



**ASIC**

Australian Securities & Investments Commission

## REGULATORY GUIDE 212

# Client money relating to dealing in OTC derivatives

July 2010

### **About this guide**

This is a guide for Australian financial services (AFS) licensees who are required to hold client money and for investors who pay money to an AFS licensee for the purpose of trading in derivatives in the over-the-counter (OTC) market.

This guide provides an overview of the client money provisions in Div 2 of Pt 7.8 of the *Corporations Act 2001* (the client money provisions) generally and, in particular, the specific provisions that relate to derivatives. It also seeks better disclosure in connection with client money.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Document history

This regulatory guide was issued on 12 July 2010 and is based on legislation and regulations as at 12 July 2010.

### Disclaimer

This guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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## A Overview

### Key points

In complying with the client money provisions, an AFS licensee must:

- identify which money is client money (see RG 212.2–RG 212.3);
- ensure that client money, and no other money, is paid into a client money account (see RG 212.4–RG 212.7); and
- only use and withdraw client money as provided for in the client money provisions, and properly inform clients about the risks associated with that use (see RG 212.8–RG 212.13).

Clients are exposed to counterparty risks notwithstanding these protections and an AFS licensee must provide clear disclosure to allow clients to evaluate these risks: see RG 212.14–RG 000.17.

We may take action if we become aware that an AFS licensee has failed to comply with the client money provisions: see RG 212.21.

- RG 212.1 The client money provisions protect the interests of clients of AFS licensees by:
- (a) separating client money from money belonging to licensees;
  - (b) generally requiring that licensees hold client money on trust;
  - (c) limiting the uses of client money;
  - (d) limiting the circumstances in which client money may be withdrawn from client money accounts;
  - (e) specifying how client money may be dealt with if a licensee ceases to be licensed or becomes insolvent;
  - (f) requiring auditors to verify licensees' compliance with the client money provisions; and
  - (g) imposing sanctions on licensees who fail to comply with the client money provisions.

### What is client money?

- RG 212.2 Client money is money paid to an AFS licensee:
- (a) in connection with either a financial service that has been provided (or that will or may be provided) to a client or a financial product held by a client; and
  - (b) either:

- (i) by a client or a person acting on behalf of a client; or
- (ii) to the licensee in the licensee's capacity as a person acting on behalf of the client.

Note: Client money can also include subscription money received from a client for a product to be issued. This regulatory guide does not deal with receipt of subscription money.

RG 212.3 The client money provisions do not apply to:

- (a) money paid as remuneration to a licensee;
- (b) money paid to reimburse (or discharge a liability incurred by) the licensee for payment made to acquire a financial product;
- (c) money paid to acquire a financial product from the licensee;
- (d) loan money; or
- (e) money paid to be credited to a deposit product.

Note: See Section B for further information.

## What is a client money account?

RG 212.4 A client money account must be designated as a client money account for the purposes of s981B of the *Corporations Act 2001* (Corporations Act) and is:

- (a) an account with an Australian authorised deposit-taking institution (Australian ADI);
- (b) an account with an approved foreign bank;
- (c) a cash management trust; or
- (d) a cash common fund.

Note: See Section C for further information.

RG 212.5 Generally a client money account is operated as a trust account. However, if a licensee is required to call margins from a client under the operating rules of a licensed market or a licensed clearing and settlement (CS) facility, the licensee may operate the client money account as either a clients' segregated account or a trust account. In either case, the account is subject to the statutory protections on use, withdrawals and distribution of client money in the event of the licensee's insolvency or ceasing to carry on business. In this regulatory guide, we use the term 'client money account' generally, irrespective of whether it is operated as a trust account or a clients' segregated account.

Note: See Section C for further information.

## Permitted deposits into client money accounts

RG 212.6 The licensee may only pay the following money into a client money account:

- (a) client money;
- (b) interest on client money;
- (c) interest on permitted investments using client money or the proceeds of the realisation of permitted investments; or
- (d) certain other money specified by the regulations.

