EXPLANATORY STATEMENT

Issued by authority of the Minister for Revenue and Financial Services

Corporations Act 2001

Corporations Amendment (Client Money) Regulations 2017

Subsection 1364(1) of the *Corporations Act 2001* (the Corporations Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed by such regulations, for carrying out or giving effect to the Act.

Paragraph 981C(a) of the Corporations Act provides that the regulations may deal with the circumstances in which payments may be made out of an account (including circumstances in which money may be withdrawn and invested, and the kinds of investment that may be made) maintained for the purposes of section 981B of the Corporations Act.

The purpose of the *Corporations Amendment (Client Money) Regulations 2017* (the Client Money Regulations) is to provide greater protection for retail client money held by Australian financial services licensees (AFS licensees). Together with the *Treasury Laws Amendment (2016 Measures No. 1) Act 2017* (Client Money Act), which strengthened client money protections in the Corporations Act, these amendments align the Australian client money regime with community expectations regarding the level of protection that should be afforded to retail consumers of complex financial products and services. Further detail about the amendments in the Client Money Act is set out in Attachment B.

In particular, the Corporations Act and the *Corporations Regulations 2001* (Corporations Regulations) specify designated accounts into which client money must be deposited, how money can be invested and the circumstances under which the licensee may withdraw client money from designated accounts. Section 981H of the Corporations Act provides that client money is held on trust by the licensee for the benefit of the client.

Regulation 7.8.02 of the Corporations Regulations allows payments to be made out of designated client money accounts in certain circumstances, including:

- making a payment to, or in accordance with the written direction of, a person entitled to the money; and
- paying to the AFS licensee money to which the AFS licensee is entitled.

Under this regulation, some AFS licensees obtain broad authorisations in their client agreements and product disclosure statements to make withdrawals from client money accounts for any purpose, including as working capital and for proprietary trading.

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Once money has been withdrawn from client accounts it ceases to be protected by the statutory trust, thereby exposing clients to higher levels of counterparty risk. That is, there is a higher risk that clients may not be able to recover their money if there is a deficit in the client money account and the AFS licensee becomes insolvent or is otherwise unable to pay the deficiency.

Counterparty risk is of particular concern in markets for derivatives, due to the complexity of evaluating counterparty risk in that context, and exceptions to the limitations in the Corporations Act on the use of money related to derivatives or a dealing in a derivative.

The use of derivatives has developed beyond what was contemplated when the existing client money regime came into effect. For example, at that time, it was uncommon for retail clients to deal in over-the-counter derivatives. This is no longer the case.

Wholesale clients typically have substantial experience dealing in derivatives and the capacity to assess risks associated with the use of their money. However, when providing authorisations to withdraw moneys from their accounts, retail clients may not understand or appreciate the risks associated with their client money being used for any purpose of the AFS licensee. Thorough assessment and evaluation of counterparty risk in derivatives markets is complex, and cannot be reasonably expected of retail clients. The changes contained in the Client Money Regulations ensure retail client money is appropriately protected.

The Client Money Regulations prevent payments being made out of a client account to the extent that the relevant direction or entitlement allows the AFS licensee to use derivative retail client money:

- as the AFS licensee's capital, including working capital;
- for the purpose of meeting obligations incurred by the AFS licensee other than on behalf of the client; or
- for the purpose of hedging the licensee's exposures arising from its transactions with the client.

The amendments made by the Client Money Regulations apply in relation to payments made, on or after the commencement of the Client Money Regulations, out of an account maintained for section 981B of the Corporations Act, whether the relevant direction or entitlement was given before, on or after that commencement.

Details of the amendments are contained in Attachment A.

A policy paper on the proposed changes, 'Enhanced Protection of Client Money', was released for public consultation on 22 December 2015. An exposure draft of the proposed legislative amendments was released for public consultation on 29 February 2016. Forty-nine submissions were received.

Almost all stakeholders agreed that retail client monies should be better protected; and with the proposals to increase reporting and reconciliation, and prohibit the use of retail client money as AFS licensees' working capital.

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However, there were divergent views about how best to protect client money.

Stakeholders including the Australian Securities and Investments Commission (ASIC) and a number of industry representatives strongly supported the proposed reforms; while others, including a subset of AFS licensees that issue over-the-counter retail derivatives, sought a compromise in order to mitigate potential impacts on their profitability.

Following careful consideration of these submissions, Treasury officials met with a range of stakeholders to explore issues raised and to test potential refinements.

The Government ultimately determined that the amendments should proceed as drafted, as none of the alternatives would have given retail clients sufficient protection. However, the start date of the reforms was deferred by 12 months (from Royal Assent of the Client Money Act 2016) to give affected licensees time to adjust.

There are no conditions that must be satisfied before the power to make the Client Money Regulations is exercised.

A statement of compatibility with human rights is set out in Attachment C.

A Regulatory Impact Statement (RIS) has been prepared in respect of the amendments made by the Client Money Regulations and Schedule 5 to the Client Money Act. The Office of Best Practice Regulation has confirmed that a separate RIS for the Client Money Regulations is not required. The RIS is set out in Attachment D.

The Client Money Regulations commence at the same time as Schedule 5 to the Client Money Act. Schedule 5 to the Client Money Act commences 12 months after Royal Assent.

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ATTACHMENT A

Details of the *Corporations Amendment (Client Money) Regulations 2017*

Section 1 – Name of the Regulations

This section provides that the name of the regulations is the *Corporations Amendment (Client Money) Regulations 2017* (Client Money Regulations).

Section 2 – Commencement

The Client Money Regulations commence at the same time as Schedule 5 of the *Treasury Laws Amendment (2016 Measures No. 1) Act 2017* (Client Money Act).

The Client Money Regulations use the new definition of 'derivative retail client money' inserted into section 761A of the *Corporations Act 2001* (Corporations Act) by the Client Money Act. This commencement provision ensures that the new definition is in force when the Client Money Regulations commence.

Section 3 – Authority

The Client Money Regulations are made under the Corporations Act.

Section 4 – Schedules

Item 1

The Client Money Regulations amend the *Corporations Regulations 2001* (Corporations Regulations) to limit the ways in which Australian financial services licensees (AFS licensees) can use derivative retail client money.

Paragraphs 7.8.02(1)(a) and (c) of the Corporations Regulations allow payments to be made out of client accounts of AFS licensees for the following purposes:

- making a payment to, or in accordance with the written direction of, a person entitled to the money; and
- paying to the AFS licensee money to which the AFS licensee is entitled.

Item 1 adds a clause at the end of each of those paragraphs making it clear that they only operate subject to the restrictions imposed in new regulation 7.8.02A.

Item 2

Item 2 inserts a new regulation 7.8.02A after regulation 7.8.02 that prevents payments being made out of a client account to the extent that any written direction given by a client (as set out in paragraph 7.8.02(1)(a)) or entitlement (as set out in paragraph 7.8.02(1)(c)) allows the AFS licensee to use derivative retail client money:

- as the licensee's capital, including working capital;

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- for the purpose of meeting obligations incurred by the AFS licensee other than on behalf of the client; or
- for the purpose of entering into, or meeting obligations under, transactions that the AFS licensee enters into to hedge, counteract or offset the risk to the AFS licensee associated with a transaction between the AFS licensee and the client.

This means that client money cannot be used for these three purposes, which narrows the scope of uses to which client moneys can be put and reduces the risk to retail clients of losing their money, especially in cases of insolvency of AFS licensees.

Item 3

Item 3 inserts an application provision in Part 10.26 of the Corporations Act providing that the Client Money Regulations apply in relation to payments made, on or after the commencement of the Client Money Regulations, out of an account maintained for section 981B of the Corporations Act, whether the relevant direction or entitlement was given before, on or after that commencement.

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ATTACHMENT B

Summary of amendments made in Schedule 5 of the *Treasury Laws Amendment (2016 Measures No. 1) Act 2017*

Schedule 5 to the *Treasury Laws Amendment (2016 Measures No. 1) Act 2017* (Client Money Act) makes amendments to the *Corporations Act 2001* (Corporations Act) to provide that Australian financial services licensees (AFS licensees) may only use derivative retail client money or property to meet an obligation where:

- the entry into of the derivative is cleared through:
  - a licensed clearing and settlement facility; or
  - a clearing and settlement facility, the operator of which is authorised to operate the facility in a foreign country in which the operator's principal place of business is located, and that meets any requirements specified in regulations; and
- the AFS licensee incurred the obligation, in connection with the derivative, under the operating rules of the clearing and settlement facility.

Definition of derivative retail client money

Schedule 5 to the Client Money Act inserts a new definition of 'derivative retail client money' into section 761A of the Corporations Act.

'Derivative retail client money' is money paid to a financial services licensee by or on behalf of a client in connection with:

- a financial service that:
  - has been, will or may be provided to the client; and
  - is or relates to a dealing in a derivative; or
- a financial product that is a derivative; and
- the financial service or product would be provided to the client as a retail client if the service or product were provided to the client when the money was paid.

For the purposes of the definition of 'derivative retail client money', Schedule 5 provides that 'retail client' includes clients who are sophisticated retail investors as set out in section 761GA. This ensures that the sophisticated investor carve-out contained in section 761GA cannot be exploited to circumvent the amendments in the Client Money Act and the *Corporations Amendment (Client Money) Regulations 2017*. While sophisticated investors are generally high net worth individuals, like other retail clients, they may not always have the requisite knowledge of complex financial services such as derivatives to adequately evaluate the risks associated with how licensees use derivative retail client money.

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ASIC client money rules

Schedule 5 allows the Australian Securities and Investments Commission (ASIC) to make rules in relation to the reporting and reconciliation of derivative retail client money by AFS licensees.

The amendments made by Schedule 5 to the Client Money Act commence 12 months after receiving Royal Assent. The *Corporations Amendment (Client Money) Regulations 2017* will also commence at that time.

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ATTACHMENT C

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Corporations Amendments (Client Money) Regulations 2017

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

The *Corporations Amendments (Client Money) Regulations 2017* prevent payments being made out of a client account to the extent that the relevant direction or entitlement allows the AFS licensee to use derivative retail client money:

- as the licensee's working capital;
- for the purpose of meeting obligations incurred by the licensee other than on behalf of the client; or
- for the purpose of entering into, or meeting obligations under, transactions that the licensee enters into to hedge, counteract or offset the risk to the licensee associated with a transaction between the licensee and the client.

Human rights implications

This Legislative Instrument does not engage any of the applicable rights or freedoms.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.

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Regulation Impact Statement

Executive Summary

What is client money?

