (d) the capacity to determine the outcome of decisions about the AFS licensee's financial and operating policies.
- 72 For the purpose of determining the capacity to control, an AFS licensee needs to consider factors such as the practical influence the person can exert (rather than the rights it can enforce) and any practice or pattern of behaviour affecting the AFS licensee's financial or operating policies (whether or not it involves a breach of an agreement or a breach of trust): reg 7.6.04(2)(c).
- 73 A change in control includes a transaction, or a series of transactions in a 12-month period, that results in a person having control of the AFS licensee (either alone or together with associates of the person): reg 7.6.04(2)(a).

## Regulatory focus

- 74 There has been a recent increase in change of control events (e.g. material changes to share ownership) affecting entities with AFS licensing authorisations to offer retail OTC derivatives. Many of these entities have failed to notify ASIC of this change.
- 75 As mentioned in paragraphs 15–17, we have increased our scrutiny of AFS licence applications. We have observed the development of a ‘secondary market’ in AFS licences, which we have been monitoring closely. We note some compliance advisory firms appear to be encouraging new entrants to purchase existing AFS licensees rather than applying for a new AFS licence.
- 76 Preliminary intelligence indicated that many new owners of retail OTC derivative businesses appeared to be using entirely different systems, personnel, policies, business structures and, in some cases, even product offerings that bore little to no resemblance to the original business proofs provided to ASIC as part of the initial AFS licence application process.
- 77 We are concerned that many entities operating in the retail OTC derivative sector have entered the Australian market by buying an existing AFS licensee without undergoing the required vetting process undertaken during the AFS licence application process. Of particular concern are new owners that have failed to demonstrate to ASIC that they have adequate business and operational arrangements as part of a previous unsuccessful AFS licence application. We are increasing our focus in this area.
- 78 As part of our review, we requested AFS licensees that had appeared to have gone through a change of control to produce documentation outlining their business structure and demonstrating their ability to comply with the AFS licence requirements. In particular, we requested the following information:
- (a) information about the people and/or entities able to control the licensee;
  - (b) a current organisational chart detailing the primary functions of the business and details of geographical location, number and names of key staff and location of where each of these functions are undertaken;
  - (c) hedging agreements;
  - (d) liquidity agreements;
  - (e) prime broker agreements;
  - (f) risk management policies or procedures;
  - (g) service-level agreements;
  - (h) outsourcing agreements;
  - (i) evidence of compliance with the NTA requirement;
  - (j) a certificate of currency that outlines the current professional indemnity insurance coverage, demonstrating compliance with

[Regulatory Guide 126 Compensation and insurance arrangements for AFS licensees](#) (RG 126); and

- (k) evidence that the licensee is a current member of an ASIC-approved external dispute resolution scheme.

## Key concerns

### Failure to lodge Form FS20

- 79 A considerable number of the AFS licensees reviewed had undergone some change in shareholding that amounted to a change of control event. Around 85% of these licensees had failed to notify ASIC of their change of control event in the required 10 business day timeframe, which should be done through the lodgment of Form FS20.

### New owners failed to undertake adequate due diligence of past compliance

- 80 We observed that a change in AFS licensee ownership often exposed gaps in compliance coverage with new owners unaware of past compliance failures and existing regulatory breaches.
- 81 AFS licensees have ongoing accountability for the services provided under their licence. However, many licensees did not have either an understanding or records of the past financial services provided under their newly acquired AFS licence.
- 82 We saw examples of open Financial Ombudsman Service complaints where:
- (a) the new owners were completely unaware of the complaints; and
  - (b) AFS licensees were required to submit numerous overdue financial reports with no access to previous financial records.
- 83 Some new owners found themselves served with notices of delegate hearings to cancel or suspend their AFS licence based on past conduct they had no knowledge of.

### New AFS licensee owners unaware of Australian regulatory requirements

- 84 Some new AFS licensee owners were unaware of basic AFS licence obligations, including:
- (a) being a member of an ASIC-approved external dispute resolution scheme;
  - (b) having appropriate professional indemnity insurance;

- (c) having adequate financial resources; and
- (d) having adequate risk management policies and procedures in place.

85 A number of AFS licensees appeared to implement formal agreements, policies or procedures once prompted by our inquiries during the review. In some cases, these measures still failed to comply with Australian regulatory standards as outlined in legislation or our regulatory guides. As a result, licensees were required to cease operating until they were able to rectify the breaches.

#### **Failure to produce appropriate agreements material to the provision of the financial service**

86 Despite operating complex businesses models, some AFS licensees were unable to provide any documented agreements to support the business relationships that were purportedly critical to the operation of their business. We encountered some instances where licensees had no legal binding relationship with any employee, contractor or third party involved in the provision of their financial services.

87 Even where AFS licensees were able to produce documented agreements with external third parties, in some instances the licensee was not a party to the agreement but rather a completely different entity within the same corporate group.

88 Some agreements were not legally representative of the business relationship that purportedly existed. For example, we identified AFS licensees that had stated in their disclosure documents and on websites that they were operating a model where every trade was hedged back-to-back with a third party. However, the relevant contractual agreement described business operations with a single transaction in an agency-type arrangement where the licensee was facilitating the ability for a third party to enter into trades directly with retail investors. This inconsistency raised concerns about potential unlicensed conduct and the provision of misleading information to investors. Investors did not seem to be adequately informed about the identity of the issuer of the products or the credit risks posed by that entity.

#### **Failure to demonstrate adequate competency to provide financial services**

89 We assess an AFS licensee's competency to provide financial services through the use of responsible managers. Responsible managers are expected to be directly responsible and accountable for significant day-to-day decisions about the ongoing provision of a licensee's financial services business: see [Regulatory Guide 105](#) *Licensing: Organisational competence* (RG 105) at RG 105.24. Despite this, our review identified a number of licensees that were unable to produce any contractual or employee agreements that documented a formal arrangement with responsible managers, some of whom were recorded as key persons on the AFS licence.

