



ASIC

Australian Securities & Investments Commission

REPORT 316

Review of client money handling practices in the retail OTC derivatives sector

December 2012

About this report

This report sets out our observations of the client money handling practices of issuers of over-the-counter (OTC) contracts for difference (CFDs) and margin foreign exchange contracts to retail clients in Australia. The report follows a risk-based surveillance conducted by ASIC between December 2011 and August 2012.

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- 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.

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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.

Contents

A	Executive summary	4
B	Background	7
	The CFD sector	7
	Protection of client money	8
	Current law and guidance	9
C	Scope of surveillance and methodology	12
	Scope of surveillance	12
	Surveillance methodology	13
D	Industry characteristics	14
	Industry snapshot	14
	Market share	15
	Active and inactive accounts	15
	Leverage and margin utilisation	15
	Outsourcing and 'off-shoring'	16
E	Client money handling practices and contraventions	17
	Client money handling practices	17
	Contraventions of the client money provisions	20
F	Weaknesses in the reconciliation of client money accounts	23
	Frequency of reconciliations	24
	Segregation of duties	24
	Escalation of variances	25
	Ongoing regulatory activities	25
	Key terms	26
	Related information	28

A Executive summary

- 1 Between December 2011 and August 2012, ASIC conducted a risk-based surveillance of the client money handling practices of 40 Australian financial services (AFS) licensees that issue over-the-counter (OTC) contracts for difference (CFDs) or margin foreign exchange contracts to retail clients in Australia.

Note: In this report, we refer to these AFS licensees as CFD issuers and refer to CFDs and margin foreign exchange contracts collectively as CFDs.

- 2 Our analysis of risks in this sector highlighted the mishandling of client money as a priority risk for our risk-based surveillance. In the worst case, mishandling of client money may result in significant losses to clients and may have a severe impact on investor confidence. Following the release of our Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212) in July 2010, we identified eight CFD issuers with client money handling weaknesses or significant breaches during 2010–11. We considered it timely to conduct a comprehensive review of the sector.
- 3 This report sets out our observations of CFD issuers' client money handling practices.

Industry characteristics

- 4 Based on the responses we received from the 40 CFD issuers in our surveillance (which comprised almost the entire CFD sector) we identified the following industry characteristics:
- (a) there were a total of 231,725 client accounts, of which only 51,800 (22%) were being actively traded;
 - (b) the total client money held by CFD issuers was \$511 million, significantly higher than the \$350 million that ASIC estimated CFD issuers held in early 2009;
 - (c) only \$55 million, or 11% of client money held, was committed as margin to support client trading—the rest was held as 'free equity', which is excess cash held in client accounts that could be used as margin to support client trading;
 - (d) a total of nine CFD issuers (23%) outsource or 'off-shore' their compliance function; and
 - (e) a total of 11 CFD issuers (28%) outsource or off-shore their finance or back-office functions.

Note: These client money figures are from 24 November 2011. The information about account numbers and outsourcing was collected during our surveillance and therefore does not reflect a specific date.

- 5 Both the number of inactive accounts and the low margin utilisation (which is client margins divided by total client money held) of 11% might be explained, in part, by the subdued market conditions that existed at the time we conducted our surveillance.

Client money handling practices

- 6 About half of CFD issuers use client money as collateral to hedge their exposure to client trades. Those that did not were typically either some of the largest, most established CFD issuers or CFD issuers that were in the start-up phase and had few clients, making it relatively cheap to use their own money to support hedging initially.
- 7 Two CFD issuers used a complex, novel arrangement to hold client money that they describe as a ‘protection trust’. The complex features and risks of these arrangements present challenges for CFD issuers to make clear, concise and effective disclosure of these arrangements in their Product Disclosure Statements (PDSs).
- 8 A number of CFD issuers invested client money, including in term deposits. Arrangements for paying interest to clients, or not paying interest, varied from CFD issuer to CFD issuer.

Contraventions of the client money provisions

- 9 We identified a number of breaches of the client money provisions, including not paying client money into a client money account on the day of receipt or on the next business day. We were concerned that many of the breaches identified were basic contraventions of well-established client money provisions. Table 1 summarises the contraventions identified, which were resolved by CFD issuers at our instruction.