RG 212.7 The client money provisions do not permit licensees to deposit their own funds into client money accounts.

Note: See Section C for further information.

## Permitted investments of client money

RG 212.8 Client money may be invested in certain permitted investments, including:

- (a) investment in a way that trustees are for the time being authorised by law to invest trust funds;
- (b) investment on deposit with an Australian ADI or eligible money market dealer; and
- (c) investment in a security issued or guaranteed by the Commonwealth or a state or territory.

RG 212.9 Generally a licensee may only invest client money in a permitted investment where the licensee has obtained the client's written agreement about how the earnings or losses on the investment are to be dealt with and how the investment is to be realised.

Note: See Section D for further information.

## Permitted uses of, and withdrawals from, client money accounts

RG 212.10 A licensee may make payments out of a client money account in the following circumstances:

- (a) making a payment to, or in accordance with the written direction of, a person entitled to the money;
- (b) defraying brokerage and other proper charges;
- (c) paying to the licensee money to which the licensee is entitled; and
- (d) making a payment that is otherwise authorised by law or pursuant to the operating rules of a licensed market.

- RG 212.11 A licensee must ensure that it complies with its obligations as an AFS licensee when making any withdrawals from a client money account: see RG 212.53.
- RG 212.12 The terms of the client agreement (or customer contract) for trading in the relevant OTC derivatives may contain provisions about when the licensee can claim an entitlement to client money. For example, the terms of the client agreement may provide that, when a derivative position is opened, the licensee is entitled to the initial margin and any variation margin while the position is opened. When the licensee withdraws margin from the client money account based on such a right, the money equal to those margin payments ceases to be client money: see RG 212.56–RG 212.64.
- RG 212.13 In addition to these payments, specific rules apply for dealings in derivatives. An AFS licensee may use client money to meet 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: see s981D.

## Counterparty risks

- RG 212.14 Even though the client money account is a separate account subject to a statutory trust, clients are exposed to counterparty risk with respect to client money. That is, the risk that in the event of the failure of another client or the licensee, a client will not receive all of their client money back. This arises because:
- (a) the licensee is permitted to use client money to meet 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;
  - (b) the licensee may make a withdrawal from a client money account of money to which it is entitled and that entitlement may be created under the terms of its client agreement by specifying when margin is due and payable; and
  - (c) the licensee may make a payment out of client money if it has obtained a written direction from the person entitled to the money—we understand that the client agreements of AFS licensees dealing in derivatives may contain a broad authorisation from clients for the licensees to make withdrawals from client money for any purpose whatsoever.
- Note: See Section D for further information.
- RG 212.15 Before depositing client money with a licensee, clients need to assess the risks that arise with client money being used when trading in derivatives. After considering any risk for clients, a licensee could advise them that they are able to:

- (a) ask for details of the licensee's policies about use of client money (e.g. when does the licensee claim an entitlement to margin deposits and when will one client's client money be used to meet the obligations arising from trading of another client); and
- (b) minimise this risk by keeping the minimum client money with the licensee to reduce their exposure.

RG 212.16 We consider that a licensee needs to clearly and prominently disclose in its Product Disclosure Statement (PDS):

- (a) how it deals with client money and when, and on what basis, it makes withdrawals from client money; and
- (b) the nature of the counterparty risk for client money used for derivatives.

RG 212.17 A licensee needs to assess carefully the information to be included in the PDS, and other disclosures given to clients, to allow potential clients to properly evaluate and quantify the nature of the risk, if any, to client money. This could include financial information of the licensee, so that a potential client can adequately quantify the licensee's solvency.

## Other issues

RG 212.18 A licensee must keep financial records in sufficient detail to explain all money received or paid by the licensee in relation to the client money accounts it holds.

RG 212.19 The auditor's report accompanying the licensee's financial statements must contain a statement of the auditor's opinion of the licensee's compliance with the client money provisions.

RG 212.20 The Corporations Act provides for how client money is to be dealt with if a licensee ceases to be licensed or becomes insolvent.

Note: See Section E for further information.

