



**ASIC**

Australian Securities & Investments Commission

## REPORT 202

# Response to submissions on CP 114 Client money relating to dealing in OTC derivatives

July 2010

### **About this report**

This report highlights the key issues that arose out of the submissions received on Consultation Paper 114 *Client money relating to dealing in OTC derivatives* (CP 114) and details our responses.

### 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.

This report does not contain ASIC policy. Please see Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212).

# Contents

<b>A</b>	<b>Overview/Consultation process</b> .....	<b>4</b>
<b>B</b>	<b>OTC derivatives and client money</b> .....	<b>5</b>
	Purpose of guidance .....	5
	Background .....	5
	Scope of guidance .....	6
	Next steps .....	6
<b>C</b>	<b>Client money accounts</b> .....	<b>7</b>
	Unidentified money .....	7
	Buffers .....	7
<b>D</b>	<b>Permitted uses of client money</b> .....	<b>9</b>
	Permitted uses of client money for derivatives .....	9
	Use of client money for licensee's own (or proprietary) trading .....	11
	General authorisation .....	12
<b>E</b>	<b>Feedback on proposed guidance</b> .....	<b>13</b>
	Feedback .....	13
	<b>Appendix: List of non-confidential respondents</b> .....	<b>15</b>

## A Overview/Consultation process

- 1 In Consultation Paper 114 *Client money relating to dealing in OTC derivatives* (CP 114), we consulted on our proposed guidance on the client money provisions and how we expect Australian financial services (AFS) licensees to comply with these provisions when dealing in over-the-counter derivatives (OTC derivatives).
- 2 In addition to setting out our proposed guidance, we sought feedback on:
  - the money that can be deposited into a client money account and the use of buffers;
  - the permitted uses of client money; and
  - our proposed guidance generally.
- 3 This report highlights the key issues that arose out of the submissions received on CP 114 and our response to those issues.
- 4 This report is not a comprehensive summary of all submissions received. It is also not a detailed report on every question from CP 114. We have limited this report to the key issues.

### Responses to consultation

- 5 We received seven responses to CP 114 from a variety of sources. The list of non-confidential respondents is set out in the Appendix and copies of their submissions are on the ASIC website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp), under CP 114. We are grateful to respondents for taking the time to send us their comments.
- 6 There was general support for improving disclosure of client money and the risks associated with client money. We also received some useful feedback that has assisted our understanding of different market practices in the treatment of money that clients deposit with an AFS licensee. We have therefore decided to finalise our guidance and issue a regulatory guide on client money in the context of OTC derivatives.

## B OTC derivatives and client money

### Key points

In recent years there has been a growth in the number of retail investors trading in OTC derivatives.

The Corporations Act contains provisions regulating the way AFS licensees deal with client money, however, there are risks for clients, particularly when trading in OTC derivatives.

### Purpose of guidance

- 7 Our objectives for the guidance are to improve:
- AFS licensees' compliance with the client money provisions;
  - licensees' disclosure of the risks that a client is exposed to by virtue of the client money provisions; and
  - investor awareness of how a licensee handles and uses a client's money and the risks that a client bears,
- in the area of trading in OTC derivatives.

### Background

- 8 As outlined in CP 114, we have seen a growth in recent years of retail investors trading in OTC derivatives, particularly on a margin basis. This is particularly in the area of trading in contracts for difference (CFDs) but also for other OTC derivatives (e.g. margin foreign exchange contracts).
- 9 The *Corporations Act 2001* (Corporations Act) contains provisions that AFS licensees must comply with when holding this money (client money provisions). These provisions seek to ensure that client money is held separately from the licensee's own money and is only used as permitted under those provisions.
- 10 This nevertheless involves client money being pooled with other clients' money and investors need to understand the risks associated with this. Investors also need to fully understand how their money may be used:
- when they enter into, and terminate, OTC derivatives (i.e. open and close positions);
  - to meet other clients' obligations; and

- to meet the licensee's obligations.
- 11 Investors need to be clear about the risk of losing their money in certain circumstances and they should be aware of this prior to entering into the transaction or paying the money to the licensee. This should be clearly and prominently disclosed in the product disclosure statement (PDS).
- 12 It is the obligation of the licensee offering OTC derivatives to ensure that their clients receive clear, concise and effective disclosure of these aspects. OTC derivatives, by their very nature, are non-standard contracts between the licensee on the one hand and the client on the other. The form of the underlying contracts differs among licensees, as do the distribution models licensees utilise. The form of the underlying contract and manner of distribution affect how a licensee deals with a client's money.

