

ASIC CLASS ORDER [CO 13/760]

EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (**ASIC**) makes ASIC Class Order [CO 13/760] under paragraph 926A(2)(c) of the *Corporations Act 2001* (the **Act**).

Paragraph 926A(2)(c) provides that ASIC may declare that provisions to which section 926A applies apply in relation to a person or financial product, or a class of persons or financial products, as if specified provisions were omitted, modified or varied as specified in the declaration.

1. Background

Obligation to have adequate resources (including financial)

Section 912A sets out the obligations of an Australian financial services (**AFS**) licensee including paragraph 912A(1)(d) that requires the AFS licensee to have available adequate resources (including financial) to provide the financial services covered by the AFS licence and to carry out supervisory arrangements. Certain bodies regulated by the Australian Prudential Regulation Authority (**APRA**) are not required to comply with paragraph 912A(1)(d).

ASIC imposes specific financial requirements on AFS licensees that are required to comply with paragraph 912A(1)(d). These financial requirements are imposed as AFS licence conditions and via ASIC class orders with guidance set out in ASIC Regulatory Guide 166 *Licensing: Financial requirements (RG 166)*. The financial requirements that apply to AFS licensees vary depending on the nature of the financial service activities conducted by the AFS licensee.

Meeting the financial requirements will assist AFS licensees in ensuring that they have adequate financial resources as required by paragraph 912A(1)(d) and an adequate risk management system as required by paragraph 912A(1)(h).

Requirements for responsible entities in ASIC Class Order [CO 11/1140]

In November 2011, ASIC introduced new financial requirements for AFS licensees that are responsible entities of registered managed investment schemes in ASIC Class Order [CO 11/1140]. ASIC Class Order [CO 11/1140] modified Part 7.6 of the Act as it applies to responsible entities (who are not market participants or clearing participants) by inserting notional section 912AA into the Act. Under [CO 11/1140] responsible entities are required to comply with the financial requirements set out in notional section 912AA of the Act as part of satisfying the obligation to have

adequate financial resources under paragraph 912A(1)(d) of the Act. The requirements in [CO 11/1140] came into effect on 1 November 2012.

ASIC Class Order [CO 11/1140] was issued to ensure sufficient rigour in the financial risk frameworks of businesses seeking to manage money or assets on behalf of members as a responsible entity. ASIC Class Order [CO 11/1140] sought to do this by expanding the pre-existing requirement for responsible entities to have adequate financial resources to assist in ensuring that for responsible entities of registered managed investment schemes:

- (a) there are arrangements to meet operating costs (e.g. costs of ensuring compliance with the Act) throughout the life of its registered schemes through robust cash flow forecasting, adequate levels of capital and liquidity, and capital levels reflecting the operational risk of a responsible entity;
- (b) there is some level of assurance that, if the responsible entity does fail, there is money available for the orderly transition to a new responsible entity or to wind up the scheme; and
- (c) there is alignment of the interests of responsible entities and scheme investors by imposing adequate minimum capital requirements so that responsible entities are entities of some substance with sufficient capital at risk to provide responsible entities with a real financial incentive to successfully manage scheme assets.

Specifically, [CO 11/1140] requires responsible entities to:

- (a) prepare 12-month cash-flow projections approved at least quarterly by directors;
- (b) meet the new net tangible asset (**NTA**) capital requirements, where responsible entities must hold the greater of:
 - (i) \$150,000 ;
 - (ii) 0.5% of the average value of scheme and IDPS property (capped at \$5 million); or
 - (iii) 10% of the average responsible entity revenue (uncapped).

A liquidity requirement was also specified where a responsible entity must hold at least 50% of its NTA requirement in cash or cash equivalents, and an amount equal to the NTA requirement in liquid assets.

IDPS operators

The expanded requirements in [CO 11/1140] apply to responsible entities that operate investor directed portfolio services (**IDPS**) provided through a registered managed investment scheme (**IDPS-like scheme**). However, the [CO 11/1140] requirements do not apply to AFS licensees that are IDPS operators but not a responsible entity of a

scheme. IDPS operators are subject to financial requirements as imposed through AFS licence conditions and explained in RG 166.