Table 1: Contraventions identified during our surveillance

Contravention	Number of CFD issuers	Percentage of CFD issuers
Failure to properly designate client accounts as trust accounts	18	45%
Failure to pay client money into a compliant account by the next business day following receipt	11	28%

Compliance weaknesses

- 10 We also identified a number of compliance weaknesses (see Table 2), including a relatively small number of CFD issuers that did not perform client money reconciliations on a daily basis or appeared to have insufficient segregation of duties within their back-office or finance function. In each case, we worked with CFD issuers to ensure they improved their processes to address our concerns. We also encouraged CFD issuers that did not have a formal policy to escalate reconciliation issues (around half the total) to implement this ‘best practice’ measure.

Table 2: Reconciliation weaknesses identified during our surveillance

Weakness	Number of CFD issuers	Percentage of CFD issuers
Client money reconciliations not performed on a daily basis	6	15%
Inadequate segregation of duties	5	13%
No formal escalation process for reconciliation issues	19	48%

Ongoing regulatory activities

- 11 We will continue to monitor compliance within the CFD sector, with client money handling practices remaining a focus of our regulatory activities. We anticipate taking strong action in response to any future breaches of client money rules, especially where any breaches are not self-reported to ASIC.

B Background

Key points

The CFD market has experienced significant growth in recent years with a large number of retail investors trading CFDs.

ASIC has been active in the oversight and regulation of the CFD sector through engagement with CFD issuers and CFD industry bodies, as well as a number of regulatory initiatives.

The client money provisions are contained in Div 2 of Pt 7.8 of the *Corporations Act 2001* (Corporations Act). We gave guidance about OTC derivative issuers' client money handling obligations in RG 212.

The CFD sector

- 12 CFDs are highly leveraged derivative products marketed to, and traded by, retail investors. CFDs are essentially a leveraged bet on future changes in the market price of a share or commodity, or the value of an index or a currency exchange rate. With a 'long' CFD, investors are seeking to profit from increases in the market price of a particular asset. With a 'short' CFD, they are seeking to profit from falls in the market price.
- 13 As CFDs are derivatives, investors do not actually invest in the underlying asset, but rather in a contract whose value is determined by reference to the market price of the underlying asset or index.
- 14 Because CFDs are merely a contract between parties (the investor and the CFD issuer), retail investors trading CFDs are exposed to the counterparty risk posed by the AFS licensee issuing the CFDs. Counterparty risk is the risk that the CFD issuer will not meet its obligations to the client under the CFD contract, which may be due to the CFD issuer's insolvency.
- 15 In the case of CFDs, particular counterparty risk arises in respect of client money. This is because, after clients open and fund their trading accounts, they rely on the CFD issuer to properly deal with their money, including keeping clients' money separate from the CFD issuer's own funds.
- 16 As our July 2010 CFD 'health check' Report 205 *Contracts for difference and retail investors* (REP 205) noted, the CFD market has experienced rapid growth in recent years with a large number of retail investors trading the products. Indeed, since we began our surveillance in December 2011, the number of licensed CFD issuers has increased by about one-quarter. Some of these newer CFD issuers were included in our surveillance.

- 17 Consistent with ASIC's mandate to promote confident and informed participation by investors and consumers in the financial system, and to ensure the effective and efficient operation of financial markets, we have sought to improve compliance in the CFD market. In addition to our reactive and risk-based surveillance activities, we have sought to achieve this through:
- (a) RG 212, published in July 2010, which provides an overview of the client money provisions contained in Div 2 of Pt 7.8 of the Corporations Act and encourages better disclosure of client money handling practices;
 - (b) our investor guide *Thinking of trading contracts for difference (CFDs)?*, published in November 2010, which provides retail investors with clear, independent information on CFDs;
 - (c) Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (RG 227), published in August 2011, which aims to improve disclosure and investor awareness of the risks and benefits of CFDs by setting seven benchmarks that CFD issuers should address in their PDSs on an 'if not, why not' basis;
 - (d) revised financial requirements that address the specific risks and characteristics of the CFD sector—published in July 2012 as Regulatory Guide 239 *Retail OTC derivative issuers: Financial requirements* (RG 239), and then subsequently incorporated as Appendix 8 into the updated and restructured Regulatory Guide 166 *Licensing: Financial requirements* (RG 166); and
 - (e) our MoneySmart website (www.moneysmart.gov.au), which provides information for prospective investors on CFDs and other financial products.