## Scope of guidance

- 13 Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212), published with this report, sets out how we expect AFS licensees to comply with the client money provisions. The focus of our guidance is on licensees' dealings with retail clients in the context of OTC derivatives and, to that end, sets out our expectations for better disclosure in PDSs offering OTC derivatives.
- 14 We note that as the client money provisions in Pt 7.8 of the Corporations Act apply to retail and wholesale clients, and trading in exchange traded derivatives, our guidance on the operation of Pt 7.8 has some broader relevance.

## Next steps

- 15 We will continue, on a selected basis, to scrutinise the standard of disclosure on all aspects relating to client money and trading in OTC derivatives. We will, if needed, raise queries with AFS licensees and, if necessary, take enforcement action in relation to the standard of disclosure we are seeking.

## C Client money accounts

### Key points

Two respondents submitted that our guidance on unidentified money should reflect the operation of payments systems.

Some submissions argued that the use of buffers was justified and favoured a pragmatic approach to regulating them. We have clarified our guidance on this, but expect AFS licensees to maintain appropriate reconciliation processes.

### Unidentified money

- 16 Two submissions were made on our proposed guidance on unidentified money, stating that the expectations about the timing of the identification of unidentified money as client money should reflect the operational capacity of both the domestic and international payments systems.

#### *ASIC's response*

Our proposed guidance refers to the requirement to remove money that is not client money as soon as practicable. Compliance with this requirement would be assessed in the particular circumstances.

### Buffers

- 17 We received some submissions regarding our proposed guidance on the use of a buffer. Feedback on the operation of the proposed guidance included:
- maintaining buffer money in a client money account does not provide mere administrative benefit, but is essential to the efficient operation of such accounts;
  - buffer money is maintained, not for the purposes of meeting client obligations, but to prevent the account from becoming overdrawn, when known and unknown bank fees and charges are applied to the account, or as a consequence of a dishonoured cheque;
  - the AFS licensee is forgoing additional interest that could have been earned on their 'house account', to better ensure that the balance of client money that is required to be held on trust is not compromised or put at risk as a result of unexpected errors;

- a pragmatic approach should be taken to the concept of buffer funds held in client accounts, especially where this relates to the licensee withdrawing commission or fees paid by the client to the licensee;
- an alternative to restricting the use of buffers would be to outline the specific purposes for which buffer funds could be used and/or a monetary limit for the level of buffer funds that may be held in a client money account (e.g. the buffer balance cannot exceed 1% of the balance of client money); and
- the potential over-reach of our proposed guidance on buffers.

*ASIC's response*

We consider our general guidance on the use of buffers is correct and appropriate and have clarified that guidance.

We expect licensees to maintain appropriate and prudent reconciliation processes in respect of their client money accounts.



## D Permitted uses of client money

### Key points

One respondent argued for a very restrictive interpretation of the provision permitting use of client money for derivatives, while another submitted that a wide interpretation was needed to reflect the reality of derivatives trading.

### Permitted uses of client money for derivatives

- 18 We received feedback on our proposed guidance on the permitted uses of client money for derivatives and, in particular, the operation of s981D of the Corporations Act. The submissions received refer to CFDs, however, s981D applies to all derivatives.
- 19 On the one hand, we received a submission querying the interpretation of s981D, contending that:
- s981D does not allow for the use of margining money for an AFS licensee’s own purposes, as the permission is predicated on an ‘obligation’ in connection with margining, and that the hedging by issuers is not an ‘obligation’ but a risk management strategy adopted by some issuers entirely at their discretion—it is never an obligation such as those imposed on a futures broker, which appears to be a fundamental precondition of s981D permitting the practice; and
  - the statutory provenance of s981D is that it is by and large the replacement provision (with the necessary changes) to s1209 of the Corporations Law, now repealed. That section related to client money of futures brokers. Importantly, futures brokers, by reason of the nature of exchange traded futures contracts, were participants in clearing houses and futures exchanges and often acted in an agency or quasi-agency capacity, so ought to have been permitted to utilise client funds for their legitimate margining obligations. It was contended that the same considerations do not apply to counterparty principals in CFD transactions.
- 20 It was also submitted that, whatever the meaning of s981D:
- use of client funds for CFD providers’ own margining should not be permitted at all, even if disclosed, because the risks are too great. In a provider’s corporate insolvency, those funds would in all probability be lost or at least be at substantial risk. Added to that, the entire CFD industry would be at risk of reputational damage if there was client money loss in such circumstances; and