2. Purpose of the class order

The purpose of this Class Order is to:

- (a) extend the requirements in [CO 11/1140] to IDPS operators to align the expectations on responsible entities that operate IDPS-like schemes and IDPS operators who are not responsible entities;
- (b) introduce new requirements on responsible entities and IDPS operators in relation to the asset holders it uses to hold the property of the scheme and IDPS (i.e. custody related requirements); and

Note: ASIC Class Order [CO 13/761] introduces new financial requirements for AFS licensees that are custodial or depository service providers. The new requirements substantially reflect the financial requirements introduced for asset holders for registered managed investment schemes and IDPS in [CO 13/760]. The Explanatory Statement to ASIC Class Order [CO 13/761] explains these requirements in full.

- (c) revoke and replace [CO 11/1140] to maintain the expanded requirements for responsible entities as contained in [CO 11/1140] in substantially similar form, and consolidate the requirements for responsible entities and IDPS operators in one class order.

3. Operation of the class order

Paragraph 4 of the Class Order inserts a new section 912AA of the Act that applies to responsible entities and IDPS operators, and requires those AFS licensees to comply with the provisions in the Class Order as part of satisfying the obligation to have adequate financial resources under paragraph 912A(1)(d).

Application and Commencement

Paragraphs 3 and 4 provide that the Class Order applies to an AFS licensee that holds an authorisation to operate a registered managed investment scheme as a responsible entity or an IDPS (i.e. as an IDPS operator) on and from the commencement date as specified in paragraph 3 of the Class Order.

Responsible entities or IDPS operators that are a body regulated by the Australian Prudential Regulation Authority (APRA) that is not required to comply with paragraph 912A(1)(d) of the Act; market participants; or clearing participants are not subject to the requirements, as other requirements apply under ASIC or APRA policy.

Requirements

Paragraph 4 of the Class Order contains the terms of the modification of the Act. In order to have adequate financial resources, responsible entities and operators of IDPS must at least comply with the requirements under the provisions of section 912AA that are notionally applied under the modified provisions of the Act applying under the Class Order. These requirements are summarised below.

(a) Complying with AFS licence conditions

To avoid duplication, subsection 912AA(2) specifies that a responsible entity and IDPS operator (covered by subsection 912AA(1)), by complying with the requirements of section 912AA described below is taken to have complied with the conditions (if any) of its AFS licence that relate to:

- (i) a cash needs requirement;
- (ii) the net tangible assets that apply because it is a responsible entity or is authorised to operate an IDPS; and
- (iii) the obligation to lodge an audit opinion on the financial requirements to the extent the opinion is for a part of a financial year or other period during which the licensee was covered by subsection 912AA(1).

(b) Cash needs requirements

- (i) Paragraph 912AA(3)(a) requires a responsible entity and IDPS operator to prepare a cash flow projection covering at the least the next 12 months based on what is reasonably likely to occur.
- (ii) The cash flow projection must be approved at least quarterly by the directors of the responsible entity and IDPS operator as satisfying the cash needs requirement in Paragraph 912AA(3)(a) (see paragraph 912AA(3)(b)).
- (iii) The responsible entity and IDPS operator must document the calculations and assumptions used in preparing the projection, and describe in writing why the assumptions are appropriate (see paragraph 912AA(3)(c)).
- (iv) Under paragraph 912AA(3)(d) responsible entities and IDPS operators must update the cash flow projection if:
 - a. the projection ceases to cover at least the next 12 months; or
 - b. there is reason to suspect that an updated projection would differ materially from the current projection or show that the responsible entity or IDPS operator was not meeting the requirements in subparagraph 912AA(3)(e)(i) and (ii).
- (v) The responsible entity and the IDPS operator must document whether, based on the cash flow forecast, it will have access when needed to enough financial resources to meet its liabilities over that projected period, and will hold at all times during the projected period sufficient resources to comply with the cash or cash equivalents component of its NTA requirement under 912AA(8) (see subparagraphs 912AA(3)(e)(i) and (ii)).

