

**PARLIAMENTARY JOINT COMMITTEE ON
CORPORATIONS AND FINANCIAL SERVICES**

INQUIRY INTO REGULATION OF AUDITING

ASX Limited (“ASX”) would like to take this opportunity to provide submissions in relation to the parliamentary inquiry into the regulation of auditing. In particular, ASX would like to highlight some improvements it believes should be made to the regulatory framework for the annual audit of Australian financial services licensees, in particular, in relation to the auditing of client money controls.

Summary of recommendations

In short, ASX recommends to the Committee that:

- Regulation 7.8.13 should be narrowed to require an audit of a licensee’s compliance with the client money protections in Division 2 of Part 7.8 of the Corporations Act;
- the client money protections in Division 2 of Part 7.8 should be strengthened by adding a requirement for all financial services licensees to conduct and keep records of a daily reconciliation of their client money accounts and to report to ASIC within two business days any deficiencies identified by the reconciliation;
- the AUASB should be requested to review AGS 1068 in light of the BBY matter; and
- the AUASB and/or ASIC should be requested to provide more comprehensive guidance on what an auditor would be expected to review and test to assure compliance with the client money protections in Division 2 of Part 7.8.

The reason for these recommendations are set out below. Capitalised terms in the summary recommendations above are also defined in the submissions below.

Background

ASX operates a clearing facility through its wholly owned subsidiary, ASX Clear Pty Limited (“ASX Clear”). The Operating Rules of ASX Clear impose requirements on its clearing participants in respect of client money, including a requirement to conduct and keep records of a daily reconciliation of their client money balances and to report to ASX Clear within two business days any deficiencies identified by the reconciliation.¹

Generally speaking, clearing participants in the ASX Clear clearing facility will hold an Australian financial services licence authorising them to carry on a business of dealing in securities and derivatives.

A person who holds an Australian financial services licence is required under the Corporations Act 2001 (Cth)² to engage an auditor to prepare a report in respect of its financial statements for each

¹ ASX Clear Operating Rules 4.23.5, 4.23.6 and 4.23.7.

² Section 989B(3)(b)(ii) or 989B(3)(c) (as modified by Corporations Regulation 7.8.12A). That Act is referred to in this submission as the “Corporations Act”. References in this submission to parts, divisions and sections of an Act are to parts, divisions and sections of the Corporations Act.

financial year. Under Regulation 7.8.13, the report must be in the prescribed form (ASIC Form FS 71) and express an opinion on:

- “(a) the effectiveness of internal controls used by a financial services licensee to comply with:
 - (i) Divisions 2, 3, 4, 5 and 6 of Part 7.8 of the Act; and*
 - (ii) Division 7 of Part 7.8 of the Act other than section 991A;**
- (b) whether each account required by sections 981B and 982B of the Act to be maintained by the financial services licensee has been operated and controlled in accordance with those sections;*
- (c) whether all necessary records, information and explanations were received from the financial services licensee.”*

Divisions 2, 3, 4, 5, 6 and 7 of Part 7.8 of the Corporations Act cover a broad range of licensee financial record keeping and conduct obligations. Most importantly, these include the client money protections in Division 2 of Part 7.8, a critical set of safeguards protecting the funds provided by clients to licensees.

Auditing and Assurance Guidance Statement AGS 1068 *Audit Requirements for Australian Financial Services Licensees under the Corporations Act 2001*³ (“AGS 1068”) published by the Australian Auditing and Assurance Standards Board (“AUASB”) provides guidance on the recommended audit procedures to provide the required assurance in relation to Divisions 2, 3, 4, 5, 6 and 7 of Part 7.8 of the Corporations Act. The relevant parts addressing the client money protections in Division 2 of Part 7.8 are contained in paragraphs .56 to .60 and comprise less than one and a half pages.

In ASX’s experience, based on the copies of the Forms FS 71 ASX receives in relation to its clearing participants,⁴ auditors rarely express an opinion that the internal controls used by Australian financial services licensees to comply with Divisions 2, 3, 4, 5, 6 and 7 of Part 7.8 of the Corporations Act are not adequate. This could reflect the quality of those internal controls or it could reflect the quality of the audit.

Further, in ASX’s experience, based on the copies of the Forms FS 71 ASX receives in relation to its clearing participants, any commentary by auditors in relation to a licensee’s internal controls to comply with Divisions 2, 3, 4, 5, 6 and 7 of Part 7.8 of the Corporations Act usually involves little more than repeating issues already self-reported by the licensee to ASIC under section 912D of the Corporations Act.⁵

Sharpening the focus of Regulation 7.8.13

ASX is concerned that the breadth of the obligation in Regulation 7.8.13 to audit the effectiveness of a financial services licensee’s internal controls across all of Divisions 2, 3, 4, 5, 6 and 7 of Part 7.8 of the Corporations Act diverts attention away from the critical client money protections in Division 2 of Part 7.8.

