



Australian Government

Enhanced Protection of Client Money

Policy Paper
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CONSULTATION PROCESS

Request for feedback and comments

Interested parties are invited to comment on this policy paper.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment.

Closing date for submissions on this policy paper and the draft legislation to be released in January: 29 January 2016

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ENHANCED PROTECTION OF CLIENT MONEY

BACKGROUND

1. In October 2015, the Government, as part of a wider response to its root and branch examination of Australia's financial system (**the Inquiry**), announced that it would develop legislative amendments to improve protections for client monies held in relation to derivatives.¹ The Government noted that improvements were needed to ensure that investors' monies are adequately protected when held by intermediaries.
2. The Australian Government has announced its decision to make legislative amendments to the existing client money regime. The Government intends to make amendments to the client money regime under the *Corporations Act 2001* to enhance the protection provided to retail clients of financial services providers whilst maintaining efficiencies in wholesale markets.
3. This paper sets out the detail of the Government's proposed reforms to the client money regime. The Government intends to release draft legislation to implement the reforms set out in this paper in January. The legislation will be released to provide a comprehensive statement on the Government's position on reforms to the client money regime.
4. Considerable work has been done in recent years, both domestically and internationally, to develop appropriate protections for retail clients' client money. The Government has previously considered the handling and use of client money in relation to over-the-counter derivatives transactions in a discussion paper in November 2011 and considers it appropriate at this time to give further consideration to the issues discussed in that paper and the use of client money more generally.
5. The global financial crisis and subsequent events involving MF Global and BBY have demonstrated that Australia must have a robust client money regime which adequately protects retail clients and their client money. These and other events have indicated that the existing broad exception to the Australian client money regime, which enables an Australian financial services licensee (**AFS licensee**) to withdraw money which would otherwise be subject to the protective client money regime from client accounts for a wide range of dealings, may not be appropriate in the context of retail clients. Separately, it will be important to ensure that the protections to which client money and client property are subject do not impede an entity's ability to comply with its international obligations (for example, in respect of margining).

OVERVIEW OF EXISTING LEGISLATION

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

¹ See p 26, 'Government response to the Financial System Inquiry', www.treasury.gov.au/fsi

7. Under the Act, client money is money paid to an AFS licensee in connection with a financial service or product (and held on behalf of the client), but not as remuneration or payment for that service or product.
8. Typically, AFS licensees are required to keep client monies in designated 'client money accounts', to which a statutory trust is applied by virtue of the client money regime. This means that an AFS licensee must ensure that money to which the client money regime applies is paid into a trust account which complies with the requirements set out in the Act and Regulations. The money in that account (except for money paid to the licensee under the licensee's obligation to call margins from a client under relevant rules) must be held on trust for the benefit of the person who is entitled to the money.
9. However, there are broad exceptions to the limits on the use of client money under section 981D of the Act and paragraphs 7.8.02(1)(a) and (c) of the Regulations, which limit the protections otherwise provided under the client money regime.
10. Section 981D applies in respect of dealing in derivatives. Section 981D of the Act provides that:

“Despite anything in regulations made for the purposes of section 981C, if:

(a) the financial service referred to in subparagraph 981A(1)(a)(i) is or relates to a dealing in a derivative; or

(b) the financial product referred to in subparagraph 981A(1)(a)(ii) is a derivative;

the money concerned may also be used for the purpose of meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee (including dealings on behalf of people other than the client).”
11. Section 981D permits monies deposited by one client to be used (and withdrawn from the client account) in respect of the specified matters (including in connection with certain dealings on behalf of people other than that client). Section 981D extends to dealings in derivatives and is not limited to dealings “on behalf of” a particular client or to margins required by, for example, market operators as distinct from counterparties to trades with the licensee.
12. 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 licensee is entitled. It is understood that some AFS licensees obtain broad authorisations in their client agreements to make withdrawals from client money for any purpose, including as working capital.
13. Once money has been withdrawn from client accounts (eg under the broad permitted use set out in section 981D of the Act or paragraphs 7.8.02(1)(a) or (c) of the Regulations), it ceases to have the protections afforded to it by the statutory trust and may be exposed to a higher level of counterparty risk. This may not always be appreciated by retail clients, if they expect that their money is subject to protections under the Act and the Australian Securities and Investments Commission's (ASIC) supervisory regime.
14. The Government has decided the Act and Regulations (as appropriate) should be amended to modify these broad exceptions to the client money protections. On one

view, as it currently exists, the exceptions in section 981D and paragraphs 7.8.02(1)(a) and (c) of the Regulations significantly reduce the practical protections which would otherwise be available under the client money regime in the context of retail clients.

15. However, different considerations arise in the consideration of wholesale derivatives markets. Participants in these markets may face conflicting demands from the client money regime and other obligations in respect of derivatives (for example, margin requirements regarding non-centrally cleared derivatives). Accordingly, other amendments to the client money regime may enhance efficiencies in wholesale markets (eg the interbank market).
16. The Government intends to make additional amendments to the Act and Regulations so that the client money regime does not prevent participants in the wholesale derivatives market from meeting other obligations and to ensure that efficiencies are maintained for wholesale markets.
17. The Government welcomes the views of interested persons on the reforms set out in this paper. ASIC has also taken a range of actions to make sure licensees highlight any risks associated with their treatment of client money, for example see Regulatory Guide 212 *Client Money Relating to dealing in OTC derivatives*.