(c) NTA requirement

Paragraph 912AA(4)(a) requires a responsible entity or IDPS operator, in certain circumstances, to hold an amount in NTA. NTA is defined in subsection

912AA(11) and is a measure of assets less liabilities subject to certain adjustments to make it an appropriate measure for the purpose.

Where subsection 912AA(5) relating to the custody of scheme and IDPS property applies, paragraph 912AA(4)(a) requires a responsible entity or IDPS operator to hold the amount that is the greatest of:

- (i) \$150,000;
- (ii) 0.5% of the average value of scheme and IDPS property of registered scheme(s) and IDPS operated by the responsible entity or IDPS operator, up to \$5 million NTA; or
- (iii) 10% of the average RE and IDPS revenue of the licensee with no maximum NTA.

If subsection 912AA(5) relating to the custody of scheme and IDPS property does not apply, paragraph 912AA(4)(b) requires the responsible entity or IDPS operator to hold the greater of:

- (i) \$10 million; or
- (ii) 10% of average RE and IDPS revenue of the AFS licensee with no maximum NTA.

The NTA requirements under subsection 912AA(4) is partly based on revenue because revenue broadly reflects the risk related to the responsible entity's and IDPS operator's businesses, including non-scheme revenue streams for a responsible entity and non-IDPS revenue streams for an IDPS operator. In particular, for responsible entities with high revenue and low funds under management (e.g. agribusiness schemes), the revenue component of the NTA requirement results in a greater and more appropriate to risk level of required capital for the responsible entity than the funds under management component of the NTA requirement. For responsible entities with risky business models that tend to earn higher returns to reflect the higher risk levels, the NTA requirement will better reflect its operating risk.

Average RE and IDPS revenue

The "average RE and IDPS revenue" is defined in subsection 912AA(11). In summary, the definition refers to an amount based on the average of the RE and IDPS revenue for up to the last two preceding financial years (starting from when the RE or IDPS operator was first authorised to operate a registered scheme or an IDPS) and an estimate of the forecast RE and IDPS revenue for the remainder of the financial year.

Responsible entities and IDPS operators are expected to base its forecast on reasonable assumptions and should take into account the actual revenue over that financial year to date in making a forecast.

Responsible entities and IDPS operators may outsource performance of some of its obligations in operating a registered scheme or IDPS. Under section 601FB of the Act a responsible entity is to operate the registered scheme and is liable to members for any acts or omissions of agents or other persons the responsible entity engages to do anything that the responsible entity is authorised to do in connection with the scheme. In accordance with Australian Accounting Standards, a responsible entity or IDPS operator may or may not be taken to earn revenue and incur an expense in relation to payments to providers of outsourced services. However a responsible entity and IDPS operator's financial position is subject to risk by such activities being performed by such agents or persons, whatever the accounting treatment.

To ensure that responsible entities and operators of IDPS maintain NTA that covers all aspects of scheme and IDPS operations, the definition of RE and IDPS revenue includes payments out of scheme and IDPS property (whether or not such payments are classified as revenue of the responsible entity or IDPS operator under the Australian Accounting Standards) that relate to fulfilling a responsible entity or IDPS operator's obligations under the Act and ASIC Class Orders, even if some of those obligations are outsourced to other entities.

Average value of scheme and IDPS property

The "average value of scheme and IDPS property" is defined in subsection 912AA(11). In summary, the definition refers to an amount which is the greater of:

- (i) the current value of scheme property and IDPS property; and
- (ii) an amount derived from the averaging of the actual value of scheme property and IDPS property for up to the last two preceding financial years (starting from when the responsible entity or IDPS operator is first authorised to operate a registered scheme or IDPS) and the forecast value of the scheme property and IDPS property for the remainder of that financial year.