1.1 Client money is money paid to an Australian financial services licensee (AFSL) by or on behalf of a client in connection with:

- a financial service that has been, or may be provided; or
- a financial product held by the client;

but not as payment for that service or product.[1] It remains the client's own money, although it is held by their AFSL. For example, client money may be paid to meet opening and margining requirements for a trading account.[2]

1.2 The Government is concerned about the use of a particular type of client money: that which is associated with dealings in over-the-counter (OTC) derivatives (referred to in this document as 'derivative client money').

1.3 OTC derivatives are contracts between two parties which derive their value from shifts in the value of an object in the underlying market (such as assets, indexes or interest rates). They are privately negotiated without going through an exchange or other intermediary.

What is the problem the Government is trying to solve?

1.4 The Government wants to change the way client money in relation to derivatives is regulated in Australia because the regime no longer meets the needs of financial services consumers.

1.5 The current regulatory framework does not adequately protect retail clients, as it exposes their OTC derivative client money to risks of which they are likely unaware.

1.6 While most client money in Australia is to be held in trust for the client,[3] AFSLs can use derivative client money in a broad range of ways – for their own and other clients' purposes. It is commonly used to hedge the risks that a broker takes when it issues OTC derivatives to its clients, and can be lost or delayed in the event that an AFSL becomes insolvent.

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[1] It is money paid by the client; or by a person acting on behalf of the client; or to the licensee in the licensee's capacity as a person acting on behalf of the client. See s981A of the Corporations Act for the full definition.

[2] AFSLs may also hold property on their clients' behalf. Aside from being a different type of asset, client property has the same characteristics as client money for the purposes of regulation. See s984 of the Corporations Act for the full definition. References to client money in this document should be taken to include client property unless it is explicitly excluded.

[3] But for a specific set of instances in which it may be withdrawn (see s981A of the Corporations Act and 7.8.02 of the Corporations Regulations).

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1.7 Consequently there is a risk that clients may not receive all of their client money back if there is a deficit in the client money account and the AFSL holder becomes insolvent.

Why is Government action needed?

1.8 Investor confidence depends on robust and responsive regulation of the financial system. Inappropriate risk must be dealt with swiftly and poor design remedied.

1.9 The ASIC as the financial services regulator is unequivocal about the need for reform.

1.10 While many AFSLs have taken it upon themselves to protect retail derivative client money as standard practice, this is not universal and will not become so without regulatory change. Without such reform, retail clients will continue to suffer unnecessary (and often unexpected) losses in the event that their AFSL becomes insolvent.

What policy options are the Government considering?

1.11 To better protect retail clients, the Government has considered prohibiting AFSL use of derivative client money; continuing to allow AFSLs to use derivative client money to hedge, provided there are safeguards in place; and maintaining the status quo.

What is the likely net benefit of each option?

1.12 Prohibiting AFSLs' use of retail OTC derivative client money may affect the viability of some AFSLs, particularly those that are thinly resourced (above the regulatory minimum). However, client money will be much safer – and investor confidence in the industry is likely to increase. On balance, the Government believes this option has the highest net benefit.

1.13 Hedging with safeguards should not have a significant impact on AFSLs, would improve AFSL resilience and limit the ways in which client money can be used.

1.14 Maintaining the status quo would not have much impact on AFSLs in the short term (although inadequate regulation may affect its reputation in the longer term), and consumer protection would continue to be inadequate.

Who will the Government consult, and how will it consult them?

1.15 The Government has consulted extensively on its reform package. In late 2015 and early 2016, the Government sought public comment on a policy paper, draft legislation and regulation. Since then, officials have met with a broad range of stakeholders – including AFSLs, regulators and other experts – to explore and test the case for change.

What is the best option from those considered?

1.16 The Government proposes to amend several aspects of the Corporations Act and Corporations Regulations to create a more tailored and contemporary client money regime that prohibits AFSL use of retail OTC derivative client money for their own and other clients' purposes.

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1.17 This final assessment - second pass Regulatory Impacts Statement (RIS) considers public feedback, evaluates alternative paths for reform, and explains why the Government remains confident that its proposed approach (with minor refinements) is the most appropriate solution.

How will the Government implement and evaluate its chosen option?

1.18 The final chapter recommends a careful approach to implementation. The Government will seek ASIC's assistance in monitoring the impacts of reform, and advice on mitigation as needed. The Government has also included a one year transition period to allow industry to adjust.

Glossary

Term	Definition
Australian Financial Services Licensee (AFSL)	A business licensed by ASIC to provide financial services.
BCBS-IOSCO framework for non-centrally cleared derivatives	The Basel Committee on Banking Supervision and International Organisation of Securities Commissions' *Margin Requirements for Non-centrally Cleared Derivatives* (the BCBS-IOSCO framework) is designed to reduce the potential for contagion from the default of a market participant by ensuring that OTC derivatives exposures have enough collateral. In addition, by bringing bilateral risk management practices more into line with those used in central clearing, the framework should improve transparency and risk comparisons, and promote central clearing for derivatives that meet the preconditions for safe and reliable clearing.
Broker	A party that arranges transactions between a buyers and sellers (typically on commission basis).
Client money	In broad terms, client money is money paid to a financial services provider in connection with a financial service or financial product, but not as remuneration to acquire that service or product. With specific regard to OTC derivatives, client money is commonly money deposited with issuers (by investors) to meet the requirements associated with trading in these products, such as margining.
Collateral	Collateral is a borrower's security against a repayment obligation, such as a loan (or open OTC derivative position). Collateral serves as protection for the lender (or issuer) against the borrower's or investor's default (failure to meet their repayment obligation).
Contract-for-difference (CFD)	A common retail OTC derivative whose value is based on the difference between the current value of an asset (such as a share) and its value at the time the CFD is closed out.
Counterparty	Counterparties are parties that face each other during a transaction.
Counterparty credit risk	Counterparty credit risk is the risk one party to a contract faces that another party to that contract will not meet their contractual obligations.
Derivative	A financial product whose value is based on (derived from) the change in value of an underlying asset, index or other object. See s761D of the Corporations Act.
Exchange	A licenced financial market accessible to retail consumers where financial products are bought and sold. For example, the Australian Securities Exchange (ASX).

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Term	Definition
Futures	A (standardised) exchanged-traded contract between two parties to buy or sell a specified asset at a specific point in the future for a price agreed now.
Hedge	An investment position intended to offset the potential losses (or gains) associated with another investment.
Issuer	An issuer is an AFSL that issues retail OTC derivatives to investors.
Margin forex	A common retail OTC derivative the value of which is based on the changes in exchange rates between the opening and the closing of the contract.
Margining	Margining is the process of exchanging collateral to protect against counterparty credit risk in financial contracts and is a key component of risk reduction strategies. It is intended to reduce the kind of contagion and spill-over effects experienced in the GFC, by ensuring that collateral is available to offset losses caused by the default of a derivative counterparty. The collateral exchanged can be by way of direct transfer of, or granting security over, certain assets.
Options	A derivative that represents a contract sold by one party (option writer) to another party (option holder). Options can be exchange-traded or OTC.
Prime broker	An investment bank that offers hedging services to issuers. The use of a prime broker enables issuers to hedge their investor OTC derivatives position with a counter party (typically on a net basis).
Product Disclosure Statement	A document (prepared by the issuer) that must be provided to the investor (by the issuer) and sets out the essential features of the financial product (in this case, the OTC derivative).
Retail client	A retail client is a person as identified in section 761G of the Corporations Act. Generally speaking, retail clients are individuals or small businesses.
Retail over-the-counter (OTC) derivative	Retail OTC derivatives are a flexible derivative that is bilaterally negotiated between a retail investor and an issuer, such as a CFD.
Sophisticated investor	A sophisticated investor is an investor as defined in section 708(8) of the Corporations Act. An AFSL is exempt from providing disclosure documents to an investor classified as a sophisticated investor.
Wholesale client	A financial product or service is provided to a person as a retail client unless subsections 761G(5), 761G(6), 761G(6A) or 761G(7), or s761GA, provides otherwise. A financial product or service is provided to, or acquired by, a person as a wholesale client if it is not provided to, or acquired by, the person as a retail client.

Introduction

1.19 Client money is money paid to an AFSL by or on behalf of a client in connection with a financial service that has been, or may be provided; or a

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financial product held by the client – but not as payment for that service or product.[4] It remains the client's own money, although it is held by their AFSL.

1.20 The Government is concerned about the use of a particular type of client money: that which is associated with dealings in OTC derivatives (referred to in this document as 'derivative client money').

1.21 OTC derivatives are contracts between two parties which derive their value from shifts in the value of objects in the underlying market (such as assets, indexes or interest rates). They are privately negotiated without going through an exchange or other intermediary.

1.22 This RIS explores the case for change in respect of the regulation of derivative client money. It has been refined at each stage of the policy process, to inform key decisions.

1.23 This version follows considerable consultation on draft legislation and regulation to give effect to the Government's client money reforms.

What is the problem the Government is trying to solve?

Key issues with the client money regime

1.24 The Corporations Act establishes a regulatory framework governing how AFSLs must deal with client money.[5] These requirements are set out in Divisions 2 and 3 of Part 7.8 of the Corporations Act and Regulations 7.8.01 to 7.8.07 of the Corporations Regulations.

1.25 The use of derivatives has developed beyond what was contemplated when the existing regime came into effect in 2001.

1.26 The Government wants to resolve the following issues with the regulatory framework.

1.27 The current framework provides inconsistent and inadequate protection of retail clients' client money. OTC derivative client money in particular can be exposed to more risk than clients appreciate.

1.28 While the client money regime did not cause any of the recent AFSL collapses in Australia (for example, MF Global Australia or BBY Ltd), the regime did not stem the loss of, or promote the swift return of, client money.

1.29 According to ASIC, where an AFSL that has used client monies collapses retail clients often report that they did not realise their client money was at risk in the first place.

1.30 The Government also sees a need to improve AFSL reconciliation and reporting on retail client money to promote effective oversight and the faster return of client money in the event that an AFSL becomes insolvent.

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[4] It is also money paid by the client; or by a person acting on behalf of the client; or to the licensee in the licensee's capacity as a person acting on behalf of the client. See s 981A of the Corporations Act for the full definition.

[5] AFSLs may also hold property on their clients' behalf. Aside from being a different type of asset, client property has the same characteristics as client money for the purposes of regulation. See s 984 of the Corporations Act for the full definition. References to client money in this document should be taken to include client property unless it is explicitly excluded.

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1.31 The Government therefore proposes to empower ASIC to make rules for AFSLs in respect of reconciliation of, and reporting on, retail OTC derivative client money.