- 90 We found a number of AFS licensees had failed to inform ASIC when responsible managers or key persons nominated on their AFS licence had ceased their association with the licensee.
- 91 ASIC has concerns about responsible managers-for-hire who appear on a number of AFS licences but seem to have little operational responsibility or understanding of the respective businesses or Australian regulatory obligations.
- 92 Some of the responsible managers we reviewed had been associated with an AFS licence through a number of previous company owners that had all demonstrated serious non-compliance—yet the responsible manager knew nothing of the past misconduct. This raised questions about the responsible manager’s legitimate association with the licensee as well as the ability of the responsible manager to understand the legal and compliance obligations for the services and products provided under the AFS licence.
- 93 Where responsible managers act for multiple AFS licensees, it raises questions about their capacity to:
- (a) undertake day-to-day responsibility for each licensee; and
  - (b) adequately manage any conflicts of interest for competing licensees in the same industry.

#### **Inadequate professional indemnity coverage**

- 94 We identified a number of instances where professional indemnity insurance was deficient and not in-line with the requirements of RG 126. For example:
- (a) policies that had a ‘co-mingling exclusion clause’ that left retail investors exposed to loss or damage where their claim arose out of:
    - (i) any actual or alleged co-mingling of funds by the AFS licensee; or
    - (ii) any liability or failure of the licensee to pay, collect, safeguard or account for client funds,
  - (b) policies that excluded from coverage any actions of representatives of the licensee;
  - (c) policies that covered products and services that were different to those provided under the AFS licence; and
  - (d) AFS licensees were part of a group insurance policy that provided insufficient coverage for the number of entities operating within the group under the policy.

#### **Failure to comply with transaction reporting requirements**

- 95 Many AFS licensees were either unaware of the need to, or not in a position to, report trades as required under the ASIC Derivative Transaction Rules (Reporting) 2013 (derivative transaction rules (reporting)), which commenced operation for Phase 3B reporting entities on 4 December 2015. Phase 3B covers

the majority of entities that operate in the retail OTC derivative industry: see [Regulatory Guide 251](#) *Derivative transaction reporting* (RG 251).

- 96 A reporting entity will breach the derivative transaction rules (reporting) if it fails to report transactions as required by the rules. This breach occurs for each transaction that is not reported as required and may attract a penalty up to 1,000 penalty units: see RG 251.

### **Ceasing to conduct a financial services business**

- 97 We identified several instances where the new AFS licensee owners had ceased all services provided under the AFS licence. They had no clients, held no client money, were not employing any of the staff, operations, policies or procedures of the previous entity, and were unable to provide any evidence demonstrating they would be able to comply with many of the basic AFS licence obligations. It was also clear that many of these licensees would not be in a position to comply with their AFS licence obligations for at least a few months.
- 98 In some of these cases we decided to suspend the AFS licence, on the grounds the licensee had ceased to conduct an Australian financial services business, until it could be demonstrated the new licensee owners were in a position to commence a business that was compliant with their AFS licence obligations.

Note: Under s915B of the Corporations Act, we can immediately suspend or cancel an AFS licence if the company ceases to carry on a financial services business.

## **General observations**

- 99 Notification to ASIC after a change of control event is an important AFS licence obligation. Failure to do so is a breach of financial services law and can lead to administrative action taken against an AFS licensee.
- 100 If an entity or person is considering purchasing a company that has already been granted an AFS licence, they need to make sure they undertake appropriate due diligence, including ensuring there are adequate records for the financial services previously provided. Licensees need to be aware they remain accountable for the past conduct and disclosure of the newly purchased AFS licensee.
- 101 Purchasing an existing AFS licensee may not guarantee the right to operate a financial service business if an entity is unable to demonstrate full compliance with their Australian requirements.
- 102 When preparing the change of control notification for ASIC, AFS licensees should take the opportunity to ensure all information about the AFS licensee is up to date and accurate. The AFS licensee should also ensure it is able to

comply with all of its regulatory requirements before it begins advertising, promoting and offering its financial services to investors.

- 103 Where there is a material relationship relied on by an AFS licensee to provide its financial services, we expect there to be formal legal agreements that adequately document the provision of that service and the terms governing that relationship. This applies to both entities and individuals that are critical to the provision of the financial services: see [Regulatory Guide 104](#) *Licensing: Meeting the general obligations* (RG 104) at RG 104.33.

## C Risk 3: Client money handling

### Key points

Our review of AFS licensee client money practices identified the following key compliance concerns:

- inadequate designation of client trust accounts;
- use of general operations accounts to clear client funds;
- use of overseas money managers or payment systems;
- deposit of non-client money into client trust accounts;
- unpermitted withdrawals from client trust accounts; and
- misuse of s1017E accounts.

### Statutory obligations

- 104 AFS licensees must handle client money in accordance with the client money provisions under Div 2 of Pt 7.8 of the Corporations Act.

### Regulatory focus

- 105 Effective client money accounting and reconciliation processes are crucial to adequate risk management for retail OTC derivative issuers because they serve as a fundamental control that prevents deficiencies arising in client money accounts: see [Report 316](#) *Review of client money handling practices in the retail OTC derivatives sector* (REP 316).
- 106 Following the release of REP 316 in December 2012, it was our expectation that the client money handling practices of AFS licensees would be strengthened and any possible breaches self-reported to ASIC in a timely way. We focused on this area of compliance to determine whether there had been changes to industry compliance standards since REP 316 was released.

### Key concerns

#### Inadequate designation of client trust accounts

- 107 We identified a considerable number of AFS licensees who were still not designating client money accounts as trust accounts under reg 7.8.01(5)(b). These entities were failing to ensure the name of the client trust account contained the term ‘client trust account’ or wording that would adequately designate it as a client trust account.