- s981D is entirely inconsistent with all sound principles as ought to apply to trust money—those issuers may utilise client money for margining in respect of their own hedging purposes; and
- the practice represents a fundamental conflict of interest which is met by s912A(1)(aa) of the Corporations Act.

21 The concern underlying this submission was expressed as the potential for a licensee to use s981D to pass client money through to brokers for the licensee's own margining purposes, which has been given ASIC's apparent imprimatur in RG 000.51 of the draft regulatory guide in CP 114.

22 On the other hand, we received a submission, concerning the 'direct market' model of CFD distribution, contending that the right of a licensee to use client funds for the purposes contemplated by s981D is a right which should be maintained in the Corporations Act, as it reflects the reality of dealings in derivatives markets. It was contended that the policy reasons behind the introduction of s981D and its predecessor provision continue to be relevant today and, to the extent that a CFD provider wishes to exercise such a right, there should be clear and prominent disclosure in the PDS that the CFD provider may use client money for this purpose.

Note: A 'direct market' model of derivative distribution means that all derivative transactions the licensee enters into with clients are, in turn, hedged by the licensee through an equity swap with a third party prime broker. The licensee will usually charge its clients commission in respect of trades executed.

23 The submission contended that, under a direct market model of CFD distribution, when a client enters into a CFD (or, in other words, opens a CFD position):

- the licensee entering into the CFD with the client is entitled to withdraw amounts of money from the client money account representing initial margin and variation margin as money to which the licensee is entitled under reg 7.8.02(1) of the Corporations Regulations 2001 (Corporations Regulations)—once paid, that money becomes the licensee's money and the licensee can use the money for any purpose, including to discharge its own margin obligations; and
- to the extent that the licensee is required to pay margin to its hedge counterparty in excess of the amounts of margin it calls from its client, the licensee is entitled to use client money for that purpose under s981D, which authorises the licensee to use client money for the purposes of meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee (including dealings by people other than the client).

*ASIC's response*

OTC derivatives are bilateral contracts, the terms of which are not uniform across licensees, even if generally known under the same product name (e.g. CFDs).

Moreover, a licensee can issue OTC derivatives utilising different business models. The terms of the contract and distribution model will affect how a client's money is treated and the nature of risks to which a retail client dealing with that licensee is exposed.

Therefore, it is fundamental that a licensee clearly and prominently discloses the contract being offered, the mechanics of that contract and the risks and benefits associated with that contract. We have expanded our guidance in RG 212 to reflect this.

## Use of client money for licensee's own (or proprietary) trading

- 24 One submission referred to our statement as to the interpretation of s981D that an AFS licensee is not permitted to use client money to meet obligations incurred by the licensee's own (or proprietary) trading in derivatives, so as to make a profit for itself: see RG 000.52 of the draft regulatory guide in CP 114.
- 25 It was contended that it is important to recognise the reason why s981D and its predecessor provisions were inserted many years ago. They were inserted to specifically address the position that, although a futures broker calls margin from its client and that money is paid into a segregated account, when the futures broker (or its clearing participant) in turn pays margin to the clearing house it does so to cover its 'principal exposure' to the clearing house. The rules of clearing houses generally provide that futures brokers (or their clearing participants) owe their obligations to the clearing house as principals, that is, client money is being used to meet the brokers' own principal obligations. It was submitted that the policy rationale for s981D was to expressly acknowledge and provide for such payments, because of the necessary connection between the client's position with the futures broker and the corresponding position of the futures broker with the clearing house.
- 26 The submission continued that the position of a licensee under a direct market model is analogous to that of the futures broker and the position of hedge counterparty is analogous to that of the clearing house, and that it would be helpful if this could be acknowledged in the final guidance.