1.32 However, this part of the reform is not dealt with in this RIS as ASIC will be legally required to consult on any rules it wishes to make – and will be in a better position to assess impacts at that time.

1.33 ASIC in particular is concerned that the current regime does not adequately protect the interests of retail clients and that AFSLs should only be able to use client money for the purposes stipulated by the client – namely to support investments made on behalf of the client .This chapter sets out the context for the remaining issue, and explains why it is significant.

1.34 When the Corporations Act and Corporations Regulations were drafted in 2001, they were intended to facilitate exchange-traded futures. They did not foresee the market in OTC derivatives.[6]

1.35 As client money of retail clients is now exposed to more risk than was anticipated, the existing provisions no longer serve retail investors.

1.36 Moreover, there is a G-20 reform agenda underway to better regulate the provision of OTC derivatives. Australia has taken steps to implement these reforms, including the *Financial System* Legislation *Amendment (Resilience and Collateral Protection) Act 2016*. The client money reforms proposed in this RIS ensure that the standard of client protection in Australia keeps pace with other advanced economies.

Context: Australian OTC derivatives trade

Retail trade

1.37 AFSLs with permission to issue retail OTC derivatives provide a range of financial services, including contracts-for-difference (CFDs), binary options and margin foreign exchange (margin FX or forex).

1.38 CFDs are a way of betting on the change in value of a share, foreign exchange rate or a market index. CFDs often use borrowed money, which can magnify gains or losses.

1.39 Binary options are a type of option where the investor tries to predict the short-term movements of a share price, currency, index or commodity. Unlike other options the holder does not have the right to buy or sell the underlying asset. They are relatively new in Australia.

1.40 Forex trading is when an investor attempts to generate a profit by speculating on the value of one currency compared to another. Foreign currencies can be traded because the value of a currency will fluctuate, or its exchange rate value will change, when compared to other currencies. Forex trading is normally conducted through 'margin trading', in which a small collateral deposit – (worth a percentage of a total trade's value) is required to trade.

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[6] See the Appendix C for further information.

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1.41 ASIC warns that all three products (and OTC derivatives in general) are speculative, complex and high-risk. They are highly leveraged, their value can change quickly, and the markets they speculate on are hard to predict and monitor (markets are open 24 hours a day, seven days a week). Moreover, risk management systems such as
stop-loss orders will only give investors limited protection by capping their losses, and may cost a premium to guarantee operation.

1.42 OTC derivatives are not like investing in shares – investors buy from, and sell to, the issuer of the OTC derivative. In trading with these firms, investors bet that their provider (the issuer) is in a sound financial position and will be able to meet their obligations to the investor (the client). The chance that the provider may not be able to fulfil their obligations to the investor is known as ‘counterparty risk’.

1.43 The *2016 Investment Trends Report* estimates that there are 37,000[7] active retail OTC derivatives investors in Australia. The median size of retail notional positions is $7,200 which is relatively small and suggests these investors are not limited to those with a sophisticated understanding of the risks that may be associated with financial investments and with trading in OTC derivative contracts.

1.44 There are about 65 AFSLs that actively issue retail OTC derivatives, including about seven that are prudentially regulated. The total revenue base of these licensees is $700 million. They serve clients in Australia and overseas.

1.45 Based on recent ASIC surveillance, it seems that the market is highly concentrated: five of the 58 AFSLs that are not prudentially-regulated (or markets or clearing participants), account for about 79 per cent of market share based on revenue and about 93 per cent based on net profit.

1.46 ASIC’s 2012 *Review of client money handling practices in the retail OTC* derivatives *sector* found that most CFD issuers have very low market share, and some are part of international groups. Issuers with larger market share include domestic and offshore firms. CFDs are the most common OTC derivative products issued in the Australian OTC retail derivatives market.

1.47 The remaining AFSLs either offer OTC derivatives as part of a broader suite of products (that is, not core business), or are primarily small to medium-sized enterprises.

Box 1 - Business models for CFD issuers

1.48 In Australia, there are two types of business models for CFDs: ‘market maker ’and ‘direct market access’. Market maker and direct market access models are both provided over-the-counter and are the most commonly available CFDs in Australia and overseas. Several CFD providers offer both market maker and direct market access CFDs.

1.49 In both cases, the CFD provider determines the underlying assets on which CFDs may be traded. They also define the terms and conditions of the client agreement, including the margin requirements for client accounts.

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7 The data included active investors from 2010 -2016.

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Market maker model (OTC)	In a market maker business model, the CFD provider comes up with their own price for the underlying asset on which the CFDs are traded. The firm determines the amount of principal risk it can hold, and hedges the remainder (sometimes referred to as a B-Book or C-Book strategy).
Direct market access model (OTC)	In a direct market access model, the CFD provider places the investors' order into the market for the underlying asset. The price the investor pays will be determined by the underlying market. Firms that use this model typically hedge all trades with their clients, to protect themselves from losses (sometimes referred to as an A-Book strategy).

Issue: no regulatory distinction between retail and wholesale clients

1.50 The Corporations Act defines retail clients and wholesale clients differently.[8] It recognises that, in general, clients in different categories will need different levels of protection and assistance to invest confidently.

1.51 However, the client money regime within the Corporations Act does not differentiate between types of client. Consequently, the regulation provides:

- inconsistent, and in some instances inadequate, protection of retail and sophisticated investors' client money; and
- insufficient flexibility for wholesale clients (for example, so that they can use their client money to comply with OTC derivative margining requirements).

1.52 For more information about the distinction between retail and wholesale clients, see **Appendix A**.

Issue: inconsistent and inadequate protection of client money of retail clients

Existing regime

1.53 In Australia, AFSLs must hold client money in trust – with a couple of significant exceptions.

[8] See glossary for respective definitions.

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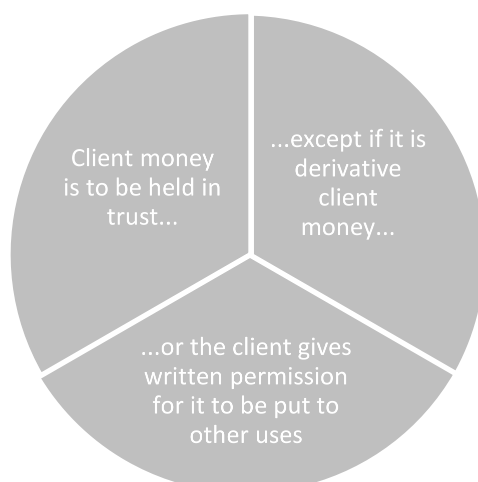
Diagram 1.1: Broad protections afforded to client money[9]



1.54 AFSLs must keep client money in designated 'client money accounts', which are generally operated as a statutory trust. This means, subject to some exceptions explained below, that funds deposited on behalf of a client in a client money account are held for the benefit of that client and cannot be used to meet the obligations of another client or be used by the AFSL. This is to protect client money in the event that the AFSL defaults.

1.55 However, there are broad exceptions to these protections. Section 981D of the Corporations Act and paragraphs 7.8.02(1)(a) and (c) of the Corporations Regulations limit the protections otherwise provided to client monies.

1.56 Section 981D permits money deposited by one client to be used (and withdrawn from the client account) in connection with dealings in derivatives. This is not limited to dealings 'on behalf of' a particular client, or to margins required by, for example, clearing and settlement facility operators (as distinct from counterparties to OTC derivative trades with the licensee).

1.57 Paragraphs 7.8.02(1)(a) and (c) of the Regulations also permit money to be withdrawn from client accounts for transactions where authorised by general written directions or for which the AFSL is entitled.

1.58 It is understood that some AFSLs obtain broad authorisations in their client agreements and product disclosure statements to make withdrawals from client money accounts for any purpose, including as working capital and for proprietary trading. This permission is often sought as part of the sign-on process for retail clients and requires the client to sign a standard form agreement between the retail client and AFS licensee which may be more than 30 pages. Retail clients do not usually seek or obtain independent legal advice before signing such client agreements.

1.59 Once money has been withdrawn from client accounts (under the broad permitted use set out in s 981D of the Corporations Act or paragraphs 7.8.02(1)(a) or (c) of the Regulations), it ceases to have the protections afforded

[9] Note that Diagram 5.1 provides a broad, high-level description of the treatment of client money.

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to it by the statutory trust and may be exposed to higher levels of counterparty credit risk, for which clients are not compensated.

AFSLs that use client money

1.60 There is no reliable data about the total number of AFSLs that use OTC derivative client money, or the amount they use. Nor is the total amount of derivative client money held by AFSLs known (the last reliable estimate is from a 2012 ASIC report, which says that the quantum of all client money held by CFD issuers was in the order of $511 million.[10]

1.61 A proximate measure of those AFSLs that use derivative client money: of the top five AFSLs by market share that issue retail OTC derivatives, only one uses client money other than in relation to the exposure of the individual client.

1.62 Of those that do use derivative client money, one common use is to hedge the risk the AFSL takes when it enters a derivative contract with a client.

1.63 The group of AFSLs that use retail client money (and to some extent, their clients), are the populations most likely to be affected by the proposed reforms.

1.64 Feedback from industry stakeholders indicates that direct market access firms are more likely to rely on the use of derivative client money than those that operate a market maker model, although this distinction is not absolute.

1.65 Under the current client money regime, retail client money is put at risk each time there is a failure of a retail OTC derivative issuer. In two high profile examples from recent years, MF Global Australia's proceedings affected about 11,000 active client accounts across all business lines, and each client account may represent one or more clients; BBY Limited's ongoing proceedings have identified potential claims from close to 4,000 clients in its OTC businesses alone. ASIC has identified other instances where retail client money was put at risk or retail clients have suffered losses.