### **Use of general operational accounts to clear client funds**

- 108 We observed client money being deposited into AFS licensees' operating accounts or parent companies' accounts rather than a designated client trust account. Even though some of these deposits were later mirrored as subsequent deposits into the client trust account at a much later date, licensees were not meeting their requirement to pay client money into the relevant client trust account on the day it is received or the next business day: s981B.

### **Use of overseas money managers or payment systems**

- 109 Many AFS licensees were also using overseas money managers to handle client money. Often these money managers would consolidate payments and only credit the licensee on a monthly basis. This meant that licensees were not meeting their requirement to pay client money into the relevant client trust account on the day, or the next business day, of it being received: s981B.

### **Deposit of non-client money into client trust accounts**

- 110 We identified many instances of AFS licensees depositing money into a client trust account that was not money received in accordance with s981A. Licensees may only pay the following money into a client money account:
- (a) client money;
  - (b) interest on client money;
  - (c) interest on permitted investments using client money or the proceeds of the realisation of permitted investments; and
  - (d) certain other money specified by the Corporations Regulations.
- 111 We observed the following conduct inconsistent with these requirements:
- (a) an AFS licensee or a related party to the licensee depositing a large buffer of house funds in a client trust account to cover all potential liabilities;
  - (b) licensees co-mingling funds from financial services that are not provided under the AFS licence (e.g. financial services provided outside of this jurisdiction) with those that are, in an account designated as a s981B client trust account; and
  - (c) licensees failing to regularly reconcile and clear out company profits from s981B client trust accounts.

### **Withdrawals not permitted from s981B accounts**

- 112 We identified some AFS licensees making withdrawals from client trust accounts that are not permitted under reg 7.8.02 or s981D. Licensees may only make payments out of a client trust account in the following circumstances:
- (a) payment to, or in accordance with the written direction of, a person entitled to the money;

- (b) paying brokerage and other proper charges;
- (c) paying money to the licensee to which the licensees is entitled; and
- (d) making a payment that is otherwise authorised by law or pursuant to the operating rules of a licensed market.

113 For example, we observed the following unauthorised AFS licensee withdrawals from client trust accounts:

- (a) money withdrawn from the client money account and deposited into a non-trust, interest-earning account to enable the licensee to accrue interest on the client money; and
- (b) money withdrawn from one client account and transferred to another client account without the permission of the client.

### Misuse of s1017E accounts

114 We became aware of some AFS licensees misusing s1017E accounts to handle client money paid by clients in connection with OTC derivatives, rather than using the required s981B account.

115 Section 1017E applies to money paid to an issuer of financial products to acquire a financial product, or acquire an increased interest in a financial product, where the product provider does not issue the product or increased interest in the product immediately after receiving the money.

116 Issues arise when using these types of accounts for OTC derivatives for the following reasons:

- (a) there is uncertainty about whether the money is paid to acquire a derivative or increased interest in a derivative, or whether it is collateral to secure obligations under the derivative; and
- (b) the derivatives are not issued immediately after receiving the money for the purposes of s1017E(1)(d).

117 While it will depend on the facts of the case, we consider it unlikely that money paid by clients in connection with OTC derivatives would be able to be treated as s1017E money given current case law on the subject: *In re MF Global Australia Ltd (in liq)* [2012] NSWSC 994.

## General observations

118 Despite our recent review of client money handling practices in the retail OTC derivatives sector in REP 316, we detected a large number of unreported breaches of the client money provisions and high degrees of client money mishandling.

- 119 AFS licensees seeking to issue retail OTC derivatives must be aware of their regulatory obligations to handle client money in accordance with the client money provisions.
- 120 [Regulatory Guide 212](#) *Client money relating to dealing in OTC derivatives* (RG 212) provides guidance for AFS licensees that are retail OTC derivative issuers on how we administer the client money provisions, in particular, it outlines what money can be paid into a client money account (see RG 212.32–RG 212.33) and what money can be paid out of a client trust account: see RG 212.50–RG 212.51.

## D Risk 4: Disclosure

### Key points

Our review of AFS licensee disclosure in online PDSs revealed the following key compliance concerns:

- inadequate disclosure about significant risks and costs associated with the financial product offering or business structure operated by the licensee;
- inconsistency meeting benchmark disclosure standards set out in RG 227;
- failure to lodge, or failure to lodge in a timely manner, [Form FS88 PDS in-use notice](#); and
- misleading or deceptive representations in disclosures that used ASIC regulation and the AFS licence as a marketing tool.

### Statutory obligations

- 121 Disclosure documents provided to retail clients must be worded and presented in a clear, concise and effective manner: s1013C(3). AFS licensees that provide financial products to retail investors are responsible for making sure their disclosure documentation meets the content requirements set out in Div 2 of Pt 7.9 and other related regulations (the PDS requirements).
- 122 In addition to the PDS requirements, [Regulatory Guide 168 Disclosure: Product Disclosures Statements \(and other disclosure obligations\)](#) (RG 168) and RG 227 provide guidance on additional important disclosure for retail OTC derivatives.
- 123 [Regulatory Guide 234 Advertising financial products and services \(including credit\): Good practice guidance](#) (RG 234) also provides good practice guidance to help AFS licensees comply with their legal obligations not to make false or misleading statements or engage in misleading or deceptive conduct.

### Regulatory focus

- 124 The complex structure of retail OTC derivatives and the nature of the risks associated with these investments mean the quality and adequacy of the disclosure provided on AFS licensee websites and in disclosure documentation is crucial to enabling investors determine if these products are suitable for their investment needs.
- 125 Over the past few years, we have received a number of complaints identifying instances of misleading information about counterparties, business structure and the jurisdictional reach of AFS licences.

