Treasury Discussion Paper: Handling and use of client money in relation to over-the-counter derivatives transactions

ASX Submission

27 January 2012

Introduction

This submission outlines the ASX Group's formal response to the Treasury Paper: Handling and use of client money in relation to over-the-counter derivatives transactions. ASX appreciates the opportunity to comment on the Treasury proposals.

About ASX Group

ASX Group is a provider of multi-asset class exchange services providing trading, clearing and settlement services. It operates Australia's main equities and derivatives exchange markets and the post-trade processing services in which transactions executed on these markets and alternative market operators trading ASX-listed equities are cleared and settled.

ASX currently operates two Central Counter Party Clearing Houses (clearing houses) – ASX Clear and ASX Clear (Futures). ASX Clear is a clearing house for a range of financial products traded on the ASX market, including cash equities, pooled investment products, warrants, certain interest rate products and equity and commodity-related derivatives. ASX Clear (Futures) is a clearing house for derivatives traded on the ASX24 market (formerly the Sydney Futures Exchange), including futures and options on interest rate, equity, energy and commodity products.

The ASX Group also has two wholly owned settlement subsidiaries, ASX Settlement and Austraclear. These two settlement facilities provide a delivery versus payment (DvP) settlement service, secure asset holding services as well as a wide network that enables 'straight through processing' to both exchange traded markets (ASX Settlement) and over the counter markets (Austraclear).

ASX is actively looking at extending its clearing services into over-the-counter (OTC) markets such as equity options and Australian dollar interest rate swaps consistent with the Australian Council of Financial Regulators' discussion paper on Central Clearing of OTC Derivatives in Australia and overseas regulatory changes such as those arising from Dodd-Frank. Client monies in relation to these derivatives will be treated in a similar way under the relevant operating rules to client monies in relation to exchange traded derivatives.

Summary

ASX's views are informed by its experience as the operator of markets and clearing houses that are subject to the regulatory standards set out in Chapter 7 of the Corporations Act. This means that ASX is subject to regulatory standards and assessment against those standards and that ASX imposes safeguards by requiring its participants to comply with operating rules.

In summary, ASX's view is that the different arrangements for the protection of client money which are in place today are not well understood by clients, even though these are set out in client documentation. Clients (particularly, but not exclusively retail clients) do not appear to understand the significant differences between regulatory safeguards that apply to client monies in the context of licensed markets and clearing houses in contrast to unlicensed markets. ASX considers that further steps could be taken to ensure that clients understand these differences. Further policy consideration should be given to whether the differences in regulatory safeguards are appropriate and, if changes are proposed, the impact on industry arrangements.

The key comments that ASX has articulated more fully in its response are:

- Clients need to understand the risk exposure that arises as a consequence of how their money is held and what protections apply. The terminology of 'client segregated account' is used to cover a number of different models for omnibus accounts. Some clients may not properly appreciate the difference between a client omnibus account and an individual client segregated account or trust account. ASX's observation of events during the global financial crisis and more recently, in relation to the insolvency of MF Global, is that these matters are not well understood by clients until a problem arises.

- Steps should be taken to ensure that clients understand these risks, and in particular the differences in regulatory safeguards that apply to client monies in the context of unlicensed markets, as opposed to licensed markets and clearing houses. This would involve strengthening requirements around education, disclosure and cautionary warnings. Policy makers should consider whether differences in regulatory safeguards are appropriate, particularly for retail clients.

- The consequences of AFSL exemptions, which have the effect of exempting certain entities from the client money requirements in the Corporations Act, could also be reviewed in this context.

- Any proposals to change the regulation of the handling of client monies would have a significant impact on the economics of the futures trading industry. The benefits of a change to the current use of segregated accounts should be weighed up against the potential consequences.

- The Government's proposal to mandate the central clearing of standardised and systemically important OTC derivative contracts will necessitate consideration of appropriate client money handling requirements in relation to such instruments.

We would be happy to discuss any of these issues further. If you have any comments or questions, please contact Sally Palmer on 02 9227 0920.

