

Guidance Note

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Key concepts:

Beneficial Ownership, Close Out and omnibus accounts

Related information:

FGL Operating Rules

Part 1, Part 3, Part 4 and Part 6

FEX Guidance Notes

GN 32 - Trading Prohibition - Wash Trades

Recommended Audience:

Compliance Managers

Derivatives Staff Members

Previous Issues:

Nil

GN 7 – Beneficial Owner

Introduction

The purpose of this Guidance Note is to assist Trading Participants and Clearing Entities in their understanding of what is meant by the term “Beneficial Owner” and provide examples of how the term is applied in the Operating Rules.

Guidance

Beneficial Owner is defined in Operating Rule 1.2.2 as follows:

“**Beneficial Owner**” means the person having the ultimate beneficial or equitable interest in a Market Contract or physical position.

The term Beneficial Owner is used in the following Operating Rules:

Rule 3.4.2 - Beneficial Owner reports

Rule 4.2.10 – Position Limits

Rule 6.2.3 - Process following registration

Rule 6.3.6 - Beneficial Owner reports

Generally, the “person” who is the Beneficial Owner is the legal entity, but depending on the structure of the legal entity, the “person” may be separate “sub accounts” within that legal entity.

A Beneficial Owner may be:

- An individual;
- A Firm;
- A Corporation;
- A Related Entity of a Corporation;
- A division within a Firm or Corporation;
- A separate account within a legal entity; or
- A separate account within the same division of a legal entity.

The following examples are provided:

1. Where a person is an individual

An individual may have a beneficial or equitable interest in a Market Contract in many ways but that individual is only a Beneficial Owner for the purposes of the Operating Rules where the individual has the ultimate beneficial or equitable interest

- (a) The individual is a shareholder in a company and the company has an account with a Clearing Entity.

Joe Smith is one of 20 shareholders in XYZ Ltd. Prima facie, Joe Smith does have a beneficial or equitable interest in the Trading carried out on behalf of XYZ Ltd but only on the basis that where XYZ Ltd generates a profit it may pay a dividend to its shareholders i.e. the shareholders have a beneficial or equitable interest in the financial results of XYZ Ltd (whether generated by Trading in FGL Products or otherwise).

In this case, the legal entity, being XYZ Ltd, is the Client of the Clearing Entity. The Client Agreement is executed by XYZ Ltd. XYZ Ltd is the Beneficial Owner as it is the person that holds the ultimate beneficial or equitable interest in the Market Contract. XYZ Ltd is also the person making the Trading decisions (and not Joe Smith).

Although Joe Smith has an economic interest in the financial results of Trading in the Market Contract, he does not have actual beneficial or equitable interest directly in any Market Contract or any other assets of XYZ Ltd.

- (b) The individual is a unit holder in a Fund and the Fund has an account with a Clearing Entity.

This example is similar to (a) above.

Joe Smith is a member of Fund ABC which is operated by Fund Manager Ltd. Prima facie, Joe Smith does have a beneficial or equitable interest in the Trading carried out by Fund Manager Ltd on behalf of Fund ABC but only on the basis that where Fund ABC generates a profit it will make a distribution to its unit holders i.e. the unit holders have a beneficial or equitable interest in the financial results of Fund ABC (whether generated by Trading in FGL Products or otherwise).

In this case, the legal entity, being Fund Manager Ltd ATF Fund ABC, is the Client of the Clearing Entity. The Client Agreement is executed by Fund Manager Ltd ATF Fund ABC and is the Beneficial Owner as it is the person that holds the ultimate beneficial or equitable interest in the Market Contract.

Although Joe Smith has an economic interest in the financial results of Trading in the Market Contract, he does not have actual beneficial or equitable interest directly in any Market Contract or any other assets of XYZ Ltd.

- (c) The individual Joe Smith is a client of Broker 123 Pty Ltd (which is a Clearing Entity).

Broker 123 Pty Ltd establishes an account in the name of Joe Smith. Joe Smith is the only person authorised to place instructions on the account.

In this case, the legal entity, being the individual known as Joe Smith, is the Client of the Clearing Entity. The Client Agreement has been executed by Joe Smith in his personal capacity. Joe Smith is the Beneficial Owner as he is the person that holds the ultimate beneficial or equitable interest in the Market Contract.