## Key concerns

### PDS disclosure

#### Risks

- 126 Our review identified wide variation in the quality of disclosure in PDSs about significant risks associated with product offerings, including disclosure on leverage risk, counterparty risk and market risk.
- 127 In general, key information was excluded in disclosures about significant risk, for example:
- (a) *Leverage risk:* Many PDSs did not consistently disclose the risk that high levels of leverage could lead to unlimited losses, including losses far greater than the investor's initial deposit and increased chances of the need for margin payments. We consider it good practice for AFS licensees to include worked examples in PDSs to illustrate this risk more clearly to retail investors.
  - (b) *Counterparty risk:* Many PDSs did not disclose sufficient information about material counterparties involved in the provision of the licensee's financial service to allow investors to make an informed assessment of risk. For example, many PDSs did not name hedge counterparties or primary liquidity providers, or indicate whether they were relying on aggregator services to provide their service. This information is of particular importance where there are limited counterparties, the main counterparties are related parties of the licensee, or where the counterparties are operating without any regulatory oversight.
 

Note: Aggregator services involve a service where liquidity is aggregated from several liquidity providers or sources.
  - (c) *Market risk:* Many PDSs failed to adequately disclose information about the market risk associated with trading in such products, and the potential for large losses to arise for investors as a result of market volatility due to the following factors:
    - (i) interest rate fluctuations;
    - (ii) changes in currency valuations; and
    - (iii) suspensions in trading in the underlying financial market, financial instrument or liquidity in the instrument.

#### Costs

- 128 Our review identified that, in many instances, PDSs did not disclose sufficient information about the fees, costs or commissions (the costs) of the financial product offered. For example, where the PDS disclosed that a particular cost was applicable to the financial product, often this disclosure did not cover:

- (a) how the cost was calculated; or
- (b) the factors that were included in calculating the cost associated with the financial product.

129 We identified better disclosure practices where the PDS disclosure included illustrated or worked examples of the relevant costs associated with the financial product.

### **Information about business structure**

130 AFS licensees that provide retail OTC derivative services in Australia are operating a variety of business models, but many are not providing adequate disclosure on which model they are using.

131 Smaller retail OTC derivative issuers often operated using a ‘white label’ agreement, outsourcing the majority of their financial services to a third party. Often these AFS licensees are providing services using third-party software that provides pricing and automatically hedges any retail investor position back-to-back with an identical trade with the third party. This may expose investors to both the solvency risk of the licensee and the counterparty risk of the ‘white label’ partner.

132 Generally, the associated PDS did not disclose the name of the AFS licensee’s white label partners and counterparties, or indicate where this information may be accessed by investors. Often no financial information was provided or able to be sourced by investors regarding these key counterparties. We consider this information key to enabling potential investors to assess the counterparty risk of dealing with the licensee.

133 Other AFS licensees appear to be operating an ‘introducing broker’ model where they are not directly issuing the product themselves but are passing trades directly through to another AFS licensee. At times, these licensees had placed a PDS on their website in their own name, or inserted a cover page on another issuer’s PDS with their brand in a manner that could mislead investors into believing they are the issuer of the financial product.

134 We saw examples where the disclosure in the PDS about the business model being used by the AFS licensee was not consistent with the information on the licensee’s website.

135 For example, a number of licensees advertised on their websites that investors have ‘direct market access’ (or ‘DMA’) or are operating a ‘true electronic communication network’ (‘ECN’ or ‘pure ECN’) model that provides investors with direct connectivity to the wholesale market—when this was not true. In reality, the investor enters into a trade with the AFS licensee, the licensee then enters into one or more other trades before ending up with the final counterparty (who may or may not be a wholesale institution). As a consequence, the original investor was not a direct

counterparty to the wholesale institution. Any disclosure made by and AFS licensee should reflect these contractual relationships.

136 Some PDS disclosure stated that the AFS licensee was operating a back-to-back hedging model and, in some cases, even stated that the licensee may choose not to hedge a position.

### **Regulatory Guide 227**

137 RG 227 provides guidance on what we consider to be adequate disclosure to enable retail investors to evaluate whether OTC CFDs are appropriate for them.

138 It is our regulatory expectation that AFS licensees address the benchmark standards set out in RG 227 in the PDS on an ‘if not, why not’ basis. However, our review identified that often where a licensee did not meet a particular benchmark, this was not disclosed in the PDS.

139 Where a benchmark was not met, licensees often failed to disclose what alternative measure or control they had implemented to mitigate the risks associated with the concern underlying the particular benchmark.

140 For example, we identified low standards of compliance with Benchmark 2 in RG 227. That is, many AFS licensees were accepting more than \$1,000 via credit card, and unlimited amounts to fund opening collateral. However, the associated PDS did not:

- (a) disclose the risks involved in using large amounts of borrowed funds to open an account; or
- (b) offer an alternative control to investors to mitigate against the risks of this practice (e.g. an alternate limit).

141 We also observed a very low standard of compliance with Benchmark 3. In particular, AFS licensees failed to:

- (a) make a copy of their hedging policy available to investors or disclose where it may be accessed. In some cases licensees simply said it was on their website, but then failed to add it to the website; and
- (b) disclose the identity of their hedge counterparty or disclose where the name of their hedge counterparty or its financial profile may be accessed.

142 Benchmark 3 is particularly critical to an investor’s assessment of the AFS licensee’s market risk strategy—and is relevant to any potential counterparty or operational risk that may arise from use of specific hedging counterparties.

### **Form FS88**

143 Our review found that while some PDSs were available to investors the corresponding Form FS88 was often not lodged with ASIC.

144 Similarly, we also observed that where a PDS-in-use notice was lodged with ASIC, this notification was not lodged within the specified five-business-day timeframe. Some AFS licensees also failed to adequately notify ASIC when a PDS was no longer in use.

## **Website disclosure**

### **Risk disclosure**

145 Retail OTC derivatives are generally considered to be high-risk financial products. However, we identified an inconsistency in the clarity and prominence given to risk warnings online. As a principle of good disclosure (and in accordance with RG 234.42–RG 234.48) a PDS should provide an upfront and prominent warning to retail investors of the high-risk nature of particular financial products that cross-refers to a detailed section on significant risks associated with the product. In particular, warnings should clearly disclose specific risks associated with these products, such as leverage risk, market risk and credit risk.

