# EXPLANATORY STATEMENT

## Issued by authority of the Assistant Treasurer

### Corporations Amendment (Client Money) Bill 2016

### Corporations Amendment (Client Money) Regulation 2016

Together, the Corporations Amendment (Client Money) Bill 2016 (the Bill) and the Corporations Amendment (Client Money) Regulation 2016 (the Regulation) amend the existing client money regime to better protect retail clients of financial services providers while maintaining the efficient operation of wholesale derivatives markets.

## Current regime

The *Corporations Act 2001* (the Corporations Act) establishes a regulatory framework governing how Australian Financial Services licensees (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 Corporations Regulations).

The client money regulatory framework does not generally distinguish between retail and wholesale clients.

Under the Corporations 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.

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 Corporations Act and Corporations 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.

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.

Section 981D permits money deposited by one client to be used (and withdrawn from the client account) in connection with dealings in derivatives.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 over-the-counter (OTC) derivative trades with the licensee).

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 and product disclosure statements to make withdrawals from client money for any purpose, including as working capital and for proprietary trading.

Once money has been withdrawn from client accounts (under the broad permitted use set out in s981D of the Corporations 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 higher levels of counterparty risk, for which clients are not compensated.

The money may be used by the AFS licensee in a range of ways, and may be held by or otherwise used in dealings with a range of counterparties – including entities that are offshore and/or related, and not authorised under the Australian supervisory regime.

These kinds of permissions may be appropriate for wholesale clients (institutional clients), who typically have considerable experience dealing in derivatives and the capacity to assess risks associated with the use of their client money other than as envisioned by 981H (money to be held in trust). These clients may also have a need to comply with global margin standards in order to participate effectively in wholesale derivatives markets.

However, retail clients do not always understand that their derivative client money is afforded less protection, and may assume that it is subject to protections otherwise provided under the Corporations Act.

Thorough evaluation of counterparty risk in derivatives markets is complex, and cannot be reasonably expected of most retail – or, indeed, sophisticated investors (as defined by 761G of the Corporations Act). Retail clients who have sufficient assets to qualify as sophisticated clients still may not have the capacity to understand the ways in which their derivative client money may be handled by their respective AFS licensees, or understand the increased risk that they may suffer losses due to these uses of derivative client money.

Global margin standards are directed towards wholesale (institutional) participants. Therefore, the new exemptions are directed towards those participants rather than retail or sophisticated investors.

## Amended regime

The Regulation amends the Corporations Regulations to limit the ways in which AFS licensees can deal with retail derivative client money (including that of sophisticated investors)[1], thereby promoting its protection.

Specifically, it inserts regulation 7.8.02A (accounts maintained for section 981B of the Act—special rules for retail clients), which prevents the use of derivative retail client money from being used as the licensee's working capital; or to meet obligations incurred by the licensee other than on behalf of the client; or to enter into, or meet obligations under, transactions the licensee enters into to hedge, counteract or offset the risk to the licensee associated with a transaction between the licensee and the client.

It also amends paragraphs 7.8.02(1)(a) and (c) to make clear that retail clients (including sophisticated investors) cannot authorise such use through written general directions; and that AFS licensees are no longer entitled to use it in these ways. These changes will not affect the requirements about payments of broker commissions from accounts maintained for the purposes of section 981B. **[Schedule 1 – 7.8.02A Accounts maintained for section 981B of the Act; at the end of paragraphs 7.8.02(1)(a) and (c)]**

Section 981D of the Act will continue to apply despite anything in regulations made for the purposes of section 981C of the Act (including regulation 7.8.02). However, section 981D will be amended by the Bill to provide that payments of retail client money under section 981D may only be made if the derivative is entered into, or acquired, on a licensed market – or the entry into the derivative is cleared through a licensed clearing and settlement (CS) facility; and the licensee incurred the obligation, in connection with the derivative, under the market integrity rules or the operating rules of the licensed market or licensed CS facility.

These exceptions are made because the central clearing of derivatives through a clearing house generally means that counterparty risk is mitigated by novation to the clearing house,

1 *Derivative client money* is defined by the Bill [Schedule 1 – 981J Meaning of derivative client money]

and relevant clearing participants are subject to enhanced requirements such as capital, reporting and reconciliation requirements on the client segregated accounts they operate.

### Application

The Regulation also establishes Part 10.24 – Application provisions related to the Corporations Amendment (Client Money) Regulation 2016, which provides that sub regulations 7.8.02A(1) (relating to the use of general directions about derivative retail client money) and 7.8.02A (2) (relating to AFS licensee entitlements to derivative retail client money) apply to payments made on or after the commencement of regulation 10.23.01, out of an account maintained for the purposes of section 981B of the Act – whether the direction or entitlement was created before, on, or after commencement. **[Schedule 1 – 10.24.01 Application of regulation 7.8.02A]**

A public consultation on this Regulation is underway. The Regulation commenced on [*insert date when known*].

## Statement of Compatibility with Human Rights

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

### Corporations Amendment (Client Money) Regulation 2016

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

Together, the *Corporations Amendment (Client Money) Bill* 2016 (the Bill) and the *Corporations Amendment (Client Money) Regulation 2016* (the Regulation) amend the existing client money regime to better protect retail clients of financial services providers while maintaining the efficient operation of wholesale derivatives markets.

## Human rights implications

This Legislative Instrument does not affect 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.