Protection of client money

- 18 Our decision to focus our surveillance on the client money handling practices of CFD issuers resulted from our assessment of the various risks specific to the CFD sector. Several key factors highlighted CFD issuers' client money handling practices as a priority for comprehensive review. These factors included:
- (a) the loss of client money, whether by mishandling or misappropriation, is likely to have a severe impact on investor confidence;
 - (b) in July 2010, in RG 212, we issued guidance to CFD issuers on the operation of the client money provisions of the Corporations Act;
 - (c) during 2010–11 we identified eight CFD issuers with client money handling weaknesses or breaches; and

- (d) many CFD issuers outsource or off-shore finance or compliance functions.

Current law and guidance

The client money rules

- 19 The client money provisions protect the interests of clients of AFS licensees (such as CFD issuers) by:
- (a) separating client money from money belonging to CFD issuers;
 - (b) generally requiring that CFD issuers hold client money on trust;
 - (c) limiting the uses of client money;
 - (d) limiting the circumstances in which client money may be withdrawn from client money accounts;
 - (e) specifying how client money may be dealt with if a licensee ceases to be licensed or becomes insolvent;
 - (f) requiring auditors to verify the CFD issuer's compliance with the client money provisions; and
 - (g) imposing sanctions on CFD issuers that fail to comply with the client money provisions.
- 20 As discussed above, RG 212 gives an overview of the client money provisions in Div 2 of Pt 7.8 of the Corporations Act and encourages better disclosure in connection with client money.
- 21 For the purposes of the client money provisions, client money is money paid to an AFS licensee:
- (a) in connection with either a financial service that has been provided (or that will or may be provided) to a client or financial product held by a client; and
 - (b) either:
 - (i) by a client or a person acting on behalf of a client; or
 - (ii) to the licensee in the licensee's capacity as a person acting on behalf of the client.
- 22 The client money provisions do not apply to:
- (a) money paid as remuneration to a licensee;
 - (b) money paid to reimburse (or discharge a liability incurred by) the licensee for payment made to acquire a financial product;
 - (c) money paid to acquire a financial product from the licensee;

- (d) loan money; or
- (e) money paid to be credited to a deposit product.

Note: Section 981A of the Corporations Act describes when the client money provisions apply and when they do not.

- 23 When an AFS licensee receives client money, it must pay the client money into a compliant client money account on the day it is received or on the next business day: s981B.
- 24 A client money account must be designated as a trust account, except in certain limited circumstances where it may be operated as a client segregated account: see reg 7.8.01(5) of the Corporations Regulations 2001 (Corporations Regulations).
- 25 In our guidance, at RG 212.36, we stress the importance of CFD issuers ensuring that they separate client money from their own money. This should allow the clear identification of client money and therefore should assist in the proper distribution of client money in the event of the AFS licensee's insolvency or otherwise ceasing to carry on business.
- 26 CFD issuers are entitled to use client money to meet obligations incurred in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the CFD issuer, including dealings on behalf of people other than the client: s981D. We consider that the permitted use in s981D does not extend to meeting obligations incurred by the AFS licensee's own (or proprietary) trading in derivatives: see RG 212.67.
- 27 CFD issuers are able to pay client money out of client trust accounts for the purpose of investing the client money in permissible investments under reg 7.8.02(2) of the Corporations Regulations.
- 28 However, interest or other earnings on these permitted investments and the proceeds of the realisation of such investments must be dealt with in accordance with the written agreement between the AFS licensee and the client: reg 7.8.02(8) of the Corporations Regulations. See RG 212.43, RG 212.44 and RG 212.47 for more information about this.

General obligations

- 29 As the holder of an AFS licence, CFD issuers must have adequate risk management systems: s912A(1)(h). We consider that effective client money accounting and reconciliation processes are fundamental to risk management for CFD issuers because these serve as the key controls that prevent deficiencies arising in client money accounts.
- 30 Furthermore, all AFS licensees are subject to AFS licence conditions that require them to establish and maintain compliance measures that ensure, as

far as is reasonably practicable, that the licensee complies with the provisions of the financial services laws.

Note: See condition 4 of Pro Forma 209 *Australian financial services licence conditions* (PF 209).