Responses to Treasury questions

Section 2: Pooling of client money or property relating to derivatives

1. *Should the law be amended so that:*

   (i) *client monies held on behalf of a retail client cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee; or*

   (ii) *the monies deposited by one client in connection with a derivatives transaction cannot be used for meeting obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee on behalf of people other than that client?*

One view is that a lack of understanding in relation to segregated accounts and margins for OTC derivatives transactions has arisen from the manner in which provisions that formerly applied to futures contracts under the Corporations Act prior to the Financial Services Reform Act 2001 (FSRA) were extended by the FSRA to apply to derivatives generally. When this was done the importance of the added safeguards provided by the operator of a licensed market or clearing house was not fully recognised. This meant that the provisions were extended without the equivalent safeguards being applied in relation to unlicensed markets.

Under the pre-FSRA Corporations Act chapter 8 regulating the futures industry, a futures broker was required to be a member of a futures organisation[1] and all trading in futures contracts was required to take place on an authorised futures market.[2] This effectively obliged the broker to be a member of, and to conduct all their local dealings in futures contracts on, the Sydney Futures Exchange (SFE). The broker was therefore subject to provisions in the Corporations Act and the SFE business rules requiring them to maintain a client segregated account and regulating the withdrawals that could be made from that account.[3] The permitted withdrawals included amounts required for or in connection with the entering into, margining, guaranteeing, securing, transferring, adjusting or settling of dealings in futures contracts effected by the broker on behalf of clients generally.[4] While this created an exposure for each client to any default by another client, clients were protected to a significant degree by the fact that all relevant dealings in futures contracts had to be effected on the SFE, meaning that they were subject to a margining regime overseen by the SFE and to provisions in the SFE business rules requiring the broker to maintain a prescribed minimum level of capital and to top up its client segregated account if the account fell into deficit due to a client failing to meet a margin call.[5]

The futures client segregated account and permitted withdrawal provisions in chapter 8 were carried over by the FSRA into chapter 7 and extended to all derivatives by s981D. Hence, they now apply to OTC derivatives as well as exchange traded derivatives.[6] The issuers of OTC derivatives, however, are not subject to the risk controls and obligations to comply with the operating rules set by operators of licensed markets and clearing houses. OTC issuers currently have only limited capital requirements under their AFSL[7] and do not have any obligation to top up a

[1] Section 1148 of the pre-FSRA Corporations Act made this a statutory condition of a futures broker's licence.
[2] This was the practical effect of s1123 of the pre-FSRA Corporations Act prohibiting a person conducting an unauthorised futures market and the decision of the NSW Supreme Court in *Carragreen Currency Corporations Pty Ltd v Corporate Affairs Commission (NSW)* (1986) 11 ACLR 298.
[3] Section 1209 of the pre-FSRA Corporations Act and the predecessor provisions to rule 2.2.6 of the *ASIC Market Integrity Rules (ASX 24 Market) 2010* ("ASX 24 MIR").
[4] Section 1209(5) of the pre-FSRA Corporations Act.
[5] The predecessor provisions to rule 2.2.6(f) of the ASX 24 MIR.
[6] See generally paragraphs 65-70 of ASIC Regulatory Guide 212 *Client money relating to dealing in OTC derivatives*.
[7] An issue that ASIC has indicated it intends to address – see ASIC Consultation Paper CP 156 *Retail OTC derivative issuers: Financial requirements*.

client segregated account in the event that a client fails to meet a margin call. This has opened up a significant credit exposure for clients and represents a substantial weakening of the framework for the protection of client monies provided by part 7.8 division 2 in respect of OTC derivatives.

The difference in regulatory safeguards is not well understood by clients, particularly (but not exclusively) retail clients, until a problem arises. Further, although ASIC requires that a PDS include disclosures concerning the use of client money to meet margin obligations (including those of other clients)[8], it appears that many clients do not understand that money held in a segregated account is not held solely for the benefit of the client. Some clients appear to expect that a 'segregated account' is segregated from the funds of other clients.