[10] ASIC Report 316: http://download.asic.gov.au/media/1344092/rep316-published-3-December-2012.pdf

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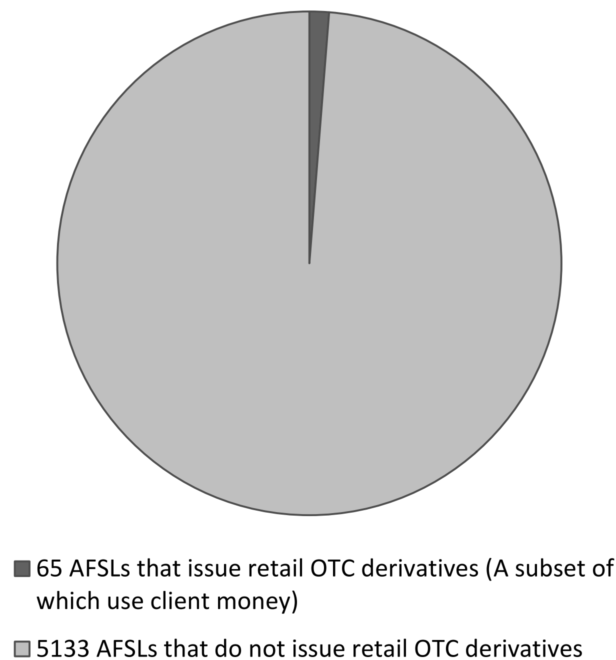
Diagram 1.2: AFSLs that use retail OTC derivative client money



The difference between OTC and exchange-listed derivatives from a regulatory standpoint

1.66 It is important to differentiate between the risks associated with exchange-traded and non-centrally cleared derivatives (that is, OTC derivatives). Exchange-traded derivatives include derivatives over a wide range of underlying contracts such as government bonds, bank bills, stock indices and individual listed equity stock. The former is significantly safer than the latter, because:

- they are traded through brokers authorised by a licensed exchange to deal in these products;
- they are regulated by the exchange's operating rules and ASIC market integrity rules;
- the exchange and the relevant clearing house are responsible for registering, clearing and processing all trades;
- the terms and conditions are standardised; and
- as the exchange or a central clearinghouse acts as the counterparty to every transaction, the counterparty credit risk is far less than if derivatives are not centrally cleared.

Risks of not keeping client money in trust

1.67 There have been a series of AFSL insolvencies in which client money has been lost, or could easily have been lost, at significant cost to clients, some of whom were not aware that their money was at risk. In these instances, AFSLs had been using their clients' derivative client money as permitted by law (for the most part).

1.68 Not holding client money in trust poses the following financial risks.

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- Exposure to counterparty credit risk – the AFSL's hedge counterparty could become insolvent, and unable to repay the client money (this risk may be pronounced with counterparties that are offshore, related, not prudentially regulated, or otherwise unreliable).
- Use of client money to hedge other clients' positions facilitates cross-subsidisation across client cohort, and exposes individual clients to more risk than they necessarily sign up for with the AFSL.
- It generally takes longer to determine entitlement, retrieve and return client money in the event of insolvency. This is because:
  - counterparties may dispute the funds provided by or on behalf of a client as client money, and may be reluctant or unable to return it;
  - there is potential for inadequate reconciliation or confusion about entitlement, especially given the range of ways it can be used and co-mingling of client and AFSL funds; and/or
  - an external administrator may treat client money outside trust accounts as an asset of the AFSL holder, and include those monies in funds for distribution to creditors instead (or ahead of clients).

Why is Government action needed?

1.69 The problems caused by the current client money provisions for retail derivatives are the result of regulation that no longer meets the needs of those it regulates, and in fact stands to produce some unintended and perverse consequences. As such, Government regulatory action is required to remedy the problem.

1.70 In October 2015, the Government, as part of a wider response to its root-and-branch examination of Australia's financial system (the Murray Financial System Inquiry), announced that it would 'develop legislation to facilitate participation of Australian entities in international derivative markets and better protect client monies' by end-2015.[11] The Government also noted that improvements were needed to ensure that investors' money is adequately protected when held by intermediaries. This announcement also brought Australia into line with international developments.

1.71 Currently, in the event of a licensee's insolvency, the extent of any shortfall in a client's money is ultimately dependent on the successful recovery of client funds. Consequently the regime inadequately protects retail clients' money as clients are also unlikely to understand the risks associated with how their money might be used.

[11] See p 26, 'Government response to the Financial System Inquiry', www.treasury.gov.au/fsi

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What is a 'retail client'?

1.72 Retail investors, or clients, of retail OTC derivatives comprise a range of different type of investors, including a large proportion of 'ordinary', inexperienced 'mum and dad' investors.

1.73 ASIC research showed that there was low utilisation of professional financial advice by retail clients before investing in these products.

1.74 ASIC research further showed that many retail investors do not have a clear grasp of how retail OTC derivatives work before they begin to trade. ASIC Report 205[12] (which focused on CFDs) states that the lack of understanding about key concepts and key aspects of how CFDs work means many retail investors "do not clearly understand the key risks and benefits of CFDs, and so may not be making good decisions about whether or not to trade them".

Retail clients should only bear risks they can understand and evaluate

1.75 When retail investors engage in an OTC derivative transaction there is generally an understanding the investor could potentially make losses as a result of adverse market movements. However, what is less well understood is the potential to make a loss as a result of the way a client's money has been handled by the AFSL holder when the holder as OTC derivative issuer or holder's broker defaults.[13]

1.76 ASIC advises that retail clients are not necessarily sophisticated enough to fully understand or effectively evaluate the risks that their client money is exposed to when it is not held in trust by the AFSL holder. As most client money for other types of financial products, such as securities, is held in trust, retail clients also often assume that their OTC derivative client money is dealt with in the same way as it is held for other types of financial products.

1.77 Government action should address the treatment of OTC derivative client money, while continuing to allow retail clients to make gains and losses as a result of market movements on those financial products.

1.78 Self-regulatory solutions are unlikely to be successful on their own as:

- The current market structure and regulatory regime incentivises continued use of client money by some operators.
- Using client money for hedging and daily operating costs provides operators with a 'free-kick', as it reduces their capital costs.
- Regulatory arbitrage is occurring as some operators enter the Australian market to take advantage of the current provisions.

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[12] ASIC 2001, *REP 205 Contracts for difference and retail investors*, http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-205-contracts-for-difference-and-retail-investors/

[13] In addition, there are a number of important issues that an investor must understand when undertaking a financial transaction, such as how the product they are investing in works. Extending the logic that the issues that are important to the financial transaction, such as client money protections, should be disclosed and explicitly agreed to by the investor could result in the investor agreeing to a large volume of material, at which point the requirement would likely lose its impact.

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1.79 Results from a 2012 ASIC survey[14] suggest that marketing products based on a client money use point-of-difference would be ineffective due to information asymmetries.

- Retail investors may not understand the risks their client monies are exposed to, and hence the benefits of using an OTC derivatives issuer that does not make use of client money.
- Thorough disclosure standards are already outlined in ASIC's Regulatory Guide 227 *Over-the-counter contracts for differences: Improving disclosure for retail investors* but appear to have reached the limit of their effectiveness due to the complex nature of the products and lack of understanding of clients about the arrangements for holding client money, particularly retail clients.

1.80 Government action is also required as the Australian regulatory regime for OTC derivatives is currently less stringent, in a number of critical areas, compared to many other jurisdictions. For example:

- the UK Financial Conduct Authority prohibits the use of client money by firms;
- the US Commodity Futures Trading Commission imposes very high capital requirements on issuers (starting from a minimum of $20 million) and requires retail derivatives to be traded on a licensed exchange (which means clients are protected by the rules of the exchange); and
- the Monetary Authority of Singapore and the Securities and Futures Commission of Hong Kong impose restrictions on a firm's use of leverage (that is, how much exposure a firm can take on).

What policy options is the Government considering?

1.81 Diagram 5.3 gives an overview of the options the Government considered for retail client money provisions.

[14] ASIC 2012, *REP 316 Review of client money handling practices in the retail OTC derivatives sector*, http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-316-review-of-client-money-handling-practices-in-the-retail-otc-derivatives-sector/

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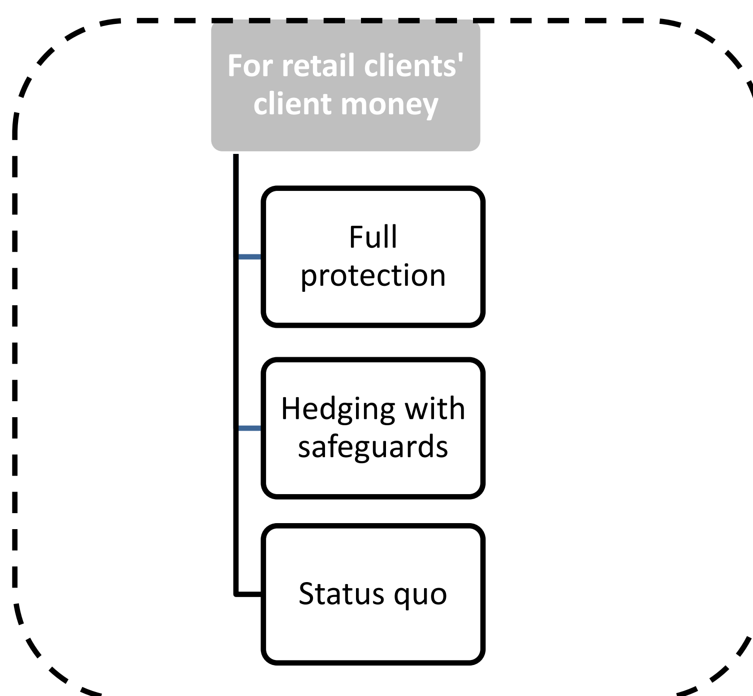
Diagram 1.3: Policy options



Option 1: Full protection (as per draft legislation)

1.82 The Government has consulted extensively on this option, including on draft legislation and regulation that would give it effect.

1.83 **Option 1 would essentially discontinue AFSL use of retail OTC derivative client money for their own (or other clients') purposes**. Client money of retail clients would not be able to be used by the AFSL as working capital, or in connection with proprietary trading, hedging, or to meet the obligations in relation to any person other than the client.

1.84 Specifically, the draft legislation and regulation propose to:

1.85 Limit the exception provided by section 981D of the Corporations Act for retail clients,[15] so that AFSLs cannot use the OTC derivative client money other than for the client who provided the particular money to the licensee.

1.86 Tighten the existing permitted uses of derivative client money, such as the ability to rely on general directions or an AFS licensee's entitlement to client money, in the context of retail clients to support this change.

Option 2: Hedging with safeguards

1.87 Several submissions from interested parties suggested alternatives to the proposed reform in respect of retail client protections (Option 1).

1.88 While almost all stakeholders agreed that retail clients deserve to be better protected, there was some disagreement about what constitutes the right

[15] For the purposes of this proposed reform, the expression 'retail clients' also includes clients which would otherwise be retail clients but for satisfying the definition of a 'sophisticated investor' for the purposes of section 761GA of the Act.

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kind of protection; and appropriate trade-offs in terms of impact on individual financial services, the direct market access business model (which tends to be more reliant on the use of client money), and the OTC derivatives sector as a whole.

1.89 Option 2 represents a compromise: allow AFSLs to keep using derivative client money to hedge their own or other clients' business risk, provided there are a suite of specific safeguards in place to increase the resilience of the AFSLs, the quality of their counterparties, and the potential uses of client monies.