2. Where a person is a Corporation, a Related Entity or a Firm (this example only refers to the term “Corporation” but that term can be substituted with a Related Entity or a Firm).

Where a Corporation is the Client i.e. the Corporation has executed the Client Agreement then generally the Corporation is the Beneficial Owner (refer example (i)(a) above). However, this may vary depending on the structure of the Corporation and the Trading activities undertaken.

It is generally straight forward and uncomplicated (for the purposes of identifying the person who is the Beneficial Owner) where the Corporation only operates one account with a Clearing Entity (unless this account is an omnibus account).

It becomes more complicated where the Corporation establishes a number of separate accounts to separate the different Trading activities undertaken.

(a) ABC Bank Limited operates as a bank

ABC Bank Limited, as a bank, may enter into Individual FGL Products for different economic purposes and accordingly, establish separate accounts in order to monitor the financial results separately and independently from other Trading activities.

For example, ABC Bank Limited may establish separate accounts for each Trading division within ABC Bank Limited. Furthermore, ABC Bank Limited may establish separate accounts within the same division. Depending on the facts and circumstances in each case, each of these separate accounts may be the “person” which is the Beneficial Owner in the Market Contract.

The legal entity, being ABC Bank Limited, is the Client of the Clearing Entity and the Client may operate separate accounts.

However, the mere establishment of separate accounts does not always mean that the separate accounts are separate Beneficial Owners for the purposes of the Operating Rules. For example, a Client may establish separate accounts for internal accounting purposes.

Examples of where separate accounts do constitute separate Beneficial Owners are as follows:

- Treasury Division.
- Derivatives Proprietary Trader (separate accounts within this division may also be assigned to individual Derivatives Staff Members who are each authorised to Trade on behalf of the Trading Participant. Separate accounts enable the Trading Participant to readily monitor the results on an individual basis and conduct risk management activities separately. Each separate account constitutes a Beneficial Owner on the basis that each individual Derivatives Staff Member makes independent and unrelated Trading decisions to other Derivatives Staff Member).
- Swaps Division (separate accounts within this division may also be assigned to individual traders as each trader manages his book independently from another trader. Each separate account constitutes a Beneficial Owner on the basis that each individual trader makes independent and unrelated Trading decisions to other traders).
- Loans Division.

(b) ABC Bank Limited operates as a bank and also has the following subsidiaries (Related Entities):

- ABC Investment Pty Ltd
- ABC Securities Pty Ltd
- ABC Property Pty Ltd

If each is a Client of a Clearing Entity (i.e. ABC Bank Limited in its own right and each of the subsidiary companies in their own right) and each separately makes Trading decisions and issues instructions to the Clearing Entity, then each legal entity is a Beneficial Owner.

(c) Fund Manager Ltd operates as a Fund Manager and has 2 separate funds:

- Fund ABC
- Fund DEF

Fund Manager Ltd, on behalf of each of these Funds, makes separate Trading decisions and therefore each Fund (account) is a separate Beneficial Owner.

In this case, the legal entities, being Fund Manager Ltd ATF Fund ABC and Fund Manager Ltd ATF Fund DEF are the Clients of the Clearing Entity. The Client Agreements are executed by Fund Manager Ltd as trustee for both Fund ABC and Fund DEF and each separate Fund is the Beneficial Owner.

3. Where a person is a division within a Corporation, a Related Entity or a Firm

Refer example in 2 (a) above.

4. Where a person is a separate account within a legal entity

Refer example in 2 (a) above.

5. Where a person is a separate account within the same division of a legal entity

Refer example in 2 (a) above.

Based on the above examples it is clear that a Client may operate a number of accounts on behalf of different Beneficial Owners. A Clearing Entity must be able to determine and have procedures in place to identify where a Client operates more than one account whether such accounts constitute separate Beneficial Owners. This is essential to enable compliance with the Operating Rules where an obligation is in relation to a Beneficial Owner.

The following examples are provided as to how the term Beneficial Owner is applied in the Operating Rules.