PROPOSED REFORM – RETAIL CLIENTS

18. The Government proposes to implement its commitment announced in response to the Inquiry to “enhance retail consumer protection for client monies” by reforming the client money regime in three key ways:
 - 1) The client money regime under the Act will be reformed by providing that **section 981D does *not* operate in respect of the client money of retail clients except in certain circumstances**. 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. The circumstances in which section 981D will operate in respect of client money of a retail client are where the money is paid out of the client money account pursuant to the market integrity rules or the operating rules of a licensed market or the operating rules of a licensed CS facility. In other words, section 981D would continue to apply only in the following circumstances:
 - a) in respect of wholesale clients (disregarding section 761GA);
 - b) if the payment was made pursuant to the market integrity rules or the operating rules of a licensed market or the operating rules of a licensed CS facility.

Therefore other than as described below, retail clients’ client money would not be able to be used by the licensee as working capital, or in connection with proprietary trading, hedging, or to meet the obligations in relation to any person other than the client.

- 2) The **existing permitted uses of client money**, such as the ability to rely on general directions or an AFS licensee’s entitlement to client money, **will be tightened in the context of retail clients to support this change**. Specifically:

- a) general directions regarding the use of money by the AFS licensee are prohibited except to the extent that the direction allows for the use of money for liabilities directly arising from transactions undertaken on behalf of the client. In other words, general directions would not be able to be used to enable an AFS licensee to withdraw money from a client money account unless the liability in respect of which the money was withdrawn directly arose from transactions undertaken on behalf of the client. The AFS licensee would not be able to enter into an agreement or arrangement with the client under which the licensee establishes an entitlement to the client money other than in relation to transactions undertaken on behalf of the client; and
- b) an AFS licensee could *not* rely on Regulation 7.8.02(1)(a) in respect of any direction² given by a retail client, or on Regulation 7.8.02(1)(c) in respect of any “entitlement”, which purported to allow an AFS licensee to use a retail client’s client money as the AFS licensee’s working capital or for the purpose of meeting obligations incurred in respect of margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the AFS licensee (including dealings on behalf of people other than the client) in circumstances where section 981D (as amended) would not otherwise apply in respect of that use. However this restriction would not prevent the direction from being valid for other purposes.

This will not change the requirements about payments of broker commissions from the account in section 981A(2)(a).

- 3) ASIC will be given the power to set reporting and reconciliation rules for retail clients’ client money in respect of derivatives, to enhance accountability and compliance with the client money requirements. ASIC is to be given the power to, by legislative instrument, make rules which must be complied with by an AFS licensee in relation to client money paid to an AFS licensee (in the manner contemplated in section 981A) in respect of:
 - a) a financial service which is or relates to a dealing in a derivative which is not subject to the market integrity rules or entered into on a licensed market or licensed CS facility that has been provided, or that will or may be provided, to a person as a retail client (disregarding 761GA); or
 - b) a financial product which is a derivative which is not subject to the market integrity rules or entered into or acquired on a licensed market or licensed CS facility which is acquired by a person as a retail client (disregarding 761GA).

19. This would enable ASIC to set, by way of rules, specific reporting and reconciliation requirements in respect of retail clients’ client money paid in respect of derivatives in sufficient technical detail (eg the level of detail which is provided in the market integrity rules, which may not be appropriate for the *Corporations Act* or even the *Corporations Regulations*). Generally, ASIC would be given the rule-making power to

² For example, a broad authorisation from a client to allow for a licensee to make withdrawals from client money “for any purpose whatsoever” (including as the licensee’s own working capital).

impose the reporting requirements and reconciliation requirements, and the rules could also specify:

- 1) the classes of derivatives in relation to which particular requirements apply;
 - 2) to whom information must be reported or reconciliations must be submitted;
 - 3) the information that is required to be reported or information/data that is required to be reconciled;
 - 4) the AFS licensees who are required to comply with requirements imposed by the rules;
 - 5) the manner and form in which persons must comply with requirements imposed by the rules;
 - 6) the circumstances in which persons are, or may be, relieved from complying with requirements in the rules that would otherwise apply to them;
 - 7) requirements as to the keeping of records, or the provision of records or other information, relating to compliance with (or determining whether there has been compliance with) the rules.
20. ASIC would be required to consult the public on the rules.
21. The issue of an infringement notice to a person for an alleged contravention of these reporting and reconciliation requirements would be available as an alternative to proceedings for an order for the payment of a pecuniary penalty.
22. AFS licensees would still be able to comingle client monies within a client monies account where this is permitted under the Act and the relevant market integrity rules and operating rules, and the statutory trust created under the client money regime under the Act would not attach to or affect subsequent transactions in respect of money which was previously client money,³ as it is understood that this could have significant impacts on certainty in financial markets.

PROPOSED REFORM – WHOLESALE CLIENTS

23. The Government proposes to implement its commitment announced in response to the Inquiry⁴ to “ensure participation in international derivatives markets” by implementing certain reforms in respect of wholesale clients (which, for the purposes of this proposed reform, does not include an entity which would otherwise be a retail client but is not solely because it satisfies the definition of “sophisticated investors”). The reforms in respect of wholesale clients are intended to maintain efficiencies in wholesale markets and ensure that the client money regime does not prevent participants in the wholesale derivatives market from being able to comply with other regulatory obligations (eg margin requirements). In respect of derivatives entered into

³ This broadly reflects some of the principles enunciated by Black J in *Re MF Global Australia Ltd (in liq)* (2012) 267 FLR 27.

⁴ See p 26, ‘Government response to the Financial System Inquiry’, www.treasury.gov.au/fsi

between an AFS licensee and a wholesale client, the Government will amend or clarify the client money regime to provide that:

- 1) the existing section 981D of the *Corporations Act* is to continue to apply; and
- 2) the AFS licensee and that wholesale client may agree the way in which client money, and client property, of that wholesale client will be held and dealt with in respect of dealings in derivatives. Of course, this would not, of itself, allow such a wholesale client to deal with the client money or client property of its own clients which are not wholesale clients in this way.