Treasury discussion paper and law reform proposals

- 31 In RG 212, we highlighted a number of risks and concerns in relation to the client money provisions.
- 32 In November 2011, Treasury issued its discussion paper *Handling and use of client money in relation to over-the-counter derivatives transactions*. The discussion paper sought submissions on a number of issues relating to the holding of client money in connection with OTC derivatives transactions, and on whether the client money provisions of the Corporations Act provide sufficient protections for investors. It also put forward four law reform options for comment:
- (a) restrict the use of client money;
 - (b) adopt the approach of the United Kingdom (as set out in the Financial Services Authority's *Client assets sourcebook*);
 - (c) impose a statutory trust fund; and
 - (d) adopt segregated individual accounts.
- 33 Treasury received 105 submissions to its discussion paper, including a confidential submission from ASIC. We continue to assist Treasury in its consideration of the submissions and its development of a law reform proposal.

C Scope of surveillance and methodology

Key points

Our risk-based surveillance tested 40 CFD issuers' compliance with the client money provisions and associated risk management obligations.

In the course of our surveillance, we sought to confirm that CFD issuers maintained rigorous client money handling measures, including performing daily reconciliations.

We gathered information from each of the selected CFD issuers and assessed the adequacy of their practices and policies relating to the handling of client money.

Scope of surveillance

- 34 Our surveillance commenced in December 2011 and comprised reviews of the practices of CFD issuers in three stages. We identified 40 active CFD issuers in the industry for inclusion in the surveillance based on their varying risk profiles. This comprised almost all CFD issuers that we are aware of that were active in the market at the time of the surveillance and comprised an overwhelming share of the total market.
- 35 Using ASIC's compulsory powers, we obtained documents and written responses from CFD issuers in the following key areas:
- (a) details of the client money accounts held, including whether the accounts are held at an Australian authorised deposit-taking institution (Australian ADI), designation of the accounts and the amounts held in the accounts;
 - (b) the extent to which the CFD issuer uses client money, including as collateral for hedging, and the discretions the CFD issuer has in its client agreements to do so;
 - (c) the extent to which the CFD issuer invests client money;
 - (d) whether the CFD issuer pays interest on client money;
 - (e) the extent to which the CFD issuer has adequate processes and policies in place for reconciling client money accounts; and
 - (f) how the CFD issuer manages and resolves unreconciled variances in its client money accounts.
- 36 It is important to note that our surveillance did not include an audit of the balances held in the client money accounts. We note that CFD issuers that

hold client money must have their accounts audited by an ASIC registered auditor. As such, it was not within the scope of this review to examine and substantiate the actual holdings in each client money account.

Surveillance methodology

- 37 While our reviews were predominantly desk-based, we also conducted follow-up meetings with CFD issuers to obtain further information and clarification of certain matters. Most often, this involved a ‘walk-through’ of the CFD issuer’s client money reconciliation process.

D Industry characteristics

Key points

There appears to have been a 46% increase in the amount of client money held by CFD issuers from early 2009 to the time period of this surveillance.

Only 22% of total client accounts are actively traded.

The margin utilisation rate across the CFD sector (client margins as a proportion of total client money held) is only 11%.

A large number of CFD issuers outsource or off-shore important control and oversight functions to external third parties and foreign parent companies.

Industry snapshot

- 38 CFD issuers managed approximately \$511 million of client money, which is a significant increase from early 2009, when industry consultation undertaken by ASIC indicated that CFD issuers held approximately \$350 million of client money.
- 39 Table 3 provides a snapshot of the CFD industry, based on industry data gathered during our surveillance.

Table 3: Characteristics of the CFD industry

Factor	
Total number of client accounts	231,725
Active client accounts	51,800
% of client accounts that are active	22%
Total client money held	\$511 million
Client margins held	\$55 million
Client 'free equity' held	\$456 million
Margin utilisation	11%

Note: Client money figures are from 24 November 2011. Information about client accounts was collected throughout our surveillance and does not relate to a particular date. 'Active client accounts' are accounts that had been traded in the last three months. 'Margin utilisation' is client margins divided by total client money held. 'Free equity' is excess cash in client accounts that could be used as margins to support client trading.

Market share

- 40 Most CFD issuers have a very low market share. Indeed, many CFD issuers had been operating for only a short time when we approached them in our surveillance. This suggests that, in recent years, the growth in the number of CFD issuers has not been matched by an equivalent rise in the uptake of CFD products by retail investors.
- 41 We found that the top 10 CFD issuers hold 88% market share by number of client accounts and 90% by client money held. The top five CFD issuers alone hold 70% market share by number of client accounts.