## ASIC's role

RG 212.21 If we become aware that a licensee has not complied with the client money provisions, we may take appropriate action by:

- (a) requiring the licensee to take remedial action;
- (b) taking civil or criminal action in the courts against the licensee; or
- (c) taking administrative action against the licensee, such as imposing additional conditions on its AFS licence or revoking the licence.

Note: See Section E for further information.

## B Identifying client money

### Key points

Client money is defined in s981A of the Corporations Act: see RG 212.22.

The client money provisions do not apply to all money received by a licensee from a client: see RG 212.24.

### What is client money?

- RG 212.22 Client money is money paid to an AFS licensee:
- (a) in connection with either a financial service that has been provided (or that will or may be provided) to a client or a financial product held by a client; and
  - (b) either:
    - (i) by a client or a person acting on behalf of a client; or
    - (ii) to the licensee in the licensee's capacity as a person acting on behalf of the client.

Note: See s981A.

- RG 212.23 If a licensee, as an issuer or seller of financial products, receives money for the issue or purchase of a financial product and the issue or purchase does not occur immediately after receiving the money and the licensee deposits it into a client money account, then that money is also client money: s1017E and 981B(1)(b)(iv) and regs 7.8.01(6) and (7).

### What is not client money?

- RG 212.24 The client money provisions do not apply to:
- (a) money paid by way of remuneration payable to the licensee;
  - (b) money paid to reimburse (or discharge a liability incurred by) the AFS licensee for payment made to acquire a financial product (or to indemnify the licensee in respect of such a liability);
  - (c) money paid to acquire a financial product or an increased interest in a financial product from the licensee;
  - (d) loan money;

Note: Loan money is defined in s982A and the provisions relating to loan money are contained in Subdivision B of Div 2 of Pt 7.8.

- (e) money deposited to the credit of a deposit product with the licensee; or
- (f) property other than money (e.g. share certificates).

Note: Div 3 of Pt 7.8 deals with other property given to a licensee by clients in connection with a financial service or financial product.

## C Client money accounts

### Key points

Client money accounts are generally trust accounts but can be operated as a clients' segregated account in certain circumstances: see RG 212.28.

Client money accounts must be designated as such and only certain money may be paid into them: see RG 212.32.

Licencees are not permitted to deposit their own funds into a client money account: see RG 212.40–RG 212.42.

Licencees are entitled to the interest on money in a client money account provided this is disclosed to the client: see RG 212.43–RG 212.44.

### What is a client money account?

RG 212.25 A client money account is an account maintained by a licensee into which client money is paid. It may consist of a single account or two or more accounts: s981B(2).

RG 212.26 A client money account must be established as one of the following:

- (a) an account with an Australian ADI;
- (b) an account with an approved foreign bank;
- (c) a cash management trust; or
- (d) a cash common fund.

Note: See s981B, regs 7.8.01(2) and (5) and Class Order [CO 04/1063] *Section 981B money in cash common funds*.

RG 212.27 Client money belonging to a client is held on trust by the licensee for the benefit of that client. The trust continues even where the licensee ceases to be licensed or there has been a breach of a relevant financial services law: s981H, regs 7.8.01(5), 7.8.03(5) and 7.8.04.

Note: Class Order [CO 03/1112] *Relief from obligation to hold client money on trust* grants a licensee who is an Australian ADI relief from the obligation to hold a client's money on trust where the client is a wholesale client and the licensee and client agree in writing.

## Nature of a client money account

- RG 212.28 A client money account must be opened as a trust account except where a licensee is required to call margins from a client under the operating rules of a licensed market or a licensed CS facility. In this case, the licensee may operate the account as a clients' segregated account and may pay all client money into that account (i.e. even if some of that client money is not for the purposes of margins collected under the operating rules of a licensed market or licensed CS facility): reg 7.8.01(9).
- RG 212.29 However, in each case:
- (a) client money is segregated from the licensee's own funds; and
  - (b) one client's client money is commingled with other client funds. This means that clients are exposed to the risk that they may not receive all the money owed to them if there is a deficiency in the client money account and the licensee becomes insolvent or is otherwise unable to pay the deficiency.
- RG 212.30 Client money is taken to be held in trust for the benefit of the client (see s981H), except for that portion of money paid to a licensee for margins required under the operating rules of a licensed market or licensed CS facility: reg 7.8.01(5). However, in the event of the licensee's insolvency, a client money account is taken to be subject to a trust in favour of each person who is entitled to be paid money from that account: reg 7.8.03(4).

