AFMA

29 March 2016

Ms Megan Quinn
Division Head
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

cc: Jerome Davidson
Zoe Cox

By e-mail: resilienceandcollateral@treasury.gov.au

Dear Ms Quinn

Enhanced Protection of Client Money – Exposure Draft Corporation Amendment (Client Money) Bill 2016, Regulation and Explanatory Memorandum

Thank you for the opportunity to provide a submission on the Corporations Amendment (Client Money) Bill 2016 and associated draft Regulations and Explanatory Memorandum.

As we stated in our response of 10 February 2016 to the Government policy paper on *Enhanced Protection of Client Money,* AFMA members support in principle the initiative to reform client money regulation in Australia. We did, however, express the view that the Government's initiative provides an opportunity to consider far more significant reform in addition to section 981D of the Corporations Act. We highlighted a number of existing problems within the Australian client money regime that would benefit from deeper consideration as to the regime's current fitness for purpose.

We appreciate that our response to the policy paper would have reached you after the task of drafting the Bill and Regulations had already commenced and we anticipate that you are considering the issues we raised. We therefore take this opportunity, in response to the Corporations Amendment (Client Money) Bill 2016, to reiterate our view that the Government's initiative provides the opportunity to fully examine the effectiveness of Australia's client money regime and to make the necessary amendments where it is clear that better outcomes can be achieved.

For the purpose of completeness, we reattach the *Enhanced Protection of Client Money – Annexure* that accompanied our response of 10 February 2016. The Annexure details the various concerns that we have with the current client money regime. In addition, Schedule 1 to the Annexure concentrates specifically on the proposed amendments to section 981D of the Corporations Act. Our comments in the Schedule remain pertinent to the draft Bill.

We are happy to provide comment on the actual drafting of the Bill if you consider that to be of assistance.

Please contact me on 02 9776 7997 or tlyons@afma.com.au if you would like to discuss any aspect of this submission.

Yours sincerely

Tracey Lyons
Head of Policy

Amendment	**Comments**
Section 981A is amended to provide that the client money rules do not apply if: (a) the financial product or service is a derivative; (b) the financial product is not centrally cleared; (c) the financial product or service is provided to a wholesale client; and (d) written agreement of the client is received	• The breadth of this provision is extremely narrow. It will only apply where the derivative is a non cleared OTC derivative. This means that it will never apply to futures and will not apply to any OTC derivative that is subject to the clearing mandate. It is not clear from the Explanatory Memorandum why there is a distinction between non cleared and cleared derivatives such that the client money provisions are only applicable to cleared derivatives. In fact, the Explanatory Memorandum seems to suggest that the ability to opt out of the client money regime is all-encompassing (see paragraph 1.18 which states: *The new law will enable wholesale clients to contract out of the client money regime if they so desire. This will facilitate the ongoing efficiency of wholesale derivatives markets, ensuring the client money regime does not impose unnecessary limitations on institutional investors).* It is not obvious why restricting any opt out provision should only apply to non-cleared derivatives and the Explanatory Memorandum should set out why it has been so narrowly drafted. • The distinction between cleared and non-cleared derivatives means that a licensee will now have to separate money from clients depending on the type of derivative the client is trading. If the derivative is centrally cleared, then the licensee will need to comply with the client money rules (to the extent they apply) for money received from clients. This is arbitrary and it is unclear what benefit this gives to clients. • The amendment will never be of benefit to futures which are always centrally cleared so the issues raised in our previous submission will continue to affect the futures market. • What is the meaning of 'cleared through a central counterparty'? Is this any central counterparty or is it only a licensed CS facility? If it is any central counterparty, why is there a distinction between section 981A where client money won't apply where the transaction is centrally cleared (anywhere in the world presumably) and section 981D that narrows the application of that section to only a licensed CS facility (in Australia only)? • Why is it necessary for the wholesale client's agreement to be obtained as per draft paragraph (d)? The money referred to is either client money or it is not client money. No other subparagraph in section 981A(3) requires written agreement from the client before money ceases to be client money for the purposes of the part. This requirement will impose an unnecessary administrative burden. Further, why is the section limited only to

derivatives? Why is there not a general power for a wholesale client and licensee to agree that money received from the client is not client money?

Section 981D – the section is restricted in relation to the use of 'derivative retail client money'. For derivative retail client money, section 981D will now only apply to an obligation where the derivative was acquired on a licensed market or cleared through a licensed CS facility.

The proposed drafting will allow licensees to continue relying on section 981D for wholesale clients (other than sophisticated investors) but narrows the use for retail clients.

- Reliance on section 981D is effectively restricted to the ASX market in Australia as this is the only licensed market dealing in derivatives, and the two clearing houses operated by ASX as these are the only licensed CS facilities clearing derivatives. It is not clear why the application of section 981D has been narrowed to just this FMI licensee group operating in Australia. A great deal of the futures business conducted by licensees for clients is carried out on offshore futures markets and cleared through offshore clearing houses. This business is conducted by licensees either as participants on those markets and clearing houses or through agents who are participants on those markets and clearing houses. The proposal needs to be widened to remove the requirement that the market or CS facility be licensed so that the current method of conducting futures business for clients can continue. If section 981D continues to be restricted to only Australian markets and clearing facilities, licensees will need to implement two different processes for meeting margin obligations:

  (a) one process will apply to futures trades executed and cleared in Australia where section 981D can be relied upon; and

  (b) another for non-Australian markets where section 981D will not be available.

  This increases regulatory risk for licensees, does not increase protection for clients and potentially increases the costs of dealing in futures outside Australia for both clients and brokers.

- It is doubtful whether section 981D will be available even where licensees are dealing in futures for retail clients in Australia. As drafted, section 981D will only apply where the licensee's obligations are incurred under the market integrity rules or the operating rules of the market or CS facility. The vast majority of licensees dealing for retail clients are not participants on the market or CS facility but instead choose an agent from amongst the 20 market participants and 16 clearing participants. Therefore, other than the participants, no licensee will be able to take advantage of section 981D.

Section 981K – the section defines 'derivative retail client money' and includes for the purposes of section 981D a sophisticated investor as defined in section 761GA.

Carving out sophisticated investors for the purpose of section 981D is questionable. The Explanatory Memorandum explains the reason thus: *Thorough evaluation of counterparty risk in derivatives markets is complex, and cannot be reasonably expected of 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.

The Bill then refers to sophisticated investors as defined in section 761GA. However, section 761GA does not have an assets test in determining whether a client is a 'sophisticated investor'. A client will be a 'sophisticated investor' if the client has previous experience in using financial services that allows the client to assess certain matters including the merits of the product or service; the value of the product or service, and the risks associated with holding the product. The assets test is set out in paragraph 761G(7)(c) which requires a client to provide an accountant's certificate stating that the client meets either the net assets or gross income thresholds.

If the Bill is to include certain wholesale clients in the retail test for section 981D, then it should include 761G(7)(c) and not section 761GA sophisticated investors. But even this is questionable – if Treasury has a concern as to whether a particular class of wholesale client is not capable of understanding the treatment of client money then that client may also not have the capability to understand the financial product itself. The place to deal with this, however, is not in section 981D but in section 761G. Making ad hoc changes for the purpose of a single section of the Act, rather than looking at the issue holistically leads to regulatory risk for licensees without adding any further protection for clients.