ASX considers that policy makers can address this lack of understanding by strengthening requirements around education, disclosure and cautionary warnings. The terminology 'segregated account' may also contribute to the apparent confusion. Alternatively, the law could be changed to address the differences in regulatory safeguards (e.g. introducing added safeguards in relation to AFSL holders in unlicensed markets such as a top up requirement, prohibiting the use of buffer funds and requiring a regular reconciliation of client monies).

2. Should licensees continue to be able to pay such funds into client segregated accounts, or should they be required to pay them into separate trust accounts for each client?

ASX has no comments on this issue in relation to OTC derivatives, but notes that a requirement to have separate trust accounts is likely to result in a significant change to industry economics.

3. Should the above changes to the law concerning client money be limited to derivatives issued OTC or include all derivatives, including those which are traded on an exchange (such as futures)?

The use of client money in relation to derivatives traded on a licensed market or cleared through a licensed clearing house is already subject to controls under the relevant ASIC Market Integrity Rules and operating rules.[9] These rules include an obligation to perform reconciliations of segregated accounts and a top up requirement on a participant where there is a shortfall in relation to a particular client. Further, there is a margining regime for exchange traded derivatives and minimum capital requirements for clearing participants imposed by the licensed operator of the clearing house.

Any proposal to extend changes to the law to exchange traded derivatives would have a significant impact on the economics of the futures trading industry. Clearing houses both in Australia and overseas impose margins on futures contracts on a net basis and hold those margins in an omnibus structure. The provisions of the Corporations Act and Regulations which allow margins to be paid into a segregated account and used for margins (including those of other clients) facilitate this structure. A move away from this structure would result in a loss in position and margin netting benefits. This would also carry a number of potential consequences for clients (both retail and wholesale), clearing participants, markets and clearing houses. Note that similar considerations apply to proposals to provide for the portability of positions and collateral, which would require individual segregated client accounts and margin (i.e. no omnibus account structures as currently applied).[10]

Hence, it would be necessary to weigh up any potential benefits of a change to the current use of segregated accounts against the significant potential consequences to industry economics. If there was to be a change transitional arrangements would be required.

A related issue is that the Government's proposal to mandate the central clearing of standardised and systemically important OTC derivative contracts will necessitate consideration of appropriate client money handling requirements for those arrangements. It will be necessary to have regard to:

- the large exposures generated under these instruments;

[8] ASIC Regulatory Guide 212 *Client money in relating to dealing in OTC derivatives*, July 2010, 212.71-212.73, ASIC Regulatory Guide 227 *Over-the-counter contracts for difference. Improving disclosure for retail investors*, August 2011, 227.73-227.75.

[9] See in particular ASX 24 MIR rule 2.2.6, *ASIC Market Integrity Rules (ASX Market) 2010* rule 3.5 and *ASX Clear Operating Rules* rule 4.23.

[10] See *ASX Submission to the Council of Financial Regulators: Review of Financial Market Infrastructure Regulation*, 23 November 2011, available at http://www.treasury.gov.au/documents/2254/PDF/ASX.PDF, section 11.

- the systemically important nature of some of the clients that are active in this market (e.g. banks and large hedge funds); and
- the potential systemic disruption that may be caused by client moneys not being fully available for withdrawal or transfer in the event of a clearing participant default.

4. Should the regulations be changed to limit the ability of a licensee to pay money out of the client money account at the written direction of the client to instances where the client provides a specified written direction for each individual payment out of the account (thereby restricting the use of general client directions in the form of clauses in the client agreement)?

The practicalities of these types of arrangements would need to be carefully considered. It is not likely to be practical for exchange traded derivatives as participants need to be able to use client monies for the purpose of paying margins.

5. Should licensees be required to conduct a regular reconciliation of client money and have a documented process in place to escalate and resolve any unreconciled variances that are identified?

ASX notes that this is already required for exchange traded or centrally cleared derivatives.

6. Do you consider there is a lack of clarity as to the meaning of the law, as described above under the heading 'Interpretation of the provisions'? If not, what is in your view the correct interpretation? What should be the preferred interpretation?