## No security

- RG 212.31 Client money (both in a client money account and before or after it is paid into a client money account) is not capable of being attached or otherwise taken in execution or being made subject to a set-off or charging order (other than at the suit of a person who is otherwise entitled to the money or investment): s981E.

## What money can be paid into a client money account

- RG 212.32 The only money that may be paid into a client money account is:
- (a) client money;
  - (b) interest on client money;
  - (c) interest or other similar payments on permitted investments using client money or the proceeds of the realisation of permitted investments;
  - (d) an amount equivalent to any losses made on permitted investments using client money (see RG 212.46);

- (e) money paid to a licensee from or on behalf of an insured person for an insurer, or vice versa, in connection with a contract of insurance;
- (f) money paid by a licensee into a client money account due to the requirements of operating rules of a licensed market;
- (g) money received pursuant to s1017E by an issuer or seller of financial products where the issue or transfer of the financial product does not occur immediately after receiving the money;
- (h) mixed money (see RG 212.34–RG 212.36); and
- (i) unidentified money (RG 212.37–RG 212.39).

Note: See s981B and regs 7.8.01(3), (4), (4A) and (6).

RG 212.33 A licensee must pay client money into a client money account on the day the licensee receives it or on the next business day: s981B.

## Mixed money

RG 212.34 Mixed money is money that is received by the licensee as a single payment and is not wholly client money but includes client money.

RG 212.35 If mixed money is paid into a client money account, the licensee should remove the part of the mixed money that is not client money as soon as practicable, but within one month after the mixed money is paid into the client money account: regs 7.8.01(12) and (14).

RG 212.36 We consider that it is important for a licensee to ensure separation of client money and its own money. This should allow the clear identification of client money and as such should assist in the proper distribution of client money in the event of the licensee's insolvency or otherwise ceasing to carry on business.

## Unidentified money

RG 212.37 Unidentified money is money that the licensee receives as a single payment where, at the time of receipt, the licensee is unable to identify whether the money is client money or mixed money that might include client money.

RG 212.38 If unidentified money is paid into a client money account, the licensee must identify any part of the money that is not client money and remove it from the client money account as soon as practicable: regs 7.8.01(13) and (14).

RG 212.39 We would expect licensees to treat unidentified money as client money until they can satisfy themselves that the money, or a portion of it, is not client money. To do otherwise risks breaching the legal requirements relating to client money.

## Licensee's money in client money accounts

- RG 212.40 The client money provisions do not permit licensees to deposit funds belonging to the licensee into client money accounts, by way of 'buffer' or otherwise. Buffers can be used by a licensee as a way of ensuring that there are adequate funds in the client money account to ensure that the licensee does not face a shortfall in the account when payments are made from the account, for example, as a result of incorrect bank fees or other unintended or uncontrollable errors that may reduce the balance of the account.
- RG 212.41 While this may provide some administrative benefit, we do not consider that the buffer would remove the need to self-report a shortfall in a client money account that may arise but for the buffer.
- RG 212.42 This differs from the practice of leaving money in the client money account that the licensee becomes entitled to by way of commission or other fees and charges. We would expect a licensee to maintain appropriate and prudent reconciliation processes in respect of its client money account.

## Interest on client money account

- RG 212.43 If a licensee discloses to the client that the licensee is keeping any interest earned on the account, the licensee is entitled to the interest: see reg 7.8.02(7).
- RG 212.44 We consider that to meet this disclosure requirement and retain the interest, a licensee should clearly and prominently disclose that it intends to retain interest and clearly disclose to retail clients that they will not earn interest on their money in a client money account. We consider that this should be done at the time when other details of the client money arrangements are disclosed, for example, in the PDS for the product for which client money is required to be paid to the licensee.

