

# ASIC CLASS ORDER [CO 13/761]

## 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 13/761] 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

Section 912A sets out the obligations of an Australian financial services (AFS) licensee including that the licensee have available adequate resources (including financial) to provide the financial services covered by the licence and to carry out supervisory arrangements and adequate risk management systems. This does not apply to bodies regulated by the Australian Prudential Regulation Authority (APRA).

ASIC imposes specific financial requirements on AFS licensees that are not regulated by APRA in accordance with ASIC Regulatory Guide 166 *Licensing: Financial requirements* (RG 166).

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).

The financial requirements that apply to AFS licensees vary depending on the nature of the financial service activities conducted by the licensee. The operation of a custodial or depository service or asset holding service, in particular, has specific financial requirements.

RG 166 states that the financial requirements for AFS licensees are designed to ensure that:

- a) they have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act;
- b) there is a financial buffer that decreases the risk of disorderly or non-compliant wind-up if the business fails; and
- c) there are incentives for owners to comply with the Corporations Act through risk of financial loss.

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## 2. Purpose of the class order

The purpose of this Class Order is to expand on the requirement in the Corporations Act for providers to have adequate financial resources and to assist in ensuring that for these licensees:

- (a) there are arrangements to meet operating costs (e.g. costs of ensuring compliance with the Corporations Act) through robust cash flow forecasting, adequate levels of capital and liquidity and capital levels reflecting the operational risks of providing custodial or depository services;
- (b) there is some level of assurance that, if the provider does fail, there is money available for the orderly transition of assets to a solvent entity or to wind up the licensee; and
- (c) there is alignment of the interests of providers with those of their clients by imposing adequate minimum capital requirements so that licensees are entities of some substance with sufficient capital at risk to provide them with a real financial incentive ensure the safe-keeping of client assets.

RG 166 provides that the same benchmark for financial requirements should be applied to asset holders for registered schemes and IDPS, as for custodial or depository service providers. Therefore, consistent with the financial requirements in this class order, the financial requirements for asset holders for registered schemes and IDPS have been reviewed and updated. The amended financial requirements for those licensees are set out in Class Order 13/760 and the related Explanatory Statement.

## 3. Operation of the class order

Paragraph 4 of the Class Order modifies subsection 912A(1)(d) of the Act as it applies to custodial or depository service providers by requiring those licensees to comply with modified provisions in the Class Order as part of satisfying the obligation to have adequate financial resources under that paragraph. Custodial or depository service providers that are market participants or clearing participants are not subject to the requirements, as other requirements apply under ASIC policy.

Pursuant to paragraph 4 of the Class Order subsection 912A is modified by inserting new "Section 912AC Adequate financial resources for custodial or depository service providers".

### Application

Paragraphs 3 and 4 of the Class Order provide that the Class Order applies to an Australian financial services licensee who holds an authorisation to provide custodial or depository services on and from the commencement date specified in paragraph 3 of the Class Order.

### Requirements

Paragraph 4 of the Class Order contain the terms of the modifications. In order to comply with the requirement to have adequate financial resources under paragraph 912A(1)(d) of the Act, the licensee must comply with the requirements under the following provisions of section 912AC that are notionally applied under the modified provisions of the Act applying under the Class Order:

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**(a) Cash needs requirements**

Subsection 912AC(3)(a) requires the licensee to prepare a cash flow projection covering at the least the next 12 months based on what is likely to happen over this period.

Under subsection 912AC(3)(d) the licensee must update the cash flow projection when:

- the projection ceases to cover at least the next 12 months; or
- there is reason to suspect that an updated projection would differ materially from the current projection or show that the licensee was not meeting paragraphs (i) and (ii) of subsection 912AC(3)(e).

The licensee must document the calculations and assumptions on which the projection is based, and describe why these assumptions are the appropriate assumptions (see paragraph 912AC(3)(c)).

The licensee must have the projection approved at least quarterly as satisfying the requirements of paragraph 912AC(3)(a)).

The licensee must demonstrate, based on the cash flow forecast, that over the projection period it will have access to enough financial resources to meet its liabilities and sufficient resources to comply with the cash or cash equivalents component of its NTA requirement (see paragraph 912AC(e)).

**(b) NTA requirement**

Subsection 912AC(4) requires the licensee to hold an amount in net tangible assets (NTA) defined in subsection 912AC(12) which is a measure of assets less liabilities subject to certain adjustments to make it an appropriate measure for the purpose. The minimum NTA amount required is:

- (a) for a licensee that is not an incidental provider – at least the greater of \$10 million or 10% of average revenue;
- (b) for an incidental provider – at least the greater of \$150,000 or 10% of average revenue.

An incidental provider does not have to meet the NTA requirements in subsection 912AC(4) if subsection 912AC(5) applies. Subsection 912AC(5) applies if the licensee is an incidental provider and all the financial products or beneficial interests in financial products to which the incidental custodial or depository services relate are held by a financial services licensee that

- (a) is authorised to provide a custodial or depository service and that the licensee reasonably believes:
  - i. is not an incidental provider; and
  - ii. complies with the NTA requirements.

An incidental provider who has obtained written assurance within the preceding 13 months from a custodian regarding its compliance with the financial requirements and who has no reason to suspect that this information is not correct, is taken to have the reasonable belief referred to in subsection 912AC(5): see subsection 912AC(6).