1.90 Option 2 draws on public feedback and suggestions, and considerable advice from ASIC on the viability and effectiveness of this approach.

1.91 Specifically, it would:

- Only permit AFSLs to hedge with authorised deposit-taking institutions (Australian-based banks, referred to as ADIs – Authorised Deposit-taking Institutions), and require that they do so directly.
  - Restricting the hedging transaction to Australian banks and foreign subsidiary banks (and excluding foreign branches) would assist recovering such money from those institutions, as the client money may be expected to remain in the jurisdiction. The AFSL would need to deal directly with the ADI when hedging, rather than intermediaries.
  - Such ADIs are subject to Australian Prudential Regulation Authority (APRA) prudential supervision, including risk management and capital requirements.
- Ensure that client money retains its character as "client money".
  - Client money should be traceable by the retail client when it is passed to the ADI as a hedge counterparty. This is intended to address concern that the client money used for hedging purposes may not be able to be located or recovered after it has been transferred to the hedging counterparty.
  - Ideally, any client money that is passed on to an ADI as a hedge counterparty should continue to be identified as client money and be protected in accordance with Part 7.8 Division 2 of the Corporations Act. The current regime means that in many cases the client money loses its character as trust money being held on behalf of the retail client.
  - Note that ASIC has strong reservations about whether this safeguard could be implemented (see Part 5 below).
- Impose additional capital requirements for those AFSLs that use client money.
  - Introducing new regulations that would enable ASIC to impose risk-based capital requirements to mitigate the additional risks created by the use of derivative retail client money as it would provide additional capital to be used in the event of the insolvency of the AFSL holder and so ideally minimise the potential for retail client loss.

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- As per Option 1: limit other uses of client money.
  - This option only seeks to facilitate AFSL use of client money to hedge their risk of default. Like Option 1, it seeks to restrict the use of client money for an AFSL's proprietary trading.

Option 3: Maintain the status quo

1.92 This option involves no change to the existing client money regulatory regime in the Corporations Act. It would allow the continued use of OTC derivative retail client money by AFSLs for a range of purposes.

What is the likely net benefit of each option?

Summary of costs and benefits: retail client protections

Table 1.1: An outline and initial evaluation of regulatory options

	1. Full protection	*2. Hedging with safeguards*	*3. Status quo*
+	Derivative client money would be as protected as other client money, and in a manner expected by many retail clients. Retail clients would not be required to evaluate complex risks to their client money. In the event of AFSL insolvency, clients would be more likely to get their money back quickly and in full. It would probably reduce the capacity of relatively thinly resourced firms to enter and operate in the Australian market.	It represents a compromise. Some AFSLs will become more resilient, reducing their risk of default. Some restrictions would be in place on the use of retail client monies. Hedge counterparties will be of a higher quality, potentially increasing recoveries in the event of insolvency. It would cost AFSLs somewhat more (in terms of regulatory compliance) than Option 1 (full protection), but AFSLs could still utilise retail client money to hedge.	There have not been any recent examples where the client money regime has actually caused AFSL failure. This option would not affect the viability of any AFSLs or their business models.

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	1. Full protection	2. Hedging with safeguards	3. Status quo
-	This option may make some AFSLs less viable. Stakeholder feedback suggests that the impact may be felt most by AFSLs which use a direct market access model, as they tend to use client money to hedge their trades. It may reduce competition for a sector of the market, although this is not certain. It has the potential to increase risk-taking by some AFSLs. That is, some AFSLs may choose to hedge less; and/or to promote products that are cheaper to hedge, but riskier for investors to hold.	While AFSLs will be more resilient and the use of client money curtailed, client money used for hedging would continue to be exposed to more risk than other retail client money. The compromise would still create material costs for AFSLs, particularly if the additional capital requirements were robust. Robust capital requirements can be complex for a regulator to implement, monitor and update. ASIC may require additional resources to enforce this element.	Client money is not money paid to an issuer to acquire a specific service or product, and therefore should be treated as the client's money. It is not clear that clients (especially retail clients) are fully aware of, or can effectively evaluate the current risks to their client money. Maintaining the status quo would mean derivative client money continues to be treated differently to other client money – and the Government may be asked to account for this discrepancy in the event that an AFSL fails, and results in a loss of client money. It may also mean that relatively thinly resourced firms are encouraged to enter and remain in the market.

Option 1: Full protection

1.93 The following sets out the benefits and costs of implementing Option 1.

Derivative client money would be as protected as other client money, and in a manner expected by many retail clients.

1.94 Most client money (as defined by section 981A of the Corporations Act), aside from that which is associated with dealings in derivatives, is to be held in trust. It is not money paid for a specific service or product, and is the money in which the client has a beneficial interest.

1.95 ASIC reports that insolvencies of licensed OTC derivative issuers (such as that of BBY Ltd[16]) often result in complaints from retail clients to the financial regulator; they often stand to lose money, and claim they did not realise that their client money was at risk in the first place.

[16] BBY Ltd was an Australian stock broking, corporate advisory and asset management firm. Prior to its voluntary administration on 18 May 2015, it claimed to be the largest independent stockbroker in Australian and New Zealand by market share.

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Retail clients would not be required to evaluate complex risks to their client money.

1.96 The current regime assumes that retail clients can fully understand and evaluate the risks to which their derivative client money is exposed, particularly counterparty credit risk. That is, the chance that their AFSL becomes insolvent and unable to repay their client money.

1.97 To evaluate this risk, clients would need to consider a range of issues (and continue to do so over time) including that:

- their AFSL may hedge with a related counterparty, the default of which may impact on the viability of their AFSL;
- their AFSL may hedge with unreliable or unregulated counterparties, some of whom may be offshore;
- their client money may pass through multiple counterparties and may not be able to be traced;
- their client money may not be treated as such by the AFSL's hedge counterparty, which may claim entitlement to the money in the event that the AFSL defaults and financial transactions are closed out;
- if returned by the hedge counterparty to the AFSL, the money may cease to be held on trust. The liquidator may treat the money as part of the general pool of assets of the AFSL to be distributed by liquidators, rather than subject to special protection.

1.98 ASIC, along with several of the larger AFSL providers in this sector and the Australian Securities Exchange (ASX), are clear that retail clients are not generally able to effectively evaluate all the issues outlined above to come to an informed assessment of the risk associated with the use of the derivative client money, and should not be expected to conduct such an evaluation.

1.99 The existing provisions that allow AFSLs to use derivative client money were carried forward from previous regulations which were directed at exchange traded derivatives, and the policy rationale is less applicable to OTC retail derivatives.

In the event of AFSL insolvency, clients would be more likely to get their money back quickly and in full.

1.100 At present, if an AFSL becomes insolvent, it can take months or years to return derivative client money if it has been deployed outside a trust account (as defined by section 981B of the Corporations Act).

1.101 If Option 1 is implemented (and the AFSL were legally compliant) derivative client money should be administratively and legally much easier to locate and return.

This option would probably reduce the capacity of new relatively thinly resourced firms to enter and operate in the Australian OTC derivatives market.

1.102 AFSLs need to meet minimum capital requirements in order to obtain an operating licence from ASIC. However, it is highly desirable for OTC

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derivatives issuers to hold capital above and beyond this amount to mitigate the risk of counterparty default and/or to cover the AFSL's own losses (where their dealings are not fully hedged).

1.103 Because the current regime effectively means that retail clients are providing funding or capital to AFSLs that choose to use derivative client money, it is possible that some of these firms may not be able to continue to operate if this option is pursued.

1.104 This could affect either domestic or foreign firms.

1.105 While some businesses may become less viable, or lose interest in operating in the Australian market, the Government does not consider this to be a bad outcome - if it is because they are unable to meet the costs of doing business and it enhances the protection of derivative client money for retail investors.

This option may make some AFSLs less viable, but should not affect the viability of the direct market access model.

1.106 Through the public consultation process, the Government heard from several AFSLs concerned about the ongoing viability of their business, should this option be implemented. Several individual traders that invest with these AFSLs made similar submissions.

1.107 They suggested that the impact will be felt most by AFSLs that use a direct market access model, as they tend to use client money to wholly hedge with other parties the derivatives trades they enter into with retail clients.

1.108 They also suggested that the direct market access model would not itself survive because it depends on the capacity to use client money to make that model viable.

1.109 The relative impact is not likely to be large, as:

1.110 The regulated population is small relative to all AFSLs; AFSLs that deal in retail OTC derivatives and use derivative client money is smaller still; and of these, it would likely only be a subset that could not continue.

1.111 Moreover, there are entities in Australia that already operate a fully hedged trading strategy, without using client money.

1.112 However, as discussed earlier in this document, it is not possible to determine how much client money is actively deployed by AFSLs for their own purposes. Nor is it possible to definitively say how many AFSLs use retail client money to deal in derivatives; or what funding they might be able to call on in the event that they could not continue to use their clients' client money.

1.113 This lack of information is part of the problem the Government is seeking to address in pursuing this reform (see the description of the ASIC reporting and reconciliation power earlier).

1.114 While some AFSLs may become less viable, the Government does not believe that the direct market access model itself will become defunct. The United Kingdom introduced comparable client money regulation for CFD issuers

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in 2014, and the Financial Conduct Authority recently advised Treasury that the direct market access model[17] is still in common use.

This option has the potential to increase risk-taking by some AFSLs.

1.115 A small number of the AFSLs that raised concerns during public consultation also warned that - in the event that client money is no longer available for hedging, rather than stop operating, AFSLs may:

- choose to hedge less of their exposure to trades with clients, and therefore hold more principal risk that they will default on their contracts; and/or
- promote products that are cheaper for the AFSL to hedge, but riskier for investors to hold.

1.116 These would be poor and unintended consequences if they transpired. In addition to the impact on individual investors, it could increase risk in the sector resulting from AFSL default, which could have flow on consequences for their clients.

1.117 It is not certain that AFSLs would respond in this way, but risk-taking behaviour is certainly a matter to monitor if and when such an option is implemented.

1.118 However, ASIC notes that robust risk management arrangements, including hedging where appropriate, is an expectation of all AFSLs.

1.119 Given that AFSLs need to maintain appropriate risk management strategies, the inability to use client money to hedge (and thereby requiring additional funding to maintain hedging practices) is more likely to impact upon AFSL profitability rather than the use of hedges to mitigate risk.

1.120 Irrespective of how client money is protected, AFSLs will still be required to act in the best interests of clients, avoid conflicts of interest, and have adequate risk management arrangements in accordance with general law and conditions of their licence.