## D Permitted uses of, and withdrawals from, client money accounts

### Key points

Client money may be invested in certain permitted investments, provided the licensee has obtained the client's written agreement in relation to the terms of the investment: see RG 212.45–RG 212.49.

A licensee may make certain withdrawals from a client money account, including:

- paying to the licensee money to which the licensee is entitled;
- making a payment in accordance with the written direction of a person entitled to the money; and
- using client money relating to a derivative to meet obligations incurred by the licensee in connection with margining or for related purposes (see RG 212.50–RG 212.64).

Where client money for derivatives is used to meet obligations of the licensee, licensees can use the client money belonging to one client for some aspects of dealings in derivatives on behalf of other clients: see RG 212.65–RG 212.73.

### Permitted investments using client money

- RG 212.45 Client money may be invested in the following kinds of investments:
- (a) investment in any manner in which trustees are for the time being authorised by law to invest trust funds;
  - (b) investment on deposit with an eligible money market dealer;
  - (c) investment on deposit at interest with an Australian ADI;
  - (d) the acquisition of cash management trust interests;
  - (e) investment in a security issued or guaranteed by the Commonwealth or a state or territory;
  - (f) investment on deposit with a licensed CS facility.

Note: See reg 7.8.02.

- RG 212.46 A licensee must not invest client money in any of the above ways unless the money is money to which the client is entitled and the licensee has obtained the client's written agreement to the following matters:
- (a) the making of the investment;

- (b) how earnings on the investment are to be dealt with (including whether or not the earnings are to be shared, and whether or not the earnings are to be paid into the account);
- (c) how the realisation of the investment is to be dealt with (including whether or not the capital invested, and the proceeds of the investment, are to be deposited into the account);
- (d) how any losses made on the investment are to be dealt with (including the circumstances in which the licensee is required to pay an amount equal to the difference between the amount invested and the amount received, into the account or otherwise); and
- (e) the fee (if any) that the licensee proposes to charge for the investment.

Note: Client money that relates to money paid by an insured person for an insurer in relation to a contract of insurance or vice versa is not subject to the above requirements provided that the balance of the client money account and the amount invested is at least the sum of any amounts that the insurer and the insured are entitled to receive from the client money account. For further information, see reg 7.8.02.

- RG 212.47 Interest or other earnings on permitted investments of client money or the proceeds of the realisation of such an investment must be dealt with in accordance with the written agreement between the licensee and the client: reg 7.8.02(8).
- RG 212.48 The making of an investment in accordance with the specific direction of a client is not considered a permitted investment. Rather this would be considered a withdrawal from the client money account in accordance with the written direction of a person entitled to the money: see RG 212.50.
- RG 212.49 If money in a client money account has been invested, the investment is taken to be subject to a trust in favour of each person who is entitled to be paid money from the client money account to the extent that the person is entitled to the money: regs 7.8.03(5) and 7.8.04.

## Permitted withdrawals from client money account

- RG 212.50 Payments may be made out of a client money account in any of the following circumstances:
- (a) making a payment to, or in accordance with the written direction of, a person entitled to the money;
  - (b) defraying brokerage and other proper charges;
  - (c) paying to the licensee money to which the licensee is entitled;
  - (d) paying money due to an insurer in connection with a contract of insurance;
  - (e) making a payment that is otherwise authorised by law; or

- (f) paying to the licensee money to which the licensee is entitled pursuant to the operating rules of a licensed market.

Note: See reg 7.8.02(1).

RG 212.51 If a licensee makes a payment to another licensee from its client money account under a written direction, it must notify the receiving licensee that the money has been withdrawn from the client money account of that licensee and the client money should be paid into the client money account of the receiving licensee: see reg 7.8.02(1A). The receiving licensee must pay the money into its client money account not later than the day after receipt.