Close Out of Open Contracts

Rule 6.2.3 (c) provides that:

A Clearing Entity must ensure that any equal and opposite Open Contracts held on behalf of the same Beneficial Owner in the same Individual FGL Product are Closed Out as soon as practicable and in any case ensure that such Open Contracts are not included in the reports provided in accordance with Rules 6.3.5 and 6.3.6.

The intent and purpose of this Rule is to ensure that the published overall open interest in each Individual FGL Product is accurate and not misleading to the Exchange Market. Open interest is used by various participants of the Exchange Market to assess depth and liquidity.

The accuracy of the open interest is subject to a number of factors such as the accurate allocation of Trades to the Beneficial Owner, the timely allocation of Trades to the Beneficial Owner and the receipt of instructions (which the Exchange expects will be standing instructions) to Close Out all equal and opposite Open Contracts held on behalf of the same Beneficial Owner in the same Individual FGL Product rather than allow the Beneficial Owner to continue to hold the Open Contracts as “back-to back”.

Where an account is permitted to hold back-to back Open Contracts, then the Clearing Entity must be able to demonstrate that the Open Contracts are held on behalf of separate and distinct Beneficial Owners (e.g. an omnibus held by a Clearing Entity on behalf of a Trading Participant) and ensure that any back-to-back positions at the Beneficial

Owner level are Closed Out. If not, then the effect of those Open Contracts is to inflate the open interest which is detrimental to the interests of the Exchange Market as it is not an accurate reflection of the underlying liquidity.

Thus, the important element is accurately determining the Beneficial Owner. If a person opens two separate accounts but that person is acting in the same capacity then it is likely that the establishment of the two accounts is for no economic benefit and maybe, for example, to avoid Closing Out back-to-back Open Positions e.g. all long positions are allocated to one account and all short positions to the other account.

A Clearing Entity must ensure its Clients do not hold back-to-back Open Contracts. If the Clearing Entity has not been provided with standing instructions and is unable to obtain specific instructions to Close Out the Open Contracts then the Clearing Entity must make other arrangements to ensure that such Open Contracts are not included in the reports provided in accordance with Rules 6.3.5 (i.e. open interest reports) and 6.3.6 (i.e. Beneficial Owner reports).

Beneficial Owner reports

Rule 6.3.6 provides that:

- (a) Each Clearing Entity must provide to the Exchange or the Clearing House a report detailing the Beneficial Owner of each of the Open Contracts held by the Clearing Entity.
- (b) A report required by Rule 6.3.6(a) must be provided to the Compliance Department in the form, and within the times, specified in the FGL Procedures for Rule 3.4.2.

The Beneficial Owner reports are used by the Exchange for a number of regulatory purposes but primarily Beneficial Owner reports are reviewed on a daily basis and provide a mechanism to validate open interest in FGL Products and also enable concentration risk to be evaluated.

In addition, the analysis of the information contained in the Beneficial Owner Reports by Exchange staff includes financial analysis to monitor the financial impact potential market movements may have on an Open Position i.e. scenario testing is conducted. Such analysis has the objective of identifying potential default situations.

For example, should a large Open Position be held by a Clearing Entity on behalf of a Client and that Clearing Entity maintains only the minimum Capital Level required to be maintained, then this will trigger an alert which may result in the Clearing Entity being directed by the Exchange to Close Out some or all of the Open Contracts. Alternatively, the Exchange may direct the Clearing Entity to call additional margin from the relevant Client. In addition, the Exchange may revise a position limit.

The Beneficial Owner reports must detail the Beneficial Owner of each of the Open Contracts held by the Clearing Entity. These must be summarised to provide a total long or short position for each Individual FGL Product for the Beneficial Owner. This means summarising:

- at an account level, where a Client operates one account;
- at an account level, where a Client operates a number of separate accounts and each separate account represents a different Beneficial owner;
- across accounts, where a single Beneficial Owner operates a number of accounts (for whatever reason);
- at a sub-account level, where the Clearing Entity operates an omnibus account representing several sub-accounts for different Beneficial Owners.

For more detailed explanations with respect to the Restrictions on conducting an EFP, we refer you to **GN45 - Fair and Orderly Pricing for Block Trades & EFP Transactions.**

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