Active and inactive accounts

- 42 The number of active accounts we observed is broadly similar to the numbers cited in other publications about the CFD market. This leaves a very high proportion of inactive accounts. We believe this may be a result of:
- (a) subdued market conditions;
 - (b) promotions that attract clients to sign up and activate an account, but fail to induce clients to actively trade;
 - (c) a tolerance within the CFD sector for the maintenance of dormant accounts; and
 - (d) the ability of clients to easily open and hold CFD trading accounts with multiple CFD issuers.
- 43 CFD issuers are earning significant interest income from client 'free equity' balances. This income supplements CFD issuers' income from commissions, spreads and overnight financing fees.

Leverage and margin utilisation

- 44 Clients are, on average, trading with much lower rates of leverage than the minimum rates offered (and advertised) by CFD issuers. The average margin utilisation of the CFD issuers reviewed was found to be 11%, measured as client margins divided by total client money held.
- 45 We note, however, that we conducted our surveillance during a period of subdued activity in the CFD industry and relatively flat performance in the market generally. Therefore, if market conditions improve, we would expect that the amount of client money held by CFD issuers would also increase, along with the volume of client trading and leverage rates.

Outsourcing and ‘off-shoring’

- 46 We observed that the industry has relatively high rates of outsourcing of important control and oversight functions to external third parties or off-shoring to foreign parent companies: see Table 5 in Section E. In part, this is due to the high incidence of CFD issuers being part of international groups. However, the practice of outsourcing was also evident among many small CFD issuers that outsource key functions to third party service providers.

E Client money handling practices and contraventions

Key points

Our surveillance on client money handling practices revealed that:

- about half of CFD issuers use client money as collateral for hedging their exposure to client trades;
- two CFD issuers (5%) made use of a novel and complex arrangement, which they described as a ‘protection trust’; and
- CFD issuers commonly invest a portion of clients’ ‘free equity’ in term deposits—however, arrangements to share (or not share) the interest or other income from the investment of client money differed from CFD issuer to CFD issuer.

A concerning number of CFD issuers had either failed to designate their client money accounts as trust accounts or failed to pay client money into a compliant trust account within the required time, and five CFD issuers (13%) failed to comply with both of these basic requirements. We worked with issuers to ensure the breaches were rectified promptly.

Client money handling practices

Use of client money as collateral

- 47 About half of CFD issuers use client money as collateral for hedging their exposure to client trades. This was fewer than we had anticipated. Some of the CFD issuers that did not use client money for hedging had a smaller client base and were in the ‘start-up’ phase of their business. Given it is more costly for CFD issuers to use their own capital to hedge trades as their businesses expand, these smaller CFD issuers may consider using client money as collateral to hedge client trades in future.
- 48 We also noted that many of the larger, more established CFD issuers did not make use of client money as collateral to hedge client trades, but used their own capital to do so.
- 49 Since March 2012, a CFD issuer should disclose in its PDS whether it makes available its policy on client money handling and use. CFD clients should read the client money handling policy outline and associated risk disclosure in their CFD issuer’s PDS to understand and ensure they are comfortable with their CFD issuer’s arrangements. This includes whether the CFD issuer uses client money as collateral for hedging purposes. Further information to

help clients to understand risks to client money is available in our investor guide *Thinking of trading contracts for difference (CFDs)?*, available from our MoneySmart website at www.moneysmart.gov.au.

Use of protection trusts

- 50 We identified two CFD issuers (5%) that used what they described as ‘protection trusts’ to hold client money. According to these CFD issuers, the transfer of client money into protection trusts provides an additional level of protection to clients.
- 51 Importantly, the CFD issuers that use protection trusts also limit the recourse of their clients on counterparty’s insolvency to the extent the CFD issuer can recover from that counterparty. Consequently, the CFD issuer would not be liable for any money owed to clients in excess of the amount recovered. The limited recourse clause underpinning the arrangement between the client and the AFS licensee effectively shifts the CFD issuer’s counterparty risk to its hedge counterparty onto the client.
- 52 We observed that CFD issuers using a protection trust pay client money out of the client money account based on a standing written direction given by the client for the purpose of reg 7.8.02(1)(a) of the Corporations Regulations. They pay that money either to their hedge counterparties as collateral to support client trading or into a specific bank account subject to the protection trust.
- 53 These CFD issuers say that the protection trust is intended to crystallise in the event of the bankruptcy of the CFD issuer, and money in the protection trust account—along with money recouped from counterparties—should be paid to clients under the protection trust.
- 54 The protection trusts we have observed are complex and highly technical arrangements, and we do not express a view as to whether they will achieve their stated aims.
- 55 Given the complexity of these protection trust arrangements, CFD issuers may find it challenging to explain the nature of protection trust arrangements and associated risks in their PDSs in a clear, concise and effective manner.
- 56 Moreover, it may be particularly challenging for clients to fully comprehend the characteristics, benefits and attendant significant risks of the product, including those relating to a protection trust. Consequently, it may be beneficial for clients to seek advice in order to assess the risk that these arrangements may not operate as intended on insolvency, which may expose the client to loss of all, or part, of their client money.