### **Written direction of the client**

RG 212.52 The scope of a licensee's power to withdraw money from a client money account is very broad as a licensee may make a payment in accordance with the written direction of the client. We have seen client contract terms in which authorisation is obtained from a client to withdraw money for any purpose.

RG 212.53 While the wording of the legislation may appear broad enough to permit this general right, we consider that reliance on such a right by a licensee could be inconsistent with the licensee's:

- (a) obligations to hold the client money on trust for the benefit of the client; and
- (b) general AFS licence obligations under the Corporations Act, including to have adequate arrangements to manage conflicts of interest and to act efficiently, honestly and fairly.

RG 212.54 Further, the client money provisions have been designed to protect the interests of clients of licensees and to limit the permitted uses of client money. Thus, it would not be consistent with the intention of the client money provisions for a licensee to attempt to circumvent the restrictions imposed by the Corporations Act by obtaining a broad authorisation to use client money for the licensee's own purposes.

RG 212.55 Any purported reliance on this right would need to be supported by an appropriate written direction with effective disclosure of all aspects of the direction, including the consequences of that direction. For example, it would also need to describe the effect of the written direction, the risks to which the client will be exposed and the protections the client is giving up by providing the written direction.

## Client money to which the licensee is entitled

- RG 212.56 The scope of the licensee's power to withdraw money from a client money account also extends to client money to which the licensee is entitled: reg 7.8.02(1)(c).
- RG 212.57 We consider that licensees, in considering how to rely on this regulation, need to be mindful of:
- (a) the purpose of the client money provisions to protect clients (see RG 212.60); and
  - (b) the obligations under the Corporations Act, including to have adequate arrangements to manage conflicts of interest and to act efficiently, honestly and fairly.
- RG 212.58 These obligations can have the effect of limiting the licensee's purported reliance on reg 7.8.02(1)(c).
- RG 212.59 For example, if the licensee claims an entitlement to an amount on the opening of a derivative position because such an amount (termed 'margin' or otherwise) is due and payable at that time, then we consider that the licensee can rely on reg 7.8.02(1)(c) to withdraw the amount claimed. Clearly a licensee would not be entitled to the payment if the contract did not contain an obligation to make a payment at that time.
- RG 212.60 However, we think that it is inconsistent with the intention of the client money provisions for a licensee to attempt to circumvent the restrictions imposed by the Corporations Act by establishing a broad entitlement to withdraw client money, such as claiming an entitlement to all money paid by the client to cover potential future liabilities of the client.
- RG 212.61 A withdrawal by the licensee by claiming an entitlement to the client money has the effect that the amount of the margin ceases to be client money and the client becomes an unsecured creditor of the licensee for any payment that the licensee may be required to make on the close of the derivative position or as a consequence of 'mark-to-market' adjustments during the currency of the derivative.
- RG 212.62 This means that a client becomes an unsecured creditor of the licensee for any payments that the licensee may be required to make to the client during or at the close of the derivative position. We think the power to withdraw money from the client money account should be interpreted to ensure that client money remains subject to the protections in the client money provisions for the maximum time possible and client money is only withdrawn for clearly defined purposes that the client understands.
- RG 212.63 We consider licensees should clearly and prominently disclose in their PDSs how and when they claim an entitlement to client money. This disclosure

should be supplemented by a clear description of the timing of cash flow during a typical transaction, and when money may be held as client money and when it may cease to be held as client money. A diagrammatic representation of each step of the transaction may assist this disclosure. The risks and benefits associated with these processes should also be clearly disclosed.

- RG 212.64 For example, we are aware that some, but not all, licensees provide in their client agreement that the licensee has no obligation to pay margin adjustments to the client during the currency of the derivative position and any such obligation only arises on close of the derivative position. On the other hand, the client must pay variation margins to the licensee as and when they arise during the currency of the OTC derivative contract. There should be clear and prominent disclosure of the timing of these payments and the risks arising for the client.