*ASIC's response*

As OTC derivatives are bilateral contracts and different licensees employ different distribution models, licensees need to ensure their practices fully comply with the Corporations Act. We do not consider that our guidance is inconsistent with s981D.

As noted in RG 212, a licensee needs to ensure that it provides effective disclosure in the PDS of the OTC derivative contract being offered, the mechanics of that contract and the risks and benefits associated with that derivative.

## General authorisation

- 27 We received one submission relating to our comments about a general authorisation for withdrawals from the client money account.
- 28 It was contended that our concerns with the appropriateness of a general authorisation should not extend to an authority limited to a use of funds that is specifically identified and directly connected with the purpose for which the funds were deposited.

### *ASIC's response*

The Corporations Act contemplates that an AFS licensee may make a withdrawal from a client money account in accordance with the written direction of a person entitled to the money: Corporations Regulations, reg 7.8.01(a).

Licensees should consider the purpose of the client money provisions and their general licensee obligations in deciding how to use this authority.

If a licensee seeks a written direction from its clients, it should also clearly disclose the consequences of the written direction, the risks associated with it and the protections the client may be giving up by providing a written direction. This disclosure should be given clearly and prominently in non-financial language.

We have included guidance to this effect in RG 212.

## E Feedback on proposed guidance

### Key points

One respondent questioned our guidance on the need for disclosure of financial information about a licensee, in order to judge its solvency, when considering counterparty risk.

## Feedback

### Reconciliation

- 29 One respondent submitted that it is essential for client money accounts to be reconciled daily to ensure transparency of each client's account balance.

#### *ASIC's response*

An AFS licensee must keep financial records that correctly record and explain all money received or paid by the licensee in relation to a client money account. We would expect this to include prudent reconciliation processes. We have included guidance on this in our regulatory guide.

### Disclosure of counterparty risks

- 30 One submission commented on our proposed guidance relating to the provision of financial information to retail clients. The submission accepted that there are counterparty risks for investors trading OTC derivatives, as trading involves bilateral contracts between providers and clients to buy or sell derivative products. It noted that these risks are minimised by putting in place risk management policies, such as ensuring that they are not excessively exposed to any client or group of clients or individual positions and that exposure is managed relative to size, to manage market risk, and by providing their clients with education and information so that they can assess the risks involved in trading CFDs.
- 31 The submission referred to our proposed guidance that AFS licensees may consider providing information, such as financial information of the licensee, to allow clients to quantify the licensee's solvency.
- 32 It was contended that financial information, through documents such as income statements and balance sheets, is not sufficient to enable a full assessment of counterparty risk. Many non-financial considerations, such as

adequate risk management, directly impact the level of counterparty risk and they need to be considered to make a complete assessment of risk.

33 It was further submitted that, for example, to adequately quantify a licensee's solvency, an assessment may need to take into consideration factors such as:

- open position concentration;
- quality of stocks held;
- total open positions;
- risk management policies;
- liquidation procedures;
- proprietary positions and limits;
- compliance policies ensuring correct use of client money;
- information technology system reliability; and
- financial information.

34 It was also contended that, as licensed entities, CFD providers must comply with a range of financial resource and operational capacity obligations, notably those contained in Regulatory Guide 105 *Licensing: Organisational competence* (RG 105), Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146) and Regulatory Guide 166 *Licensing: Financial requirements* (RG 166). Hence, through its administration of the law, ASIC was better placed than retail clients to assess a provider's solvency and risk management controls (including by reference to the abovementioned factors). It was further submitted that, in practice, retail clients who are not well equipped to assess complex financial and risk management information may be inclined to rely on ASIC's oversight in assessing the counterparty risk of licensed entities and that the disclosure of counterparty risk to retail clients should be seen in this context.

#### *ASIC's response*

It is important that licensees properly disclose the risks and benefits associated with the financial product being offered. We consider this must include effective disclosure of counterparty risks associated with OTC derivatives and licensees will need to assess the information relevant to this. At a minimum, we consider this must include financial information.

ASIC's supervision of licensees is not a substitute for a licensee's own compliance with its various obligations.

## Appendix: List of non-confidential respondents

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- Australian Bankers Association
  - Australian Financial Markets Association
  - IG Markets Limited
  - Securities and Derivatives Industry Association
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