This averaging is to ensure that a responsible entity's and IDPS operator's NTA requirement is not reduced because of a drop in the value of scheme and IDPS property, which might itself indicate the potential for the responsible entity's and IDPS operator's financial resources to be strained.

Custody of scheme and IDPS property

The circumstances set out in subsection 912AA(5) relating to the custody of scheme and IDPS property as applicable to responsible entities and IDPS operators are summarised below.

Responsible entities

A responsible entity must hold the higher NTA specified under paragraph 912AA(4)(b) unless certain requirements are satisfied for each of the schemes the responsible entity operates, including any of the following requirements:

- (i) all the scheme property and IDPS property and other assets of the scheme not held by members are held by a custodian (or a subcustodian appointed by that custodian) who the responsible entity reasonably believes meets the financial requirements for AFS licensees authorised to provide a custodial or depository service other than as an incidental provider under section 912AC as notionally inserted by [Class Order 13/761] (see subparagraph 912AA(5)(a)(iii)(A)), or by an eligible custodian (see subparagraph 912AA(5)(a)(iv);
- (ii) all the scheme property and IDPS property and other assets of the scheme not held by members are Tier \$500,000 class assets (see subparagraph 912AA(5)(b)), each of which are held by the responsible entity or a custodian appointed by the responsible entity (or a subcustodian appointed by that custodian), and:
 - a. if the responsible entity holds the scheme property and IDPS property or assets, the responsible entity has at least \$500,000 NTA; or
 - b. if a custodian or subcustodian holds the scheme property and IDPS property or assets, the custodian has at least \$500,000 NTA, or is an eligible custodian; or
- (iii) the only scheme property and IDPS property and other assets of the scheme not held as described in the two paragraphs above are special custody assets (see subparagraph 912AA(5)(c)), each of which is held by:
 - a. the responsible entity;
 - b. a custodian that has the level of NTA that the responsible entity is required to have (or a subcustodian appointed by that custodian) or an eligible custodian; or
 - c. the members of the scheme.

A responsible entity that has obtained written assurance within the preceding 13 months from a licensee that is authorised to provide custodial or depository services regarding its compliance with the financial requirements for custodians that are not incidental providers and who is not aware of any information to the contrary, is taken to have the reasonable belief referred to above.

The operation of a registered scheme or holding assets of a registered scheme does not constitute a custodial or depository service under s766E of the Act.

Therefore a custodial or depository services authorisation is not required in order to provide these services.

If the custodian appointed by the responsible entity is not authorised to provide custodial or depository services, the responsible entity must meet the higher NTA specified under paragraph 912AA(4)(b) unless they have received:

- (i) written assurance within the preceding 13 months from the custodian regarding its compliance with the financial requirements that apply to custodians that are authorised to provide custodial or depository services that are not incidental providers; and
- (ii) a report from a registered company auditor in respect of a 12 month period ending no more than 16 months prior to the relevant period, confirming the custodian's compliance with these requirements on terms reflecting the audit report required for AFS licensees.

IDPS operators

An IDPS operator must hold the higher NTA specified under paragraph 912AA(4)(b) unless it has appointed a custodian to hold all IDPS property who:

- (i) the IDPS operator reasonably believes meets the financial requirements for AFS licensees authorised to provide a custodial or depository service other than as an incidental provider and complies with the requirements of section 912AC as notionally inserted by [Class Order 13/761] (see subparagraph 912AA(5)(a)(iii)(A); or
- (ii) is an eligible custodian.

An IDPS operator that has obtained written assurance within the preceding 13 months from a licensee that is authorised to provide custodial or depository services regarding its compliance with the financial requirements for custodians that are not incidental providers and who is not aware of any information to the contrary, is taken to have the reasonable belief referred to above.

(d) Liquidity requirement

There are two components under the liquidity requirement in subsection 912AA(8).