## Permitted use of client money for derivatives

- RG 212.65 If the money required to be placed in a client money account relates to a derivative or a dealing in a derivative, the licensee may use the money to meet 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: s981D.
- RG 212.66 This provision has its origins in exchange-traded futures through futures brokers, however, given the reference to derivatives, the provision is broader in application than its original context.
- RG 212.67 The permitted use in s981D does not, however, extend to obligations incurred by the licensee's own (or proprietary) trading in derivatives, that is, trading by the licensee using its own money so as to make a profit for itself.
- RG 212.68 This permitted use also requires that the licensee has incurred an obligation in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives. We consider that licensees should not use or withdraw client money from the client money account in purported reliance on s981D in anticipation of an obligation arising.
- RG 212.69 The amount of client money that is used in exercise of this right must also be limited to the amount necessary to meet the licensee's obligations so incurred in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives.
- RG 212.70 Clients should be aware that all money that relates to a derivative, or a dealing in a derivative, that they deposit in a client money account can be

used for margining and other purposes related to dealings in derivatives and not just the amount relating to an individual client's margin payments.

### **Counterparty risk**

- RG 212.71 The fact that licensees can use the client money belonging to one client for meeting margin obligations on behalf of other clients means that one client's money for dealing in derivatives may be used to satisfy obligations arising from dealings on behalf of another client of the licensee. This exposes the client to counterparty risk, that is, the risk that they may not receive all the money held by the licensee on their behalf in the client money account if there is a deficit in the client money account and the AFS licensee becomes insolvent or is otherwise unable to pay the deficiency.
- RG 212.72 We consider that this risk should be clearly and prominently explained to clients before they transfer any client money to an AFS licensee. For example, we consider that clear and prominent disclosure should be included in the initial PDS, as part of any discussion of the need to pay client money to be held by the licensee. We would regard a PDS as misleading if it did not include this.
- RG 212.73 This disclosure should be meaningful in the context of the particular derivative contract being offered. This could mean that a licensee needs to set out the mechanics of the customer contract and the timing of cash flows of a typical transaction entered into under the client agreement.

## E Other aspects of client money

### Key points

A licensee must keep financial records in sufficient detail to explain all money received or paid by the licensee in relation to client money accounts: see RG 212.74.

The auditor's report accompanying the licensee's financial statements must contain a statement of the auditor's opinion of the licensee's compliance with the client money provisions: see RG 212.75.

The Corporations Act provides for how client money is to be dealt with if a licensee ceases to be licensed or becomes insolvent: see RG 212.76–RG 212.78.

We may take administrative, civil or criminal action if the client money provisions have not been complied with: see RG 212.79–RG 212.82.

### Financial records and auditor's certification

RG 212.74 A licensee must keep financial records that correctly record and explain all money received or paid by the licensee in relation to a client money account: s988A, 988E and reg 7.8.11. We would expect this record keeping to include prudent reconciliation processes to ensure the accuracy of the financial records. The ASX has recently updated its client money rules to include requirements for reconciliation, including daily reconciliation of aggregate balances and weekly reconciliation of individual client balances. These provide a useful reference point for a licensee in formulating the timing and manner of its reconciliations of its client money account.

RG 212.75 An auditor's report lodged with a licensee's financial statements pursuant to s989B(3) must contain a statement of the auditor's opinion of:

- (a) the effectiveness of internal controls used by the licensee to comply with the client money provisions;
- (b) whether each client money account required to be maintained by the licensee has been operated and controlled in accordance with the client money provisions; and
- (c) whether all necessary records, information and explanations were received from the licensee.

Note: See reg 7.8.13.

## How client money is dealt with if licensee ceases to be licensed

RG 212.76 The Corporations Act provides for how client money is to be dealt with if a licensee:

- (a) ceases to be licensed (including a cessation because the licensee's AFS licence has been suspended or cancelled);
- (b) becomes insolvent under an administration, has an administrator or receiver appointed or is subject to similar proceedings; or
- (c) ceases to carry on an activity authorised by the AFS licence and is paid money in relation to that activity.

Note: See s981F and reg 7.8.03.