ASX considers that there is a lack of clarity which contributes to the general lack of understanding of the client money safeguards (as discussed above). Steps should be taken to address this. Based on the current law, the preferred interpretation is that section 981D allows an AFSL holder to make payments from the client money account to meet margin obligations arising from contracts entered into on behalf of any of its clients, but does not allow the AFSL holder to use the funds for hedging its own positions.

7. If the current general approach in the law is retained, should its application be altered? If so, would it be preferable to continue to allow pooling of clients' money, or to specify the circumstances in which monies can be used? Should the right to use client money be temporary, e.g. requiring that any shortfall arising from one client's money being used to cover the obligations arising from another client's trading is topped up by the licensee within a short period of time? Please provide any other options you would like us to consider.

The following issues could be considered.

There could be a review of exemptions from the requirement to hold an AFSL which have the effect of exempting certain entities from the client money requirements under the Corporations Act. For example, exemptions apply to foreign financial services providers regulated by overseas regulators as specified in ASIC class orders.[11] While the relief for foreign providers is limited to providers who have only wholesale clients, the underlying clients of the wholesale clients may be retail clients. In these situations the client money provisions will not apply, although services are being provided indirectly to retail clients. This is another situation where the limitations of the safeguards on handling client money are not well understood.

The use of 'buffer funds' could be prohibited and replaced with a 'top up' requirement. Notwithstanding ASIC guidance on the use of buffer funds[12] we understand that some AFSL holders put their own funds in a segregated account or trust account to cover a shortfall of client funds. In the event that the AFSL holder becomes insolvent the buffer funds may be treated as the AFSL holder's funds rather than the clients' funds. Hence, the 'buffer funds' have the effect of masking the shortfall in the account without providing protection to clients. ASX considers that this practice should be prohibited. Further, there should be a 'top up' requirement whereby if there is a shortfall of client funds due to a client not paying a margin the AFSL holder is required to deposit funds into the client segregated

[11] Corporations Act s991A(2)(h) and (l) and relevant ASIC class orders (e.g. 03/1099 (UK FSA regulated), 03/1100 (US SEC regulated), 03/1101 (US Federal Reserve and OCC regulated), 03/1102 (Singapore MAS regulated), 03/1103 (Hong Kong SFC regulated), 04/829 (US CFTC regulated), 04/1313 (Germany BaFin regulated)

[12] ASIC Regulatory Guide 212 *Client money in relating to dealing in OTC derivatives*, July 2010, 212.40-212.41.

account for the benefit of the clients and such funds may only be withdrawn if the outstanding margin is received and paid into the segregated account.

In relation to exchange traded derivatives, the experience with MF Global has demonstrated that clients do not appreciate that once money is paid to the clearing house as margin it is no longer held for the benefit of the client. This is another area where further education of clients is required. Note that ASX intends to add further information to its website concerning money paid to the clearing house.

8. What would be the impact of the possible changes identified in the paper? Please provide as much detail as possible of any costs or other impacts.

See question 3 above.

9. Should any enhanced protection apply to the money and property only of retail clients? Why?

Wholesale clients are in a better position to be advised on and appreciate the regime that applies. Enhanced protection will come at an increased cost. The benefits would need to be evaluated in that context.

11. Are there any additional protections needed for client money where the licensee holds the financial products outside Australia?

Consideration could be given to structures where a domestic AFSL holder uses client funds to pay for dealing with a foreign financial services provider (often a related body corporate). This may result in a complex situation for clients if the foreign financial services provider becomes insolvent. Consideration of this issue could be linked to a review of the exemptions given to financial service providers as discussed in question 7 above.

ASX has no comments in relation to questions 10, 12 and 13.

Section 3: Reporting requirements

1. Do you agree that there is a gap in the information being provided to OTC derivatives clients by the Act not requiring monthly reporting of money and property held on their behalf?

ASX notes that there are reporting requirements for exchange traded derivatives in the ASX Clear Operating Rules.[13] These requirements do not apply to clients using OTC derivatives.

2. Are the items listed above information which would benefit clients?

Yes, clients would have more timely access to information to understand the transactions which involve their money and property.

ASX has no comments in relation to questions 3 to 6.

[13] *ASX Clear Operating Rules* rule 4.15