Impacts by stakeholder group

Table 1.2: Impacts of Option 1 on key stakeholder groups

Retail clients	*AFSLs*	*Government/regulator*
It would significantly increase the level of protection afforded to client money by reducing the counterparty credit risks to which investors are exposed. Retail clients ought to be better situated, as opportunities for regulatory arbitrage will be removed and less scrupulous operators will be less likely	Under this option, there would be a level playing field in the industry in relation to the treatment of client money, as AFSLs would be required to treat their client money in the same way as other AFSLs in the financial sector. The reputation of the retail OTC derivatives industry may improve too, as retail clients	Under this option there may be reduced compliance/monitoring burdens on ASIC as the regulatory framework relating to the use of client money would be simpler and compliance easier to monitor. Removing regulatory inconsistency with other jurisdictions would also eliminate the occurrence of

[17] Referred to in the UK as the 'matched principal' model.

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Retail clients	AFSLs	Government/regulator
to enter the Australian market. However it may impose the following costs on investors: • investors would no longer be able to choose to use an issuer that makes use of client money; and • investors may face increased costs as a result of increased issuer compliance and operating costs. These effects are likely to be limited, as competition based on lower standards of investor protection is of more potential harm than good, the market appears relatively competitive and entry costs are low.	will be less likely to lose their client money in circumstances in which they assumed that it would be protected; and only AFSLs that are adequately funded will be able to operate in the Australian market. However, Option 1 would increase capital costs of issuers that use client money (predominantly those that use a direct market access issuing model), which may be passed onto investors. Depending on the extent of these capital costs, direct market access operators who had been receiving a 'free kick' from the existing provisions may no longer be viable. In addition, AFSLs would likely face increased compliance-related operating costs—including staff training, and the costs associated with one-off changes to disclosure documentation and IT systems. More broadly, AFSLs would need to analyse the effect of the prohibition of the use of client money on their business practices.	regulatory arbitrage and its associated risks and regulatory burdens. However, ASIC would need to review and update its regulatory guidance on client money to reflect revised legislation (potentially at the same time as any rulemaking).

The regulatory burden estimate is $516,572[18]

1.121 The costs identified here relate specifically to the compliance costs to businesses and individuals in order to comply with or understand the changes to the arrangements. The costs do not reflect the cost to businesses for any loss of revenue due to changes in the law. Certain stakeholders have advised that these reforms will adversely affect their business model, as additional capital will be required to maintain their current hedging practices.

1.122 Under Option 1, there will be some initial costs to:

- update IT systems (at an annualised cost of $68,723 for all firms, for an average of two weeks' work for two IT staff);

[18] Annualised.

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- understand the changes to the legislation as well as monitor compliance with the changed legislation, and for businesses to update their documentation, policies and procedures, and develop and implement training (at an annualised cost of $173,880 for all firms, for an average of five weeks' work for two compliance staff); and
- review business processes as a result of the ban on the use of client money (at an annualised cost of $44,178 for all firms, for an average of two weeks' work for two business operations staff).

1.123 Notably, the cost of securing additional funding to replace any reliance on client monies for working capital is not included in these quantitative costs as it is a second-round impact of Option 1.

1.124 Under Option 1, there will also be some additional ongoing monitoring and review work (at an annual cost of $257,709 for all firms, for an average of two weeks' work for three compliance staff over the period of a year), but many of these costs will be business as usual.

1.125 For individuals affected by the changes, as a client, there will be a one off cost of $3,987.50 in order to understand the changes, particularly how they affect their financial advice.

1.126 The total annualised regulatory impact on business is $516,572, as displayed in Table 5.3.

1.127 Details on the assumptions used to generate the cost benefit analysis are provided at **Appendix E**.

Table 1.3: Regulatory burden estimates of Option 1 – full protection

Option 1				
Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$ 512,585	$0	$3,988	$ 516,572

Option 2: Hedging with safeguards

1.128 The following sets out the benefits and costs of implementing Option 2.

This option represents a compromise

1.129 This option does not address the fundamental vulnerability currently faced by retail client money; but would potentially improve the resilience of certain AFSLs and limit the ways in which client money may be used.

Retail clients may be more protected than they are now

1.130 AFSLs would be more limited in the way in which they can use retail derivative client money. Use as working capital, for example, would be prohibited. Client money could only be used to hedge the AFSL's positions provided there are additional requirements for the licensees to identify client

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money, there are limits on the identity of the hedge counterparties, and additional capital requirements apply.

1.131 The safeguards, as set out in chapter 4, should make default of the AFSL's hedge counterparty less likely. It would also limit the purposes for which licensees can use client money.

1.132 At present, none of the identified safeguards are required and are not uniformly used in the sector.

1.133 However, these proposed alternative reforms still leave client money exposed to substantially the same risks as under the status quo.

1.134 While these proposed alternative reforms go some way to addressing adjacent risks (such as the resilience of the AFSLs), they do not address the core risk that that client money may not be returned to retail clients in the event of an AFSL failure.

Derivative client money would still be exposed to more risk than other retail client money

1.135 As client money may be taken out of the client money trust account, there will be significantly less certainty that the tracing requirements will be effective in safeguarding client money. This is the key risk with these proposals, which could undermine the policy objective of the Government's client money reforms.

1.136 This view is strongly supported by ASIC. ASIC does not see any considerable benefit in enhancing the quality of the hedge counterparty. Whilst quality hedge counterparties may increase overall recoveries in the event of insolvency, it does not overcome the fundamental problem of the client money being removed from the protection of a trust account.

1.137 The risk of client money losing its protections is not mitigated by the identity of the hedge counterparty, or whether the hedge counterparty is subject to client money rules. The hedge counterparty would not recognise the client as its 'client', as such, the money would still cease to be identified as money belonging to the client.

1.138 There are significant legal risks for the hedging with safeguards approach. ASIC also advises that seeking to ensure client money continues to be identified as money belonging to the client, after it has been paid out of the client money trust account, is unlikely to be effective under Australian law.

1.139 Imposing additional capital requirements could help to reduce the likelihood of failure, depending on the circumstances of each AFSL. However this still does not address the core problem that client money may not be returned to retail clients in the event of an AFSL failure.

This option would cost AFSLs somewhat more than Option 1 (full protection), and compromise would still have material regulatory and commercial costs for AFSLs

1.140 AFSLs would still have access to retail client money to fund their hedging activities, so would not need to use their own capital, though the cost of compliance would increase.

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1.141 However, AFSLs and their ADI hedge counterparties would still incur additional costs because they would need to:

- prepare the legal documentation (which could be in the form of a separate derivative trading master agreement, to ensure there are no set-off rights between the issuer's house trades and client trades);
- make the operational arrangements (including segregated accounts at the ADI for holding client money); and
- potentially comply with higher capital requirements.

1.142 Hedging may also become more expensive under this Option because there would be more limits on hedging relationships.

1.143 It is estimated that the difference between Option 1 and Option 2 in terms of regulatory costs is sizeable/in the order of magnitude of just under $200,000.

Impacts by stakeholder group

Table 1.4: Impacts of Option 2 on key stakeholder group

Retail clients	*AFSLs*	*Government/regulator*
Retail clients would be better protected than they are now, albeit not as well as they would be under Option 1. Investors may face slightly higher costs due to increased costs for AFSLs to operationalise the change in regulation.	It should not trigger a step-change in AFSL business operations. AFSLs would still be able to use client money to hedge their trades, although their hedge counterparties would be more limited. This option would likely increase the cost of hedging due to the more limited set of potential counterparties, and would involve material regulatory costs.	It may be operationally difficult to determine when an AFSL is hedging, as opposed to simply undertaking speculative trade. It may increase ASIC's supervisory responsibilities, as this solution is not as straightforward as Option 1.

The regulatory burden estimate is $715,337 [19]

1.144 The costs identified here relate specifically to the compliance costs to businesses and individuals in order to comply with or understand the changes to the arrangements. The costs do not reflect the cost to businesses for any loss of revenue due to changes in the law.

1.145 Under Option 2, there will be initial costs to:

- update IT systems in order to be able to effectively track, monitor and audit how they are using client monies is anticipated to be a one off cost of $44,178 for all firms;

[19] Annualised.

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- understand the changes to the legislation as well as monitor compliance with the changed legislation, and for businesses to update their documentation, policies and procedures, and develop and implement training at an estimated cost of $188,567;
- legal costs to understand changes to the regime;
- change any commercial arrangements firms may have with banks; and
- review business processes as a result of increased limits on use of client money.

1.146 Under Option 2, there will also be some additional ongoing monitoring and review work (at an annual cost of $257,709 for all firms, for an average of one weeks' work for three compliance staff over the period of a year), but many of these costs will be business as usual.

1.147 This option, unlike Option 1, will also have a regulatory cost for ADIs with which an affected AFSL holder has a contractual relationship. The ADI would need to adjust its invest in understanding the changes to legislation, establishing documentation, policies and procedures, set up operational arrangements, and develop and implement training. The estimated compliance cost of this for all ADIs is $117,810.

1.148 For individuals there is expected to be a small one off cost to understand the changes, estimated at $3,987.50

1.149 The total annualised regulatory impact on business is $711,350, as displayed in Table 5.5 below.

1.150 Details on the assumptions used to generate the cost benefit analysis are provided at **Appendix E.**

Table 1.5: Regulatory burden estimates of Option 2 – hedging with safeguards

Option 2				
Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$ 711,350	$0	$3,988	$ 715,337

Option 3: Maintain the status quo

1.151 The following sets out the benefits and costs of implementing Option 3.

This option would not have any impact on AFSLs or their business models.

1.152 AFSLs would be able to continue to operate as usual.

There have not been any recent examples where the client money regime has actually caused AFSL failure.

1.153 The client money regime does not appear to have caused, or contributed to, any recent AFSL insolvencies.

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1.154 While the BBY Ltd (BBY) collapse is not attributed to the misuse of client money, retail clients would probably have recovered all their OTC derivative client money back, had the proposed regulatory regime (full protection – Option 1) been in place and complied with.

1.155 BBY used client money to hedge its own market risk. Saxo Capital Markets Pty Ltd (Saxo), a BBY hedge counterparty, did not recognise the money as 'client money' and, as such, BBY lost around $2.5 million in client money upon default. Saxo was assigned legal title to the funds and the retail investors lost their money. BBY could have sent any proportion of the client money pool to Saxo.

1.156 This outcome compares poorly with the outcome for BBY's ASX funds, which were fully recovered because ASX monitors compliance with its operating rules which reinforce the Corporations Act client money provisions.

It is not clear that clients (especially retail clients) are aware of, or can effectively evaluate the current risks to their client money.