RG 212.77 If any of the above events occurs, client money is to be paid as follows:

- (a) the first payment is of money that has been paid into the account in error;
- (b) if money has been received on behalf of insured persons in accordance with a contract of insurance, the second payment is payment to each insured person entitled to receive money from the client money account in respect of claims that have been made and then in respect of other matters;
- (c) the next payment is payment to each person who is entitled to be paid money from the client money account;
- (d) if the money in the client money account is not sufficient to be paid in accordance with paragraph (a), (b) or (c), the money must be paid in proportion to the amount of each person's entitlement; and
- (e) if there is money remaining in the account after payments made in accordance with the above, the remaining money is taken to be money payable to the licensee.

Note: See reg 7.8.03(6).

RG 212.78 For each person who is entitled to be paid money from a client money account, the account is taken to be subject to a trust in favour of the person: reg 7.8.03(4). Similarly, if money in a client money account has been invested the investment is taken to be subject to a trust in favour of each person who is entitled to be paid money from the account: reg 7.8.03(5). These arrangements override anything to the contrary in the *Bankruptcy Act 1966* or a law relating to companies: reg 7.8.03(7).

## Administrative action

- RG 212.79 ASIC may take administrative action to vary, suspend or cancel an AFS licence where breaches of the client money provisions have occurred: Subdiv C of Div 4 of Pt 7.6.
- RG 212.80 We may also take administrative action to ban or disqualify a person who has not complied with the client money provisions: Div 8 of Pt 7.6.

## Enforcement options

- RG 212.81 We may apply to the Court for an order to restrain dealings in respect of client money accounts and to make orders relating to the payment or freezing of money: s983A–983E.
- RG 212.82 A licensee commits an offence if it is required to pay client money into a client money account and does not do so or if the licensee fails to comply with the client money provisions: s993B and 993C.

## Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A.
ASIC	Australian Securities and Investments Commission
Australian ADI	An authorised deposit-taking institution within the meaning of the <i>Banking Act 1959</i> or a person who carries on state banking within the meaning of paragraph 51(xiii) of the Constitution Note: This is a definition contained in s9.
client money	Money that is paid to an AFS licensee pursuant to s981A
client money account	An account that is maintained for s981B, whether maintained as a trust account or a clients' segregated account
client money provisions	Div 2 of Pt 7.8 of the Corporations Act
[CO 03/1112] (for example)	An ASIC class order (in this example numbered 03/1112)
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
derivative	Has the meaning given in s761D
financial product	Generally a facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> <li>• makes a financial investment (see s763B);</li> <li>• manages financial risk (see s763C);</li> <li>• makes non-cash payments (see s763D)</li> </ul> Note: See Div 3 of Pt 7.1 for the exact definition.
financial service	Has the meaning given in Div 4 of Pt 7.1
licensed CS facility	Has the meaning given in s761A
licensed market	Has the meaning given in s761A

<b>Term</b>	<b>Meaning in this document</b>
licensee	An AFS licensee
OTC derivative	A derivative that is entered into over the counter and not through a licensed market
PDS	Product Disclosure Statement
Pt 7.8 (for example)	A part of the Corporations Act (in this example numbered 7.8)
reg 7.8.01 (for example)	A regulation in the Corporations Regulations (in this example numbered 7.8.01)
s981D (for example)	A section of the Corporations Act (in this example numbered 981D)

## Related information

### Headnotes

client money, client money account, trust account, clients' segregated account, mixed money, unidentified money, buffers, derivatives, OTC derivatives

### Class orders

[CO 03/1112] *Relief from obligation to hold client money on trust*

[CO 04/1063] *Section 981B money in cash common funds*

### Legislation

*Bankruptcy Act 1966*

Corporations Act, Div 2 of Pt 7.8, s981A, 981B, 981C, 981D, 981E, 981F, 981G, 981H, 988A, 988E, 989B, 993B, 993C, 1017E; Corporations Regulations, regs 7.8.01, 7.8.02, 7.8.03, 7.8.04, 7.8.11, 7.8.13

### Consultation papers and reports

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

REP 202 *Response to submissions on CP 114 Client money relating to dealing in OTC derivatives*