### **ASIC regulation**

146 We were concerned to find overemphasis of ASIC regulation and AFS licences on websites—to a level that made the statements potentially misleading, including when discussing the requirements and protections of an AFS licence.

147 This has the potential to give retail investors a false or misleading impression they are protected from investment loss because the entity holds an AFS licence, or because it is regulated by ASIC. The fact an entity holds an AFS licence does not mean investors should disregard the risks involved in trading in retail OTC derivatives.

148 Being regulated by ASIC or holding an AFS licence does not mean that we endorse the entity, its financial products or advice, or that investors cannot incur a loss from the investment.

### **Provision of financial services overseas**

149 We observed some websites providing a false or misleading impression that ASIC regulates all financial services provided by the AFS licensee, including those outside Australia. This was concerning because an AFS licence permits AFS licensees to carry on a financial services business in this jurisdiction only. ASIC regulation does not negate the need for an AFS licensee to obtain proper regulatory approval in the overseas jurisdiction in which they intend to operate.

### **Provision of financial services by other group entities**

150 Another area of disclosure requiring significant improvement was where the licensee is operating in a corporate group structure. Where the licensee allows



information about its AFS licence and Australian regulation to be made available on a website that mentioned other entities within a group corporate structure, it is important the licensee clearly discloses the limitations of the AFS licence and takes steps to ensure they are not facilitating the provision of unlicensed conduct by other entities in that group.

- 151 We requested a number of AFS licensees improve disclosure to ensure investors were aware the AFS licence and Australian regulation did not necessarily cover the financial services provided by other members within the same corporate group structure.

## General observations

- 152 The poor disclosure standards identified in our review revealed that the disclosure provided to retail investors in this sector requires substantial improvement.
- 153 We have issued a number of regulatory guides to assist AFS licensees with their disclosure obligations, including RGs 126, 227 and 234.
- 154 AFS licensees should also review the information on [our MoneySmart website](#) which provides guidance on the key risks investors should be aware of. For example, for [CFDs](#), [margin FX trading](#) and [binary options](#).

## E Risk 5: Financial reporting

### Key points

Our review of AFS licensees' compliance with their financial reporting obligations revealed the following key concerns:

- failure to lodge [Form FS70](#) *Australian financial services licensee profit and loss statement and balance sheet* and/or [Form FS71](#) *Auditor's report for AFS licensee*;
- failure to meet reporting obligations under [CO 12/752]; and
- failure to lodge [Form 388](#) *Copy of financial statements and reports*.

### Statutory obligations

- 155 Section 989B provides that an AFS licensee must lodge with ASIC Form FS70 and Form FS71 each financial year. A licensee may also be required to lodge an annual report if it is a small proprietary company controlled by a large foreign company: s292(2)(b).
- 156 In addition, [CO 12/752] sets out additional reporting obligations for retail OTC derivative issuers and requires them to report their NTA position, together with detailed working, to ASIC as part of their annual submission of Form FS70 as required under s989B.
- 157 Under [CO 12/752], a retail OTC derivative issuer is required to lodge with ASIC a report by a registered auditor which includes, among other things, statements advising if the AFS licensee had complied with its relevant financial requirements. Including whether it has:
- (a) complied with the NTA requirement, and any other financial requirements that apply;
  - (b) had, at all times, cash flow projections that purported to, and on their face appeared to, comply with RG 166.314; and
  - (c) correctly calculated the cash flow projections based on the assumptions the AFS licensee based them on ([CO 12/752]).

Note: RG 166.321 sets out the detailed audit requirements for AFS licensees that are retail OTC derivative issuers.

## Regulatory focus

- 158 The lodgement of financial accounts and audited reports is very important to consumer protection because it enables ASIC to check that AFS licensees are complying with the financial reporting obligations under their AFS licence. Financial reporting records also allow ASIC to monitor the following:
- (a) the counterparty/credit risk of AFS licensees; and
  - (b) the sufficiency of AFS licensee capitalisation.

## Key concerns

### Form FS70 and/or Form FS71 not lodged

- 159 We identified a considerable number of AFS licensees that were not lodging a Form FS70 and Form FS71 by the required time each financial year. Some licensees had been late in submitting their reports for multiple years.

### Form FS70 and/or Form FS71 lodged incorrectly

- 160 Often the 'retail derivatives issuer' section of Form FS70 and the independent audit report required under [CO 12/752] had not been completed.
- 161 We also identified a number of instances where we had notified an AFS licensee that it had incorrectly lodged Form FS70 and/or Form FS71; however, these AFS licensees failed to re-lodge a correct and complete Form FS70 and/or Form FS71 within the required timeframe.
- 162 Reasons for incorrect lodgement Form FS70 and/or Form FS71 included:
- (a) a non-ASIC registered auditor had signed-off on the report;
  - (b) mandatory sections were not complete; and
  - (c) partial financial statements were provided.

### Form 388 not lodged

- 163 AFS licensees controlled by a foreign company during the previous financial year are required to lodge a Form 388 under s292(2)(b), unless relying on specific relief under a legislative instrument. The lodgement of a Form 388 is required in addition to Form FS70 and Form FS71. A number of licensees subject to this requirement were unaware of their obligation.

## General observations

- 164 During our review, we became aware of an incorrect presumption made by some AFS licensees that we are not concerned if financial reports are lodged with ASIC a few months late.
- 165 Ensuring financial statements are up to date and lodged on time ensures we maintain an up-to-date, comprehensive and accurate corporate register.
- 166 AFS licensees are required to lodge financial statements with ASIC to demonstrate their capacity to provide financial services. Failure to strictly comply with reporting obligations is not just a material breach; it may also be an indicator of a poor compliance culture and can lead to administrative action against an AFS licensee, including licence cancellations or suspensions.