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A licensee must provide a written statement regarding its compliance with the financial requirements for providers, if requested to do so by a financial services licensee for whom it provides custodial or depository services (appointing licensee), for the purpose of assisting the appointing licensee to determine whether it complies with its own obligations regarding custody of client assets; see subsection 912AC(8).

A licensee must notify a financial services licensee for whom it provides custodial or depository services if it lodges a report to ASIC under subsection 912D(1B) relating to a breach of that section: see subsection 912AC(9).

*Average revenue*

'Average revenue' is defined in subsection 912AC(12). In summary, the definition refers to an amount based on the average of the licensee's revenue for up to the last two preceding financial years (starting from when the licensee was first authorised to provide a custodial or depository service) and an estimate of the forecast custodial or depository service revenue for the remainder of the financial year.

*Incidental provider*

Incidental provider is defined in subsection 912AC(12) to mean a financial services licensee that is authorised to provide a custodial or depository service:

- (a) that does not provide any custodial or depository services other than services which:
  - (i) are a need of the person to whom the services are provided because of, or in order to obtain the provision of other financial services by the licensee or its related bodies corporate; and
  - (ii) do not form part of an IDPS; and
- (b) whose custodial or depository services revenue is less than 10% of its financial services business revenue.

*Custodial or depository services*

Custodial or depository services revenue means the aggregate of the AFS licensee's:

- (a) estimate of the revenue attributable to custodial or depository services provided by the licensee and its related bodies corporate for the current financial year-to-date; and
- (b) forecast of such revenue for the remainder of the financial year;

determined on the basis that such revenue must at least include the cost of providing those services.

### *Financial services business revenue*

Financial services business revenue is defined in subsection 912AC(12) to mean, in relation to a financial services licensee, the aggregate of the licensee's:

- (a) estimate of the revenue attributable to the financial services business of the licensee and its related bodies corporate for the current financial year to date, excluding any revenue attributable to custodial or depository services provided by the licensee or a related body corporate; and
- (b) forecast of such revenue for the remainder of the financial year;

determined on the basis that the revenue attributable to custodial or depository services must at least include the cost of providing those services.

### **(c) Liquidity requirement**

Of the NTA required to be held under subsection 912AC(4), licensees are required to hold at least 50% in cash or cash equivalents and 100% in liquid assets: see subsection 912AC(7).

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

'Cash or cash equivalents' is defined in subsection 912AC(12) as assets that are:

- (a) cash on hand, demand deposits and money deposited with an Australian ADI that is available for immediate withdrawal; and
- (b) 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
- (c) the value of any eligible undertaking provided by an eligible provider; and
- (d) a commitment by an eligible provider to provide cash upon request that can be drawn down within 5 business days and has a maturity of at least 6 months.

'Liquid assets' is defined in subsection 912AC(12). 'Liquid assets' means cash or cash equivalents other than in (d) above and assets that the licensee can reasonably expect to realise for their market value within six months. It excludes any asset that is not free from encumbrances or, in the case of receivables, free from any right of set-off.

### **(d) Audit opinion**

Subsection 912AC(10) sets out the requirements for the content of an opinion of a licensee covering the period during which the licensee was authorised to provide custodial or depository services. The auditor is required to provide an audit opinion on the matters specified in paragraph 912AC(10)(a) and negative assurance based on a review on the matters specified in paragraph 912AC(10)(b).

In relation to the NTA requirement and calculation, there is no requirement for the auditor to express an audit opinion or conduct a review of the forecasts but merely to audit whether a forecast as

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required to calculate average revenue exists and whether the licensee has the NTA that would be required based on what appears in the forecast and the other matters relevant to ascertaining the NTA required.

If the licensee is seeking to rely on the definition of incidental provider in order to meet the lower NTA requirements in subsection 912AC(4)(b), the audit opinion must include a statement from the auditor regarding the licensee's compliance with part (b) of the definition of incidental provider.

#### **(e) Compliance with AFS licence conditions**

To avoid duplication, subsection 912AC(2) clarifies that where a licensee has complied with the above requirements, it is taken to satisfy any conditions of its AFS licence that relate to the cash needs requirement, the net tangible assets requirement and the audit opinion lodgement requirement (in so far as the opinion covers a period for which the licensee was authorised to provide custodial or depository services).

#### **(f) Definitions**

The definitions that are relevant to the above requirements are set out in subsection 912AC(12) of the Class Order. The definitions generally reflect existing requirements applying in accordance with RG 166.

## **4. Consultation**

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 met also with representatives of the Financial Services Council (FSC) and the Australian Custodial Services Organisation (ACSA) to discuss the proposals in CP 194.

Report 352 *Response to submissions on CP 194: Financial requirements for custodial or depository service providers* highlights the key issues that arose during the consultation process and our response to those issues.

ASIC has prepared a Regulatory Impact Statement for this Class Order, which has been approved by the Office of Best Practice Regulation (see attachment).

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## **Statement of Compatibility with Human Rights**

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

### **ASIC Class Order [CO 13/761]**

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 13/761] relates to paragraph 912A(1)(d) of the Corporations Act, which requires a financial services licensee to have available adequate resources to provide the financial services covered by the license.

Developed in consultation with industry, the class order outlines the minimum financial requirements that a licensee who is authorised to provide custodial or depository services must meet in order to fulfil their obligations under paragraph 921A(1)(d).

CO 13/761 requires custodial or depository service providers 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 licensee is a custodian or an incidental provider, as these terms are defined in CO 13/761.

The requirements in CO 13/761 are designed to address weaknesses in the earlier financial requirements by ensuring 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 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.

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