Investment of client money

- 57 As we explained in Section B of this report, issuers can pay client money out of client trust accounts for a number of reasons. This includes investing the client money in permitted investments, under reg 7.8.02(2) of the Corporations Regulations.
- 58 We identified a number of CFD issuers that invested client money in term deposits held with Australian ADIs making use of the reg 7.8.02(2) permission. Some CFD issuers designated the term deposit accounts into which they paid client money as client trust accounts for the purpose of s981B and, therefore, they did not need to make use of the reg 7.8.02(2) permission.
- 59 Investment of client money in term deposits is enabled by the large sums of free equity held by CFD issuers. While the investment of client money in this manner is permitted under reg 7.8.02, it is important that CFD issuers ensure they can access sufficient client money when required.
- 60 We noted that, although client money was held in term deposits, the terms of the arrangements typically allowed CFD issuers to access the money in a timely manner. Furthermore, CFD issuers do not appear to believe they need ready access to all, or a large majority of, the client money.
- 61 We found that all CFD issuers had given disclosure and obtained the client's written agreement to the proposed means of investing client money.
- 62 The approach taken to handling the interest earned from investing in client money varied across CFD issuers, with arrangements to pass on to clients or retain investment income differing from CFD issuer to CFD issuer.
- 63 Clients should consider the opportunity costs associated with leaving large amounts of free equity in a CFD issuer's client money account.
- 64 Clients should not consider leaving money in a client money account with a CFD issuer as equivalent to placing money on deposit at a bank. Leaving excess funds in a CFD issuer's client money account exposes the client to counterparty risks, including potential losses in the event of a CFD issuer's insolvency. In part this is because issuers may pay client money out of client trust accounts: see Section B. In extreme cases, client money may also be subject to misuse or misappropriation.

Contraventions of the client money provisions

Our approach to rectifying contraventions

- 65 Overall, we took a facilitative and educative approach to working with CFD issuers to resolve any contraventions of the client money provisions identified during our surveillance.
- 66 On each occasion where we identified contraventions, we drew these concerns to the CFD issuer's attention and sought prompt rectification. In most cases, CFD issuers resolved breaches in a timely manner.
- 67 At the midpoint of our surveillance in May 2012, we issued Media Release (12-108MR) *ASIC highlights compliance concerns in client money handling*. In the media release we raised concerns about non-compliant client money handling practices. This report builds on the interim findings set out in that media release.
- 68 In light of our media release and this report, we now see no reason why CFD issuers should not be fully aware of their obligations in respect of client money handling. We would therefore be highly concerned about any issuer that failed to meet these obligations in future and would look to take regulatory action, including enforcement action, if warranted, in such cases.

Nature of contraventions identified

- 69 A concerning number of the breaches we identified were of an elementary nature in that the failings constituted a basic failure to comply with client money rules, such as not paying client money into a client money account on the day of receipt or on the next business day. Table 4 provides a summary of the outcomes identified and resolved by CFD issuers at our instruction.

Table 4: Contraventions of the client money provisions

Issue	Number of CFD issuers	Percentage of CFD issuers
Failure to properly designate client accounts as trust accounts	18	45%
Failure to pay client money into a compliant account by the next business day following receipt	11	28%

- 70 The contraventions were identified in both well established CFD issuers as well as firms that had only recently commenced operating. We also observed that there appeared to be some correlation between outsourced or off-shored functions (see Table 5) and compliance breaches and concerns.