## F Risk 6: Authorised representatives

### Key points

Our review of AFS licensee supervision and monitoring of their authorised representatives revealed the following key compliance concerns:

- failure by licensees to adequately supervise their authorised representatives;
- authorised representatives acting beyond the scope of their authorisations;
- authorised representatives engaging in unlicensed conduct; and
- authorised representatives making false or misleading representations.

### Statutory obligations

- 167 Under s916A, authorised representatives can be authorised to provide a specified financial service ‘on behalf of’ an AFS licensee, and not on their own behalf.
- 168 AFS licensees have obligations under s912A(1)(ca) to take reasonable steps to ensure their authorised representatives comply with financial services laws. An AFS licensee should also ensure its representatives are adequately trained and competent to provide financial services: s912A(1)(f). AFS licensees must also have adequate resources (including financial, technological and human resources) to provide the financial services covered by their AFS licence and to carry out supervisory arrangements: s912A(1)(d).
- 169 We also expect AFS licensees to have measures in place to determine whether their authorised representatives are complying with financial services laws: see RG 104.1(e).

### Regulatory focus

- 170 We were concerned to discover that a number of entities—after finding they could not satisfy the requirements to be granted an AFS licence that covers retail OTC derivatives—mistakenly assumed they could access similar AFS licensing coverage by becoming an authorised representative of a licensee. Our intelligence has shown that a number of these entities appeared to be either providing unlicensed services or were misleading investors as to the identity of the issuer of the products they provided.

## Key concerns

### Authorised representatives acting outside of their authorisations or engaging in unlicensed conduct

#### Issuing financial products on their own behalf

- 171 Our review confirmed that many authorised representatives were attempting to issue retail OTC derivative products on their own behalf. Even if an AFS licensee purports to give its authorised representatives authority, it is unlawful for authorised representatives to issue financial products on their own behalf.

#### Authorised representatives unlawfully using an intermediary authorisation

- 172 We identified instances where AFS licensees were unlawfully using an intermediary authorisation licensing exemption (s911A (2)(b)) to facilitate the issuing of retail OTC derivative products by their authorised representatives.
- 173 An authorised representative may only be authorised to provide a financial service on *behalf* of an AFS licensee as its agent, and not on its own behalf. In addition, an intermediary authorisation cannot be used by licensees for authorised representatives because the licensing exemption in s911A(2)(b) does not cover market-making services.

#### Providing unauthorised financial products or services

- 174 We encountered instances where authorised representatives were:
- (a) authorised to provide wholesale services only, but were advertising services to retail investors; and
  - (b) providing financial services for a financial product type they were not authorised to, such as managed discretionary account services.

#### Facilitating provision of unlicensed conduct by other entities

- 175 We identified corporate groups that were using their subsidiary's authorised representative status to show a connection to the Australian regulatory regime for marketing purposes. While the authorised representative was not issuing products directly, other unlicensed overseas entities within the same corporate group were advertising services on their group website.
- 176 This strategy appeared to mislead investors that other entities within the corporate group that were issuing products had some connection to the Australian regulatory regime, or were otherwise licensed or authorised, when this was not the case.

## Authorised representatives making false or misleading representations

- 177 Where the authorised representative confirmed they were not issuing retail OTC derivative products on their own behalf, we remained concerned when the authorised representative was representing or marketing itself as the issuer of financial products on its website and in disclosure documentation.
- 178 Disclosures that present an authorised representative as the issuer of a financial product have the potential to be false and misleading, or to confuse prospective investors as to the identity of the entity or counterparty they are dealing or transacting with. Advertising or other promotional material for the financial products must clearly identify the underlying issuer of the financial product.

## General observations

- 179 We are concerned about the emerging compliance risk from entities attempting to circumvent the AFS licensing regime. Avoidance techniques we identified include acting as an authorised representatives and issuing financial products on their own behalf. This issue was most evident in the unlawful use of an intermediary authorisation arrangement by authorised representatives to facilitate the issue of financial products on their own behalf.
- 180 We are particularly concerned that authorised representatives are using their position to demonstrate a connection to the reputable Australian regulatory regime in order to market themselves to investors in Australia or in other jurisdictions. Some related entities within the same corporate group as the authorised representative have attempted to misuse this association for their own business or marketing strategies.
- 181 Authorised representatives need to be aware of the potential for investors to be confused or misled when trying to determine the identity of the entity they are dealing or transacting with. Including, for example, if an authorised representative:
- (a) adopts company names that are similar to the trading names of the authorising AFS licensee; or
  - (b) uses branding or company logos similar to the authorising AFS licensee or another regulated entity.
- 182 AFS licensees and authorised representatives need to ensure they clearly disclose their relationship and business structure in all promotional material. The authorised representative relationship must remain an agency relationship—the authorised representative may act only on behalf of the licensee and not in their own right.

- 183 Where authorised representatives are issuing financial products in their own right or are representing themselves as the issuer of financial products through their website or disclosure documentation, these entities are risking serious regulatory action for either or both:
- (a) unlicensed conduct; and
  - (b) misleading or deceptive conduct.
- 184 In addition, AFS licensees that facilitate this type of conduct by their authorised representatives must be aware that it is their responsibility to ensure their representatives are adequately supervised. Facilitating misconduct or failing to prevent misconduct by their authorised representatives can lead to administrative action against the AFS licensee.



## G Risk 7: Claims that no financial services are provided under the AFS licence

### Key points

Our review identified the following key compliance concerns in assessing AFS licensee claims that they were not operating a financial services business:

- licensee failure to comply with their regulatory obligations before advertising and offering their financial services to investors; and
- licensees providing potentially false or misleading disclosure on their website and in advertising materials.

### Regulatory focus

- 185 We have recently seen an increase in retail OTC derivative issuers purchasing existing AFS licensees that have ceased providing financial services. The new management of the licensee is often not in a position to recommence providing services that are compliant with Australian obligations for an extended period of time.
- 186 We expect AFS licensees that are authorised to provide financial services to retail investors to be in a position to fully meet all of their AFS license obligations before:
- (a) offering a financial product to investors; and
  - (b) commencement of any advertising or promotion of their financial services business.