³ Available at https://www.auasb.gov.au/admin/file/content102/c3/AGS1068_10-04b.pdf.

⁴ Under ASX Clear Operating Rule 4.5.4, a clearing participant must immediately notify ASX Clear in writing if an auditor identifies a significant issue in an ASIC Form FS 71 or equivalent report lodged with ASIC.

⁵ As referenced in paragraphs .51 and .52 of AGS 1068.

ASX believes that this could be contributing to auditors undertaking a relatively high-level review of the licensee's control framework, without testing more closely the licensee's actual compliance with Divisions 2, 3, 4, 5, 6 and 7 of Part 7.8 of the Corporations Act, including in particular the critical client money protections in Division 2 of Part 7.8.

ASX believes that better regulatory outcomes would be achieved if, in conjunction with the other measures suggested in this submission, Regulation 7.8.13 were narrowed to require an audit of a financial services licensee's compliance with the client money protections in Division 2 of Part 7.8. This would include within its scope whether the licensee was maintaining each account required by sections 981B and 982B of the Act, since those sections fall within Division 2 of Part 7.8.

Improving the client money protections in Division 2 of Part 7.8

In 2014-15, the Australian financial system witnessed a significant contravention of the client money protections in the Corporations Act by BBY Limited (BBY). This was reported on by the joint liquidators of BBY in their report entitled *Client monies investigations: Liquidators' Report* dated 22 December 2015.⁶

BBY's joint liquidators concluded that the client money accounts related to BBY's ASX Clear business were in surplus, but the client money accounts for BBY's non-ASX businesses were in material deficit.⁷

ASX attributes this difference in outcomes to a number of key differences between ASX Clear's client money regime and the client money protections in Division 2 of Part 7.8:

- participants in ASX Clear are required to conduct and keep records of a daily reconciliation of their client money balances and to report to ASX Clear within two business days any deficiencies identified by the reconciliation;⁸
- ASX provides comprehensive guidance on the client money obligations of clearing participants in the form of ASX Clear Operating Rules Guidance Note 12 *Trust and Client Segregated Accounts*;⁹ and
- ASX Clear conducts periodic and ad hoc reviews of compliance by its clearing participants with their client money obligations under the ASX Clear Operating Rules.

ASX considers that the client money protections in Division 2 of Part 7.8 would be substantially enhanced if all financial services licensees were required to conduct and keep records of a daily reconciliation of client money balances and to report to ASIC within two business days any deficiencies identified by the reconciliation.

Better guidance to financial services licensees

As a result of its reviews and other compliance activities, ASX has identified a number of improvements that it wishes to make to ASX Clear's rules and guidance around client money,

⁶ Available at <https://home.kpmg/content/dam/kpmg/pdf/2016/01/bby-client-monies-investigation-report-22-dec-2015.pdf>.

⁷ See section 7 of the report referred to in note 6.

⁸ ASX Clear Operating Rules 4.23.5, 4.23.6 and 4.23.7.

⁹ Available at https://www.asx.com.au/documents/rules/asx_clear_guidance_note_12.pdf.

including requiring a more detailed examination of client moneys by auditors as part of their annual audit of clearing participants.

Consequently, ASX is in the process of developing changes to ASX Clear's rules and guidance in relation to client money. Among other things, this will include expressing ASX's expectation that an auditor providing an ASIC Form FS71 report in relation to a clearing participant will examine and specifically report on the participant's compliance with the ASX Clear Operating Rules around client money and, more particularly:

- examine the participant's systems and processes for complying with client money requirements, including its processes for reconciling client money balances;
- conduct testing to verify that the information recorded in and generated from the participant's accounting system around client money balances is complete, accurate and complies with relevant requirements; and
- conduct testing to verify that reconciliations of client money balances have been performed correctly and that any deficiencies in client money identified are reported to ASX Clear in a timely manner.

ASX would note that AGS 1068 was published in October 2004 and has not been updated since. In the interim, the Australian financial system has experienced the BBY contravention of the client money protections referenced above.

ASX believes that AGS 1068 would benefit from a review in light of the BBY matter.

ASX also believes that financial services licenses and auditors would benefit from more comprehensive guidance from the AUASB and/or the Australian Securities and Investments Commission ("ASIC") on what an auditor is expected to review and test to assure compliance with the client money protections in Division 2 of Part 7.8.

Hopefully, in the case of financial services licensees who are clearing participants in ASX Clear, any new guidance provided by the AUASB and/or ASIC will dovetail with the enhancements ASX is making to the ASX Clear rules and guidance relating to client money mentioned above.