Under paragraph 912AA(8)(a), the responsible entity or IDPS operator must hold the greater of \$150,000 or 50% of the NTA requirement that would be required to be held under paragraph 912AA(4) as cash or cash equivalents.

“Cash or cash equivalents” is defined in subsection 912AA(11) as assets that are:

- (i) cash on hand, demand deposits and money deposited with an Australian ADI that is available for immediate withdrawal; and

- (ii) short-term, highly liquid investments that are readily convertible to known amounts of cash that are subject to an insignificant risk of changes in value; and
- (iii) the value of any eligible undertaking provided by an eligible provider; and
- (iv) a commitment by an eligible provider to provide cash upon request within 5 business days: which will not expire within the next 6 months and which cannot be withdrawn by the provider without giving at least 6 months written notice to the person to whom the commitment is made; and in relation to which any cash provided is not repayable for at least six months.

Paragraph 912AA(8)(b) requires responsible entities and IDPS operators to hold liquid assets in an amount that is at least 100% of the required NTA.

“Liquid asset” is defined in subsection 912AA(11). The definition includes cash or cash equivalents (other than a commitment by an eligible provider as described in paragraph (iv) above), and an asset that can reasonably be expected to be realised for its market value within six months. It excludes any assets that are not free from encumbrances or, in the case of receivables, free from any right of set-off.

A primary objective of the liquidity requirement is to ensure that a responsible entity and IDPS operator’s NTA is in a form that can be called upon when required. The liquidity requirement requires that a portion of a responsible entity and IDPS operator’s NTA be held as cash or cash equivalents to help it meet any immediate and unexpected expenses.

(e) Audit opinion

Subsection 912AA(9) sets out the requirements for the contents of an opinion of a registered company auditor (**audit opinion**) covering the period during which the responsible entity was authorised to operate a registered managed investment scheme or an IDPS operator was authorised to operate an IDPS. The auditor is required to provide an audit opinion on a ‘positive assurance’ basis on the matters specified in paragraph 912AA(9)(a) and an opinion on a ‘negative assurance’ basis on the matters specified in paragraph 912AA(9)(b).

(f) Definitions

The definitions that are relevant to the above requirements are set out in subsection 912AA(11) of the Class Order. The definitions generally reflect existing requirements applying in AFS licence conditions and [CO 11/1140] as set out in RG 166 with amendments to extend them to IDPS operators. Material amendments are summarised as follows.

“Adjusted liabilities”

To ensure that the NTA requirement appropriately reflects the risk associated with any personal guarantees, a responsible entity or IDPS operator would be

required to assess the value of, and exclude from the NTA calculation (by adding to adjusted liabilities), the maximum potential liability of any guarantee provided by the licensee other than:

- (i) a guarantee limited to an amount recoverable out of any scheme property (and in the case of a scheme which is not registered, out of any contributions, money, property or income that would be scheme property if the scheme were registered) of a managed investment scheme operated by the AFS licensee; or
- (ii) a guarantee of the obligations of another member of a stapled group, except where the AFS licensee is the responsible entity of a registered scheme that is not part of the stapled group.

“Calculation date”

Calculation date is defined as the day on which the AFS licensee is authorised to operate a registered scheme or an IDPS. This term replaces the previous term ‘commencement date’ and extends the definition to cover IDPS operators.

“IDPS “

The definition of IDPS has the same meaning as in ASIC Class Order [13/763].

“Incidental provider”

The definition of incidental provider has the same meaning as in section 912AC of the Act as notionally inserted by [CO 13/761].

Revocation and transitional

Paragraph 5 of the Class Order revokes ASIC Class Order [CO 11/1140].

Paragraph 6 and 7 of the Class Order provides a transitional period for existing responsible entities and IDPS operators to comply with the Class Order and the option for existing responsible entities and IDPS operators to adopt the new custody related requirements in the Class Order at an earlier date.

Responsible entities and IDPS operators who are authorised prior to the commencement of the Class Order must comply with the Class Order on 1 July 2014.