1.157 GTL Tradeup Pty Ltd was another retail OTC derivatives provider with about 1500 clients (half of whom were Australian) that went into liquidation in 2013. It was unable to recover over $1 million of client money used to hedge its own market risk as the money was lost by its Dubai hedging broker. One of GTL's Australian clients, who can no longer access his funds, started a blog online following the firm's collapse. Writing under the name Maurice Conchis, he said "there would appear to be a common misapprehension that client funds provided to a margin operator like GTL Tradeup is somehow quarantined in a trust. Indeed, I assumed this to be the case. However, it seems that is not the case at all."

Client money is not money given for a service or product, and should be treated as such. Maintaining the status quo would mean derivative client money continues to be treated differently to other client money.

1.158 Maintaining the status quo does not specifically address any of the existing concerns regarding the protection of client money.

1.159 The Government may be asked to compensate retail clients for any deficiency of money for retail clients in the event that an AFSL fails, and results in a loss of client money.

This option may also mean that relatively thinly resourced firms are encouraged to enter and remain in the market.

1.160 While the Australian financial system is generally very well regulated and has a reputation for being so, in respect of retail OTC derivatives it imposes fewer restrictions than some of its key international counterparts, such as Japan and the UK (for example, it does not set caps on leverage).

1.161 The ongoing availability of derivative client money – effectively an interest-free loan - and the existing regulatory settings would probably continue to attract new operators to the Australian market.

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Impacts by stakeholder group

Table 1.6: Impacts of Option 3 on key stakeholder groups

Retail clients	*AFSLs*	*Government/regulator*
Retail clients' client money would continue to be exposed to risks that they are not equipped to effectively evaluate. Retail clients may stand to lose their client money upon AFSL insolvency. Clients would not be subject to any increase in costs that may result from changes to the regulatory framework. Clients may benefit from issuers' efforts to differentiate their business practices, including around the use of client monies. Investors would continue to be able to choose between different issuers and may benefit from the more cost-competitive services offered by issuers that use client money to fund hedging transactions.	No immediate impact. This Option would allow AFSLs to continue business as usual. Issuers may face reputational damage (and loss in business) if a future collapse of an issuer further highlights the risks around the currently permitted use of client monies.	As the opportunities for regulatory arbitrage are unaltered under Option 3, ASIC may face increased compliance/monitoring burdens in respect of international issuers seeking to enter the Australian market to take advantage of Australia's permissive regime. The occurrence of regulatory arbitrage heightens the supervisory burden for ASIC, due to the risks associated with overseas operators providing financial services to Australian clients: when client monies have been moved offshore, ASIC faces jurisdictional difficulties pursuing cases to recover them. No specific benefits for the government have been identified under this option.

The regulatory burden estimate is $0

1.162 Option 3 provides a business-as-usual base case for illustrating and comparing the costs and benefits of the other options and, as such, does not impose any additional regulatory burden.

Table 1.7: Regulatory burden estimates of Option 3 – maintain the status quo

Option 3				
Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$0	$0	$0	$0

<u>Who will the Government consult, and how will it consult with them?</u>

There have been a number of rounds of consultation on changes to the client money regime.

1.163 In November 2011, the then Gillard Government released a discussion paper to seek stakeholder views on issues relating to the use of client money and

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to review whether the client money provisions of the Corporations Act provide sufficient protection for investors.

1.164 A large number of submissions—greater than 100—were received to the Discussion Paper and the claimed effects of any regulatory change were varied. Several large OTC derivative providers supported the proposal to prohibit the use of client monies by AFS licensees for their own purposes, recognising the importance of aligning Australia's regulatory framework with overseas developments. However, some CFD providers did not support the proposed changes.

1.165 More recently, the Government released a policy paper, draft legislation and regulation which proposed a suite of specific changes to the client money regime. The policy paper was issued on 22 December 2015, and the draft legislation and regulation followed on 29 February 2016. Interested parties were invited to comment by 25 March 2016.

Consultation is now complete.

1.166 The Government received forty-nine submissions on its proposed reform. Of these, thirty-one did not support the reform, seventeen were supportive, and one was neutral.

1.167 Treasury officials also held discussions with a range of stakeholders to explore key issues raised in submissions and test potential refinements.

Stakeholders agree that client money should be better protected, but diverge strongly on how this is to be achieved.

1.168 There is almost uniform recognition of the need to ensure the law adequately reflects the needs of retail clients and to prohibit the use of retail client money as working capital.

1.169 Stakeholders expressed strong support for the proposal to give ASIC power to make client money reconciliation and reporting rules to enhance transparency and accountability.

1.170 However, there were clear disagreements about the level of protection that retail clients require and the right trade-off between consumer protection and industry competition.

1.171 The reform as a whole has some significant and unwavering supporters, including ASIC, the ASX and issuers who do not currently use client money to hedge derivative positions. These issuers are large market maker firms that collectively have the majority of the CFD market share. These parties believe that retail client money should be wholly protected, and that this outweighs any concerns about business impacts.

1.172 However, the Government also received a relatively large number of submissions from small and medium-sized firms who hedge with client money and individual retail traders, who agree that retail client money should not be used as working capital – but argue for its continued use by issuers for hedging.

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Those that want to continue to use client money to hedge fear that prohibiting such practice may have inadvertent consequences.

1.173 Issuers that use client money to hedge are concerned that banning hedging with retail client money will threaten the viability of their business model and unfairly benefit market makers, leading to less competition.

1.174 They, and a small collection of other stakeholders, suggest that the reform could result in more risk-taking by firms that can no longer afford to completely hedge their exposures.

1.175 Issuers that use client money argue that they should be permitted to continue to use it to hedge their exposures and have suggested a range of possible safeguards to reinforce client protection.

1.176 Individual retail traders that made submissions strongly favoured the continued use of their client money for hedging. They all trade with issuers that operate direct market access models (that is, the firm fully hedges the positions it takes with clients in the underlying market) as they believe that these firms have more transparent prices and better investment outcomes.

1.177 Both these groups argue that the proposed reforms will lead to less competition and consumer choice. They believe this will leave retail clients further exposed to market maker firms whose interests, they argue, do not necessarily align with their clients' interests – as to the extent that they do not hedge their trades, they stand to benefit from client loss.

1.178 The Government also heard from a small collection of stakeholders who are concerned that prohibiting use of client money to hedge may prompt some issuers to take more risks (that is, hedge less), due to the increased cost of capital.

1.179 Some smaller issuers also raised concern that differentiating between wholesale and retail investors will pose an additional administrative burden that will unduly impact smaller businesses, and that the inclusion of sophisticated investors in the definition of retail clients will further complicate administration.

Some stakeholders also feel that the scope of reform should be broader.

1.180 Several interested parties felt that the reform did not address other, more significant issues associated with client money such as fraud, inadequate capital requirements and gaps in the insolvency regime. They suggested that, without additional safeguards, retail clients' overall protection may not significantly improve.

There is broad agreement that the Government should allow AFSLs adequate time to transition.

1.181 Stakeholders generally agreed that the implementation of the reform should allow industry reasonable time to transition.

What is the best option from those considered?

1.182 The Government remains confident that it's proposed reform of full protection (Option 1), with minor refinements (such as a transition period for changes to retail client provisions), is the best option.

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1.183 This view is on the basis that the existing regime no longer meets the needs of the consumers of financial services.

1.184 While maintaining the status quo would not have much impact on AFSLs in the short term (although inadequate regulation may affect the sector's reputation and consumer confidence in the longer term), consumer protection would continue to be inadequate.

1.185 Moreover, the alternative option considered, Option 2, does not materially enhance the protection available to retail client money. Whilst some of the safeguards proposed in Option 2 are likely of benefit to the industry, those benefits (such as enhancing the resilience of AFSLs) are in related but ultimately adjacent areas. The core problem of protection of retail client money in the event of insolvency of an AFSL would remain unaddressed.

1.186 Consequently, the potential positive impact that would come from the full protection of retail client money held by AFSLs outweighs the cost that will be incurred by the industry.

1.187 It will also see Australia implement reforms about the management of client monies in line with other jurisdictions, enhancing Australia's reputation for providing appropriate protection of retail clients.

1.188 The cost to industry has also been considered and weighed against the potential for increased investor confidence in the sector as this is a key reason for the Government's commitment to these reforms.

1.189 The Government intends to finalise draft legislation and regulation that amend the Corporations Act and Regulations to create a more tailored and contemporary client money regime that prohibits AFSL use of retail derivative client money for their own and other clients' purposes.

How will the Government implement and evaluate its chosen option?

1.190 The Government will seek to amend the Corporations Act, and make necessary changes to the subordinate legislative instruments.

1.191 A few minor changes will be made to the draft Bill and Regulations, including delayed commencement of the retail component of the reform to allow AFSLs time to transition to the new arrangements.

1.192 As part of the ongoing assessment of the Corporations Act and associated regulations, Treasury and ASIC will monitor the effect of any legislative changes to the treatment of client money to ensure they are achieving their intended purpose.

1.193 Consistent with current practice, it is anticipated that ASIC will have a significant role in the enforcement and monitoring of client money handling practices as part of its administration of the Corporations Act.

1.194 In the event that it becomes apparent that any reforms are not having their intended effect, appropriate action will be taken at that time.

Conclusion

1.195 This RIS outlines two policy options that would increase the protection of client money.

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1.196 The available options have been considered according to their respective qualitative and quantitative costs and benefits. This has been balanced against the identified problems that exist with the current framework – in that the current arrangements provide inadequate consumer protection.

1.197 On the information currently available, Option 1 is still the only option that addresses the core problem. It also has the smallest compliance cost impact on businesses and individuals.

1.198 As set out in Part 5, Option 1 clearly addresses the core problem identified. Option 2 leaves the core problem unaddressed, and would leave client money exposed to substantially the same risks as under the status quo.

1.199 At best, Option 2 could help to reduce the probability of default of the AFSL, and could help to ensure the AFSLs trade with more robust hedge counterparties.

1.200 The key risk if the regime is not updated is that the next time a collapse similar to BBY occurs, clients may not receive all of their client money back if there is a deficit in the client money account and the licensee becomes insolvent or is otherwise unable to pay the deficiency.

1.201 By prohibiting the use of retail OTC derivative client money by AFSLs for their own or other clients' purposes, the money will be much safer – and investor confidence in the industry is likely to increase.

1.202 Appropriate regulation of these important products will also support the Australian Government's objective of Australia being a regional financial centre.

Appendix A – What does a retail client look like?

- Retail investors do not have the same level of knowledge and understanding as other financial market participants, such as banks and brokers. Retail investors are therefore provided with protections under the Corporations Act to ensure they are treated fairly and equitably and promote participation in financial markets.