### Key concerns

#### **Failure to comply with regulatory obligations before advertising and offering financial services to investors**

- 187 We identified many instances where AFS licensees had commenced marketing their financial services on a number of websites. However, these licensees were unable to demonstrate compliance with their AFS licence obligations, such as the financial resource requirements. Often these licensees claimed they had not commenced servicing investors or carrying on a financial services business. Some of these licensees were not in a position to begin providing a financial services business even though they had held an AFS licence for a number of years.

## False or misleading representations

188 We identified a number of websites that contained extensive information about an AFS licensee or its licence. However, these websites were not directly controlled by the licensee, but rather by another entity that formed part of a larger group corporate structure with a similar name to the licensee. In some cases, Australian investors had been misled into opening trading accounts with a related entity within the group that was not the licensee. These entities providing services to Australians were not adequately licensed or authorised to provide those financial services.

## General observations

- 189 We are concerned that many AFS licensees appear to be heavily reliant on their AFS licence and the Australian regulatory regime for marketing purposes. However, these same AFS licensees are unwilling to commence providing financial services because they are unable to comply with their regulatory obligations.
- 190 AFS licensees need to be aware that many of their regulatory obligations arise as soon as they enter into a relationship with a client. Therefore, if an AFS licensee is advertising and offering services on their website before they are able to commence providing those services, they may be found to be engaging in misleading and deceptive conduct.
- 191 If the promotion of the AFS licence leads to an Australian investor being provided financial services by an unregulated entity within the same corporate group as an AFS licensee, this may amount to unlicensed conduct. Therefore, if an AFS licensee is operating a website that covers other entities within the same corporate group it is important that adequate disclosure is provided on the limitations of the AFS licence. The licensees must also take steps to ensure they are not facilitating the provision of unlicensed conduct by other entities within the wider group.
- 192 We noticed a number of AFS licensees are heavily marketing their financial services and AFS licence. However, financial reports received from these AFS licensees established these entities had not commenced providing financial services.
- 193 Under s911C, there is a prohibition against a person or entity holding out the following when it is not the case:
- (a) that they have an AFS licence;
  - (b) that a financial service is exempt from the requirements to have an AFS licence;

- (c) that, in providing a financial service, they act on behalf of someone else; and
- (d) that conduct, or proposed conduct, is within the authority of a particular AFS licensee.

194 Australian investors that receive financial services from an entity that is not appropriately licensed may have the right to rescind their contracts with the entity and may be entitled to recover brokerage, commissions and other fees they have paid to that entity.

195 Where an AFS licensee has failed to commence providing a financial services business after a reasonable period of time, we will consider whether to immediately cancel or suspend the AFS licence on the basis the AFS licensee has ceased to operate a previously operating financial services business.

196 We may also consider whether an AFS licence should be suspended or cancelled after offering a hearing, if we consider that information provided to ASIC as part of the AFS licence application process was false or materially misleading.

## H Summary of observations and next steps

### Key points

This report highlights areas of concern that retail OTC derivative issuers should be aware of and provides references to ASIC guidance to assist them in ensuring they are compliant with Australian requirements.

Observations highlighted in this report constitute breaches of Australian financial services laws, which can lead to the suspension or cancellation of an AFS licence, banning actions against individuals or other regulatory action that can lead to fines or imprisonment.

### Summary of observations

- 197 Many of the compliance concerns detailed in this report constitute breaches of an AFS licensee’s obligations and/or Australian financial services laws. These breaches may lead to ASIC taking:
- (a) action to suspend or cancel an AFS licence;
  - (b) banning actions against individuals that are involved in the conduct; or
  - (c) other regulatory action that may result in fines or imprisonment.
- 198 It is important that AFS licensees are fully aware of all of their Australian regulatory responsibilities and, where they are unclear, seek their own independent legal advice.
- 199 The AFS licensees involved in this review needed to consider whether the matters raised with them constituted a significant breach that is reportable to ASIC under s912D, or whether there was a material change or significant event that must be notified to investors in accordance with s1017B.
- 200 We are still working with some of the AFS licensees subject to this review to address compliance issues, improve their compliance standards and determine whether additional regulatory action is required.
- 201 This report and our general observations highlight important areas of focus and existing ASIC guidance that is relevant to the operation of financial services in the retail OTC derivatives industry.
- 202 We remind investors that retail OTC derivatives are complex, risky and difficult to understand—even for experienced investors.
- 203 We are aware of an increase in overseas entities cold calling Australian investors to encourage them to invest in retail OTC derivatives, often

referring investors to entities that are not licensed to provide them with a financial service in Australia.

- 204 As always, we urge anyone interested in trading in retail OTC derivatives to make sure they understand the risks of what they are trading in and check they are dealing with an entity that is appropriately licensed to provide these products to retail investors in Australia. This can be done by [searching the professional registers on our website](#).

## Next steps

- 205 We will continue to monitor compliance standards within the retail OTC derivatives sector. We anticipate taking strong regulatory action in response to future contraventions, especially where any breaches are not self-reported to ASIC. We will continue to keep industry and investors informed through [our media releases](#).
- 206 We have identified a recent trend among some retail OTC derivative businesses looking to purchase an existing AFS licensee or becoming an authorised representative rather than applying for a new AFS licence. We have also identified a trend in entities claiming some connection to Australia but operating without an AFS licence, or operating a retail OTC derivative business with an AFS licence that does not have the correct authorisations. Consequently, our next main area of focus will be unlicensed conduct in this industry.
- 207 We have observed a dramatic increase in unlicensed conduct by entities offering binary options. A binary option is a financial product, in particular a derivative, under the Corporations Act. Any entity that deals in, or provides advice about, binary options to Australian investors must hold an AFS licence or be authorised by an AFS licensee. It appears a number of overseas entities are unaware of this licensing requirement. Binary options are a high-risk speculative investment which, unless you are following a market carefully, are really just a bet or gamble on an asset price movement. Our future focus will be on whether binary option providers are appropriately licensed.