Table 5: Outsourced and off-shored functions

Function	Total outsourced	External third party	Intra-group/off-shore
Compliance	9 (23%)	5 (13%)	4 (10%)
Finance (back office)	11 (28%)	3 (8%)	8 (20%)

Designation and segregation of client money as trust account

- 71 An AFS licensee must designate its client money accounts as trust accounts under reg 7.8.01(5)(b) of the Corporations Regulations unless an exception applies. This requirement was breached by a considerable number of CFD issuers.
- 72 Unless some other appropriate and effective means of designation is used, we consider that the name of the client trust account should contain the words 'client trust account' or wording to that effect. This is important to ensure that, in the event of CFD issuer insolvency, the client money is protected.
- 73 We found that 18 CFD issuers (45%) had not named their client money accounts as trust accounts.
- 74 In those cases, we queried how the CFD issuers had met the designation requirements under the client money provisions. These CFD issuers were unable to point to any alternative means of designation. Consequently, they worked with us to reflect the required designation in the naming of their client trust accounts.
- 75 Some CFD issuers had claimed their failure to properly designate their client money accounts as trust accounts was due to difficulties in arranging for their bank to include 'client trust' in the name of the accounts. However, we found that these CFD issuers were usually able to have the designation reflected in the name of the bank accounts once prompted to do so.

Timely payment of client money into a compliant account

- 76 We found that 11 CFD issuers (28%) did not pay client money into a compliant client money account on the day of receipt or on the next business day, as required under s981B(1). This requirement is an important protection which limits the potential for a CFD issuer's insolvency to result in loss of client money held by the CFD issuer.
- 77 The failure to pay client money into a client money account in a timely manner was typically driven by the use of third party credit card payment facility providers to receive client deposits. After receiving client deposits through these payment facility providers, the CFD issuers then failed to

ensure funds were transferred to a s981B-compliant account within the required timeframe.

- 78 It appears the use of payment facility providers is driven by the preferences of off-shore clients who prefer using them as a payment mechanism, instead of making a bank transfer. Interestingly, many CFD issuers expressed a dislike of these facilities but saw value in them from a commercial perspective in order to satisfy client needs.
- 79 We worked with contravening CFD issuers to ensure that, where they continued to use such payment facilities, they paid client money into a client money account on the day of receipt or on the next business day.

F Weaknesses in the reconciliation of client money accounts

Key points

CFD issuers' reconciliation practices differed significantly based on factors such as the maturity of the business and quantum of client money.

We did not discover any CFD issuers that had unreconciled variances or deficiencies in client money accounts.

However, 15% of CFD issuers did not perform daily reconciliations of client money accounts, 13% did not have adequate segregation of duties, and 48% did not have a documented process for escalating reconciliation issues.

80 Table 6 highlights our key findings on the weaknesses in the processes in place for reconciling client accounts.

Table 6: Client money reconciliation weaknesses

Issue	Number of CFD issuers	Percentage of CFD issuers
Client money reconciliations not performed on a daily basis	6	15%
Inadequate segregation of duties	5	13%
No formal escalation process for reconciliation issues	19	48%

81 Where we found that the CFD issuer was not performing client money reconciliations daily, or were not satisfied that there was a sufficient segregation of duties within the CFD issuer's back office, we raised concerns with the CFD issuers who then agreed to implement changes to their processes.

82 In the course of reviewing CFD issuers' reconciliation reports, we did not identify any reports that highlighted deficiencies in CFD issuers' client accounts, or where there were significant unreconciled items. Previously, we have identified that the existence of unreconciled items and client money deficiencies can indicate misuse of client money.

83 As mentioned in Section C, we did not conduct an audit of the client money accounts and so cannot offer any assurance that there are no such

deficiencies. Our focus was centred on the adequacy of the reporting and the policy and procedures supporting the reconciliation process.

- 84 Client money reconciliations were generally conducted on an equity basis as opposed to a purely deposit and withdrawal basis. This means the CFD issuer used the liquidation value of the positions held by clients (taking into account clients' mark-to-market profits and losses) as the basis for determining whether it held sufficient funds in its client money accounts. This is the appropriate basis for conducting reconciliations because it better reflects the CFD issuer's financial position and the amount actually owed to clients than a deposit and withdrawal-based reconciliation.

Frequency of reconciliations

- 85 The vast majority of CFD issuers performed daily reconciliations of client money accounts.
- 86 There were six CFD issuers (15%) that did not perform reconciliations on a daily basis. We found that these issuers were generally small, start-up operations that used more limited reconciliation methods due to the small number of accounts. In these cases, we encouraged the CFD issuers to implement daily reconciliations. We stressed that, as the CFD issuer grows and the sum of client money received increases, it becomes even more important to implement daily reconciliation processes.
- 87 As an AFS licensee, a CFD issuer must have adequate risk management systems: s912A(1)(h). We consider the discipline of daily reconciliations to be an important risk management practice to ensure there are adequate checks in place to identify and resolve client money account deficiencies in a timely manner.