- A distinction between retail and wholesale clients was inserted into the Corporations Act by the Financial Services Reform Act 2001 (FSR Act). This was the main piece of legislation in the sixth stage of the Corporate Law Economic Reform Program developed in response to the recommendations of the Financial System Inquiry (Wallis Inquiry) released in 1997.20

- The Wallis Inquiry set out a framework for the regulation of the financial system. The main motivation for drawing the distinction between retail and wholesale clients was to identify those considered in need of regulatory protection, as well as the desire to allow certain clients to participate in wholesale markets, which tend to trade more complex products.

[20] See Treasury options paper, 'Wholesale and Retail Clients Future of Financial Advice', January 2011.

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- The Wallis Inquiry Report suggested that clear definitions of retail clients entitled to disclosure and other consumer protection should be established.

- The definition of a retail client in section 761G of the Corporations Act relates in different ways to different products. For example, individuals purchasing insurance or superannuation or retirement savings are treated as retail clients if they are purchasing specific products such as motor vehicle insurance or personal or domestic property insurance. All other financial products are subject to four tests: product value, individual wealth, professional investors and small businesses:

  - if an investor is investing in a product with a value greater than $500,000 they are not considered a retail client;

  - if an investor has individual wealth greater than $2.5 million in net assets they are no considered a retail clients;

  - small businesses are considered to be retail clients, while other businesses are not; and

  - professional investors[21] are not considered retail clients.

- While many retail investors are unaware of the risks they bear in relation to client money, this is not true for sophisticated wholesale clients. The intention of the wholesale/retail distinction in the Corporations Act is to ensure that well informed financial institutions do not use their greater understanding of financial products to take advantage of less informed retail clients.

Appendix B - International comparisons

- The existing Australian regulatory regime relating to the use of client money by issuers is an anomaly amongst global practice.

United Kingdom

- The Financial Conduct Authority (FCA) has amended their Client Assets Sourcebook (CASS) to prevent firms from using title transfer collateral arrangements with retail clients.[22] ASIC has indicated that these amendments were made as the FCA found that the use of title transfer collateral arrangements were not always appropriate for retail clients and generally were not in clients' best interests.

- The rules state that where a client transfers full ownership of money to a firm for the purpose of securing or otherwise covering present or future, actual or

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21 Professional investors include financial services licensees, bodies regulated by APRA other than superannuation trustees acting for a trust holding less than $10 million in net assets, persons controlling $10 million or a body corporate or unincorporated body that carries on a business of investment in financial products, interests in land or other investments following an offer or invitation to the public.

22 Title transfer collateral arrangements in the UK allow firms to treat margin as their own working capital (rather than as client money).

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contingent or prospective obligations, such money should no longer be regarded as client money (CASS rule 7.2.3(1)).

- However, the rules also state that, where a firm makes arrangements for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations of a retail client, those arrangements must not provide for the taking of a transfer of full ownership of any of that client's money where the transfer of full ownership is for securing or covering a retail client's obligations under a CFD or a rolling spot forex contract that is a future, and in either case where that contract is entered into with a firm acting as market maker (CASS rule 7.2.3A).

Hong Kong

- The *Securities and Futures (Client Money) Rules* states that a licensed corporation or an associated entity of a licensed corporation that receives or holds client money of the licensed corporation must establish and maintain in Hong Kong one or more segregated accounts for client money each of which shall be designated as a trust account or client account (subsection 4(1)).

- The money in these accounts can be used when it is to be paid to a client, paid in accordance with a written direction, paid in accordance with a standing authority, where required in order to meet the client's obligations to meet settlement or margin requirements or where required to pay money that the client of the licensed corporation owes (subsection 5(1)).

- However, firms cannot use client money if it would be unconscionable or where it is used for related party transactions or to pay officers or employees (subsections 5(2) to 5(3)).

Singapore

- The *Securities and Futures Act (Licensing and Conduct of Business) Regulations* state that customer money must be dealt with as belonging to that customer, shall be deposited in a trust account and will not be commingled with other funds or used as margin, guarantee, secure the transaction of or extend the credit of any person other than the customer (subsection 16(1)).

- Further, the *Securities and Futures Act* states that firms cannot use customer money for payment of the firm's debts or court orders (section 104A).

Appendix C – Origins of the current regulatory framework

- The uses of client money in relation to derivatives permitted under the current regime are an unintended consequence of the historical origins of the regime. The basis of the permission for licensees to use client money for margining purposes was to facilitate clearing and settlement arrangements for exchange traded derivatives.

- Section 981D of the Corporations Act provides that if client money is paid for a financial product that is a derivative, the money may also be used for the purpose of meeting obligations incurred by the licensee in connection with

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margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee, including dealings on behalf of people other than the client. This allows licensees to withdraw money from a client money account to meet costs associated with hedging their exposure to the initial contract.

- Paragraphs 7.8.02(1)(a) and (c) of the *Corporations Regulations 2001* permit money to be withdrawn from client accounts for transactions where authorised by general written directions or for which the licensee is entitled. These paragraphs have been interpreted broadly by the industry. Some issuers obtain broad authorisations in their client agreements to make withdrawals from client money for any purpose, including as working capital.[23]

- Section 981D has its origins in investor trading in exchange-traded futures through futures brokers – a trading arrangement under which counterparty credit risk is significantly mitigated through the use of a centralised counterparty. However, as the drafting of the provision refers to 'derivatives', it is broader in application than its original context.

- The explanatory memorandum to the Financial Services Reform Bill 2001 discusses the definition of derivative that was put into the Corporations Act and states:

  – the definition of 'derivative' in proposed section 761D has been formulated to replace the existing definition of 'futures contract' in section 72 of the proposed Corporations Act. The definition focuses on the functions or commercial nature of derivatives rather than trying to identify each product that will be regarded as a derivative.

- Notably, when section 981D was added to the Corporations Act as part of the *Financial Services Reform Act 2001*, it was uncommon for clients to trade in OTC derivatives, so the definition of derivatives that was inserted to replace the definition of futures contract did not contemplate widespread use of client money arising from the trading in OTC derivatives by clients.

- In the case of retail OTC derivatives, investors deposit client monies with issuers in order to meet margining requirements imposed in their OTC derivatives contract by the issuer. Client monies therefore serve to act like collateral, reducing the risk to which issuers are exposed. In the event an investor defaults, issuers may access client monies to defray possible losses.

Appendix D – Counterparty credit risk

- In 2011, ASIC released Regulatory Guide 227: *Over-the-counter contracts for difference: Improving disclosure for retail investors*, which developed seven disclosure benchmarks for OTC CFD issuers to help retail investors understand risks and assess whether investing in OTC derivatives is suitable for them.

[23] ASIC Regulatory Guide 212, *Client Money Relating to Dealing with OTC Derivatives*, July 2010, p. 7

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- Benchmark five relates to client monies and states that the Product Disclosure Statement should clearly:
  - describe the issuer's client money policy, including how the issuer deals with client money and when, and on what basis, it makes withdrawals from client money; and
  - explain the counterparty credit risk associated with the use of client money for derivatives.
- If the issuer does not have a client money policy in place, or one that does not incorporate all of the elements described above, it should disclose this in the Product Disclosure Statement.
- The ASIC regulatory guide states that an issuer's client money policy should be explained in the Product Disclosure Statement in a way that allows potential investors to properly evaluate and quantify the nature of the risk, if any, to client money.
- While thorough product disclosure standards are in place, they appear to have reached the limit of their effectiveness due to the complex nature of the products traded and the inability of retail clients to understand the information that is being disclosed.
- Retail clients tend not to seek personal financial advice before investing in OTC derivatives and they rely disproportionately on advertising and disclosure material provided by issuers.
- ASIC has commissioned studies of contracts-for-difference investors that have shown that many retail investors do not understand how contracts-for-difference work or the significant risks involved in trading them. This is partly due to the complexity of the products traded. Further, they found that disclosure documents are often difficult to understand and do not highlight key information.

Box 2: GTL and BBY case studies

GTL case study

- GTL Tradeup Pty Ltd (GTL) was issued an AFSL in January 2011 to carry on financial services business in products including derivatives and foreign exchange (FX) contracts. The main liquidity provider of GTL was Dubai-based GTL Trading DMCC (DMCC).
- GTL transferred funds out of its client money account to its parent and was unable to meet client demands for the return of their money.
- When liquidators were appointed to GTL on 26 September 2013, GTL was owed about $4.35m by its parent, and owed about $4.4m to its clients. In this case, the client money regime may have facilitated GTL taking client money out of the segregated client money trust account for a range of purposes.

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BBY case study

- The following table sets out the potential distribution to clients in the BBY Ltd (BBY) case. It highlights the potentially different outcomes for clients, when BBY was a market participant and client money was held at an exchange, compared to client money for retail OTC derivatives including client money paid to hedge counterparties.

BBY – estimated surplus/shortfall calculation as at 29 April 2016								
Product line	**Equities**	**ETO**	**Overseas Futures**	**FX**	**Saxo**	**Carbon**	**IB**	**Other**
Cents in the dollar before costs	1.00	1.00	0.35	0.51	0.36	0.00	0.70	1.00
Note	BBY was a market participant		BBY was not a market participant					Other

Note - Surplus/(shortfall) calculations are before costs of the proceedings, realisation, adjudication and distribution

Source: KPMG BBY Liquidators Annual Report 9 September 2016
https://home.kpmg.com/content/dam/kpmg/au/pdf/bby/bby-liquidators-annual-report-9-september-2016.pdf

- Client monies relating to BBY's equities and exchange traded option (ETO) businesses may be repaid at up to 100 cents in the dollar.

- For business lines involving OTC products, client money is unlikely to be repaid at 100 cents in the dollar. This includes client money paid to third parties including hedge counterparties.

Appendix E – Compliance cost assumptions

- The costings assume an average labour cost of $65.45 per hour, based on default labour costs from the Office of Best Practice Regulation.

- The costings assume no material economies of scale between different size firms within the sector (that is, no need to disaggregate calculations on the basis of small/medium/large firm sizes).

- This is primarily due to the sector being heavily orientated towards online/electronic client contact. Hence any changes would therefore be expected to relate to updating operating systems.

- It is assumed that all related businesses (only those with AFSLs), whether they currently make use of client money or not, will have to make changes to their business, compliance practices, operating systems and disclosure documents as a result of the changes proposed in Options 1 and 2.

- The assumed inputs (that is, hours and staff numbers for the required tasks) are based on costings for similar tasks in other regulation impact statements which have been tested through consultation with stakeholders.

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