## Appendix: List of recent ASIC media releases

**Table 1: List of recent ASIC media releases on the retail OTC derivative industry**

Media release
<a href="#">16-134MR</a> Ikon rectifies client trust accounts and improves disclosure
<a href="#">16-067MR</a> FXAsia updates website disclosure to clarify the services it may offer
<a href="#">15-408MR</a> ASIC warns about false claims on www.usgforex.com
<a href="#">15-395MR</a> IronFX corrects disclosure about Australian regulation and counterparty arrangements
<a href="#">15-340MR</a> Boca Global Financial Group removes potentially misleading website representations
<a href="#">15-336MR</a> Formax removes false statements about the suspension of its subsidiary's licence
<a href="#">15-333MR</a> Ingot Brokers rectifies its 'cash and cash equivalents' arrangements to meet financial resource requirements
<a href="#">15-321MR</a> OCM pays \$30,600 penalty for misleading advertising
<a href="#">15-293MR</a> ASIC cancels retail derivative issuer's licence
<a href="#">15-233MR</a> Two overseas entities agree to stop providing unlicensed FX services
<a href="#">15-217MR</a> ASIC suspends retail OTC derivative licence after change of control
<a href="#">15-085MR</a> FX broker Advanced Markets clarifies its AFS licence
<a href="#">15-193MR</a> ASIC bans former GTL Tradeup Pty Ltd director
<a href="#">15-152MR</a> Cold calling firm FXTS Guru cut off following ASIC concerns
<a href="#">15-024MR</a> ASIC warns of Opteck and other unlicensed binary option providers
<a href="#">15-120MR</a> ASIC requires FX Primus to cease targeting Australian investors
<a href="#">15-108MR</a> ASIC cancels FX company's licence
<a href="#">15-075MR</a> ASIC suspends FX company's licence
<a href="#">15-066MR</a> ASIC issues warning about Grandegoldens

## Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A.
authorised representative	A person authorised by an AFS licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee Note: This is a definition contained in s761A.
ASIC	Australian Securities and Investments Commission
CFD	Contracts for difference
client money	Money that is paid to an AFS licensee under s981A
client money provisions	Div 2 of Pt 7.8 of the Corporations Act
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
credit risk	The risk of incurring a financial loss as a result of a third party failing to fulfil its obligations to the party at risk of incurring the loss
derivative	Has the meaning given in s761D
derivative transaction rules (reporting)	ASIC Derivative Transaction Rules (Reporting) 2013—rules made by ASIC under s901A of the Corporations Act that deal with reporting requirements, and requirements
financial product	A facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> <li>• makes a financial investment (s763B);</li> <li>• manages financial risk (s763C); or</li> <li>• makes non-cash payments (s763D)</li> </ul> Note: See Div 3 of Pt 7.1 for the exact definition.
financial service	Has the same meaning as in Div 4 of Pt 7.1
FX	Foreign exchange
NTA	Net tangible assets

Term	Meaning in this document
OTC derivative	A derivative that is entered into over the counter and not through a licensed market, including products such as CFDs, margin FX and binary options
OTC derivative issuer	An AFS licensee that is authorised to issue OTC derivatives to retail clients
PDS	Product Disclosure Statement
Pt 7.8	A part of the Corporations Act (in this example numbered 7.8)
reg 7.6.04(1)(i)	A regulation of the Corporations Regulations (in this example number 7.6.04(1)(i))
representative	Has the same meaning as in s910A of the Corporations Act
REP 384	An ASIC report (in this example numbered 384)
RG 227	An ASIC regulatory guide (in this example numbered 227)
s981D	A section of the Corporations Act (in this example numbered s981D)



## Related information

### Headnotes

AFS licence, authorised representative, client money, derivative, disclosure, OTC derivative, over the counter, net tangible assets, NTA, retail investors

### Class order

[\[CO 12/752\]](#) *Financial requirements for retail OTC derivative issuers*

### Regulatory guides

[RG 104](#) *Licensing: Meeting the general obligations*

[RG 105](#) *Licensing: Organisational competence*

[RG 126](#) *Compensation and insurance arrangements for AFS licensees*

[RG 166](#) *Licensing: Financial requirements*

[RG 168](#) *Disclosure: Product Disclosures Statements (and other disclosure obligations)*

[RG 212](#) *Client money relating to dealing in OTC derivatives*

[RG 227](#) *Over-the-counter contracts for difference: Improving disclosure for retail investors*

[RG 234](#) *Advertising financial products and services (including credit): Good practice guidance*

[RG 251](#) *Derivative transaction reporting*

### Legislation

Corporations Act, Pt 7.6–7.9, s50AAA, 292, 761G, 911A, 911A (2)(b), 911C, s912A, 912A(1)(ca), 912A(1)(f), s912A(1)(d), 912D, 914A, 916A, 917B, 917C, 951B, 981A, 981B, 981D, 989B, 1013C(3), 1017B, 1017E(3)(b).

Corporations Regulations, regs 7.6.04, 7.8.01, 7.8.02.

### Cases

*In re MF Global Australia Ltd (in liq)* [2012] NSWSC 994

## **Reports**

[REP 316](#) *Review of client money handling practices in the retail OTC derivatives sector*

[REP 384](#) *Regulating complex products*

## **ASIC forms**

[Form FS20](#) *Change of details for an Australian financial services licence*

[Form FS70](#) *Australian financial services licensee profit and loss statement and balance sheet*

[Form FS71](#) *Auditor's report for AFS licensee*

[Form FS88](#) *PDS in-use notice*

[Form 388](#) *Copy of financial statements and reports*