These responsible entities and IDPS operators may comply with the Class Order prior to 1 July 2014 by lodging a notice with ASIC and publishing a notice on its website that it will rely on the Class Order before 1 July 2014.

Responsible entities and IDPS operators receiving their respective AFS licence authorisations on the day the Class Order commences or after, must comply with the Class Order immediately.

4. Documents incorporated by reference

The following documents are incorporated by reference in the Class Order:

- (a) ASIC Class Order [CO 13/761] – that sets out minimum standards for custodial or depository service providers to have available adequate financial resources to provide the financial services covered by their AFS licence as discussed in Regulatory Guide 166 Licensing: Financial requirements.
- (b) ASIC Class Order [CO 13/763] – that modifies the Act as it applies to a person operating or involved in the operation or promotion of an IDPS, and to a person offering or issuing accessible securities through an IDPS, as discussed in Regulatory Guide 148 *Platforms that are managed investment schemes*.

Both class orders and related explanatory statements may be accessed on the Federal Register of Legislative Instruments and on ASIC's website at www.asic.gov.au.

5. Consultation

ASIC issued Consultation Paper 176 *Review of ASIC policy on platforms: Update to RG 148 (CP 176)* in March 2012. CP 176 set out ASIC's proposals for revising ASIC guidance on platforms in Regulatory Guide 148 *Investor directed portfolio services* (RG 148) and accompanying class order relief. CP 176 included ASIC's proposed changes to align the financial requirements for operators of IDPS and responsible entities of registered managed investment schemes. We received 9 submissions on CP 176, including from platform operators, a range of industry associations, and one consumer representative group. We consulted further with representatives of the Financial Services Council (FSC) to clarify certain aspects of our proposed policy.

ASIC issued Consultation Paper 194 *Financial requirements for custodial or depository services providers (CP 194)* in November 2012. CP 194 set out ASIC's proposed financial requirements for custodial or depository service providers and asset holders for registered schemes and IDPS. We received 12 submissions on CP 194, including from industry associations, industry participants and their advisers. We also met with representatives of the FSC and the Australian Custodial Services Organisation (ACSA) to discuss the proposals in CP 194.

ASIC has prepared two separate Regulatory Impact Statements for the new requirements introduced in the Class Order. Both Regulatory Impact Statements have been approved by the Office of Best Practice Regulation (see attachments).

Statement of Compatibility with Human Rights

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

ASIC Class Order [CO 13/760]

This class order 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 class order

ASIC Class Order [CO 13/760] relates to paragraph 912A(1)(d) of the *Corporations Act 2001* (the **Act**), which requires an Australian financial services (**AFS**) licensee to have available adequate resources to provide the financial services covered by its licence.

Developed in consultation with industry, the Class Order outlines the minimum financial requirements that an AFS licensee who is authorised to operate a managed investment scheme as a responsible entity or is authorised to operate an investor directed portfolio service (**IDPS**), must meet.

ASIC Class Order [CO 13/760] requires responsible entities of managed investment schemes and IDPS operators to meet a cash needs requirement, NTA requirement, liquidity requirement and audit opinion requirement. The content of these requirements may vary depending on whether the assets of the scheme and IDPS, is held by the AFS licensee or another asset holder.

The requirements in [CO 13/760] are designed to do three things:

- (a) largely maintain the pre-existing financial requirements for responsible entities as contained in [CO 11/1140];
- (b) extend the application of the financial requirements on responsible entities (including responsible entities operating IDPS-like schemes) to IDPS operators, to align the financial requirements imposed on entities performing similar financial service activities; and
- (c) modify and introduce requirements for responsible entities and IDPS operators where the assets of the scheme and IDPS are held by other asset holders (such as custodians) to ensure that the financial requirements are adequate and appropriate in light of industry conditions and developments, and reflect the risks associated with providing custodial or depository type services.

Human rights implications

This class order does not engage any of the applicable rights or freedoms.

Conclusion

This class order is compatible with human rights as it does not raise any human rights issues.

June 2013