Segregation of duties

- 88 Overall, most CFD issuers had adequate segregation of duties between the personnel performing the reconciliations and the personnel responsible for signing off on the reconciliation reports. Adequate segregation of duties is an important aspect of maintaining and ensuring a robust system of review. We consider it prudent to minimise any potential for conflicts of interest or oversight failures by maintaining clear ownership of duties in conducting client money reconciliations.
- 89 We identified five CFD issuers (13%) that did not have adequate segregation of duties—that is, the same staff member may have both conducted and reviewed the reconciliation, or staff members responsible for conducting the

reconciliation may also have been responsible for processing client deposits and withdrawals.

- 90 Where we identified concerns about the adequacy of segregation of duties, CFD issuers cooperated with us to promptly implement changes.

Escalation of variances

- 91 We found that 19 CFD issuers (48%) did not have a documented process for escalating reconciliation issues. We regard the implementation of a formal process for escalating unreconciled variances to be good practice because documented policies help staff by informing them when, and to whom, they must escalate issues. Therefore, we strongly encouraged those CFD issuers who did not already have a documented process for dealing with reconciliations variances to consider incorporating one into their compliance policies.
- 92 Most CFD issuers received this feedback constructively and either promptly took action to implement a documented policy for dealing with reconciliation variances or agreed to consider our recommendations further.

Ongoing regulatory activities

- 93 We trust that this report and our earlier media release (12-108MR) have highlighted to industry the importance of maintaining robust systems for client money handling.
- 94 As we noted in Section E, we took a collaborative approach to resolving breaches of client money handling rules in the course of this surveillance. This focused on speedy resolution of breaches and prompting issuers to improve practices so that similar breaches do not occur in future. However, in light of this report, we consider there is now no excuse for issuers to be unaware of their legal obligations for handling client money.
- 95 We will continue to monitor compliance within the CFD sector, with client money handling practices remaining a focus of our regulatory activities. We anticipate taking strong action in response to any future breaches of client money rules, especially where any breaches are not self-reported to ASIC.

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.
ASIC	Australian Securities and Investments Commission
Australian ADI	An authorised deposit-taking institution within the meaning of the <i>Banking Act 1959</i> or a person who carries on state banking within the meaning of paragraph 51(xiii) of the Constitution Note: This is a definition contained in s9.
CFD	Contract for difference or a margin foreign exchange contract
CFD issuer	An AFS licensee that issues over-the-counter (OTC) contracts for difference (CFDs) or margin foreign exchange contracts to retail clients
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
derivative	Has the meaning given in s761D
financial product	Generally, 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"> • makes a financial investment (see s763B); • manages financial risk (see s763C); or • makes non-cash payments (see s763D) Note: See Div 3 of Pt 7.1 for the exact definition.
financial service	Has the meaning given in Div 4 of Pt 7.1
OTC derivative	A derivative that is entered into over the counter and not through a licensed market

Term	Meaning in this document
PDS	Product Disclosure Statement
Pt 7.8	A part of the Corporations Act (in this example numbered 7.8)
reg 7.8.01	A regulation in the Corporations Regulations (in this example number 7.8.01)
RG 212	An ASIC regulatory guide (in this example number 212)
s981D	A section of the Corporations Act (in this example numbered s981D)

Related information

Headnotes

client money, client money account, clients' segregated account, CFDs, contracts for difference, over-the-counter derivatives, risk disclosure, trust account

Pro forma

PF 209 *Australian financial services licence conditions*

Regulatory guides

RG 212 *Client money relating to dealing in OTC derivatives*

RG 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors*

RG 166 *Licensing: Financial requirements*

Legislation

Corporations Act, Div 2 of Part 7.8, s912A, 981A, 981B and 981D

Corporations Regulations, regs 7.8.01 and 7.8.02

Cases

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

Consultation papers and reports

CP 114 *Client money relating to dealing in OTC derivatives*

REP 205 *Contracts for difference and retail investors*

Media and other releases

12-108MR *ASIC highlights compliance concerns in client money handling*
(30 May 2012)

Investor guide

Thinking of trading contracts for difference (CFDs)?

Other publications

Treasury discussion paper *Handling and use of client money in relation to over-the-counter derivatives transactions*, November 2011

UK Financial Services Authority *Client assets sourcebook*, October 2010