

ASIC CLASS ORDER [CO 13/1410]
EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission
Corporations Act 2001

The Australian Securities and Investments Commission (*ASIC*) makes Class Order [CO 13/1410] *Holding assets: Standards for providers of custodial and depository service* under paragraph 926A(2)(c) of the *Corporations Act 2001* (the *Act*).

Paragraph 926A(2)(c) of the Act provides that ASIC may declare that provisions of Part 7.6 of the Act (other than Divisions 4 and 8) 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

Broadly, section 766E of the Act provides that a person (the *provider*) provides a ‘custodial or depository service’ to another person (the *client*) if, under an arrangement, a financial product, or a beneficial interest in a financial product, is held by the provider in trust for, or on behalf of, the client or their nominee.

On 3 August 1998, ASIC released Regulatory Guide 133 *Managed investments: Custodial property arrangements (RG 133)* providing guidance on the minimum standards for holding scheme property and assets of a registered managed investment scheme.

In June 2013, ASIC released Regulatory Guide 148 *Platforms that are managed investment schemes (RG 148)* which included guidance on the minimum standards in holding property and assets of an investor directed portfolio service by providing that with limited adaptation the minimum standards in RG 133 for holding scheme property and assets of a registered managed investment scheme applied.

In 2005, ASIC re-released Regulatory Guide 167 *Licensing: Discretionary powers (RG 167)* which included guidance on the minimum standards in providing a custodial or depository service by providing that with limited adaptation reflecting RG 148 the minimum standards in RG 133 for holding scheme property and assets of a registered managed investment scheme applied.

Australian financial services licences authorising the provision of custodial or depository services impose an obligation on the licensee to meet the minimum standards as provided in RG 167.

In May 2012, the Parliamentary Joint Committee on Corporations and Financial Services (*PJC*) released a report *Inquiry into the collapse of Trio Capital*. In this report, the PJC stated that it strongly supports ASIC’s program to review custodian businesses and identify those issues requiring regulatory reform.

In July 2012, ASIC released Report 291 *Custodial and depository services in Australia*, which discusses ASIC’s review of the Australian custodial industry, the current regulatory regime and matters that ASIC considered to be ‘good practice’.

In late 2013, ASIC completed a review of RG 133 based on extensive industry consultation during 2012 and early 2013. In implementing the policy described in the replacement RG 133, ASIC made a number of class orders, which include [CO 13/1410]. This class order establishes minimum standards for custodians and minimum content requirements for agreements between custodians and sub-custodians and will commence on 2 January 2014 for new custodians. However, for custodians who were licensed to provide a custodial or depository service before the commencement date, a twelve month transition period will apply in respect of the ‘minimum standards’ requirements from 2 January 2014 until 2 January 2015 and a 22 month transition period for the ‘content’ requirements of agreements between custodians and sub-custodians from 2 January 2014 until 1 November 2015. Further details are contained in section 3 of this explanatory statement. There are also minimum content requirements for agreements between custodians and retail clients. Custodial arrangements entered into with retail clients, or varied, on or after 1 November 2015 must comply with the new retail agreement content requirements from that date.

2. Purpose of this class order

Since the application of the minimum standards in relation to holding financial products or a beneficial interest in financial products under RG 167, the custodial industry has increased in size and complexity.

ASIC’s recent surveillance of existing major custodial providers, in combination with its other industry related regulatory activities, highlighted the need to strengthen its regulation of these practices commensurate with these industry developments. ASIC recognises that responsible entities, licensed providers of custodial or depository services (*licensed custody providers*), operators of Managed Discretionary Accounts (*MDA*) and Investor Directed Portfolio Services (*IDPS*) are important gatekeepers in the financial services industry. Therefore ASIC considered it important to review and update the guidance provided in RG 133.

[CO 13/1410] specifies minimum standards that must be complied with by an entity holding financial products or a beneficial interest in financial products in providing a custodial or depository services (*custodial property*) including content requirements that are to be included in a licensee’s agreement to hold custodial property with a sub-custodian or a retail client. We consider that these standards adopt and extend conditions 34 and 35 *Agreement with Holder of Financial Product on Trust* in Pro Forma 209 *Australian financial services licence conditions (PF 209)*, which were imposed on responsible entities, IDPS operators, and licensed custody providers. At the same time, we have updated PF 209 to reflect the changes in [CO 13/1410].

The purpose of [CO 13/1410] is to impose minimum standards on custodians for holding custodial property, to ensure that efficient operational arrangements exist and that custodial property is not exposed to unnecessary risks because of the way it is held. If the custodian has delegated the holding of custodial property to a sub-custodian, [CO 13/1410] requires that the custodian must do all things necessary to ensure compliance by the sub-custodian with those minimum standards, subject to an exception in relation to certain overseas assets.

3. Operation of this class order

[CO 13/1410] modifies or varies Part 7.6 of the Act (other than Divisions 4 and 8) in relation to an AFS licensee by notionally inserting sections 912AAC, 912AAD and 912AAE into the Act.

If a custodian was licensed to provide a custodial or depository service before 2 January 2014, then it must comply with section 912AAC (which contains minimum custodial standards) from 2 January 2015 and section 912AAD (which contains minimum content requirements for agreements with a sub-custodian) from 1 November 2015. If the custodian was first licensed to provide a custodial or depository service on or after 2 January 2014, it must comply with sections 912AAC and 912AAD from 2 January 2014. A licensed custodian is not required to comply with section 912AAE (which deals with agreements between a custodian and a retail client) until 1 November 2015. Minimum content requirements for agreements with retail clients will apply to arrangements that are entered into or varied on or after that date.

Section 912AAC requires the custodian to satisfy certain minimum standards in relation to holding custodial property. The custodian must also do all things necessary to ensure that any sub-custodian engaged directly or indirectly by it to hold custodial property satisfies the minimum standards applying to custodians, subject to an exception in relation to certain overseas assets.

The minimum standards require, among other things, that:

- a) The custodian must do all things necessary to ensure that it holds custodial property on trust for the client and any custodial property held by a sub-custodian is also held on trust. This requirement does not apply to custodial property held under Division 2 and 4 of Part 7.8, to custodial property held outside of Australia under certain circumstances specified in the class order or when an exemption applies under ASIC Class Orders [CO 03/1110] or [CO 03/1112]. Further, this requirement does not apply where a person is providing custody services as an authorised representative of the custodian provided that the custodian is liable to the client for the acts and omissions of the representative and revenue received from the client is revenue of the custodian.
- b) The custodian must do all things necessary to ensure that it and any sub-custodian identifies the custodial property as held on behalf of the relevant persons and holds it separately from the property of the custodian and sub-custodian and other persons, subject to limited exceptions. Where custodial property is not so separated from the property of other persons in the circumstances specified in section 912AAC(5), certain record keeping, policy, process and procedural requirements apply.
- c) The custodian must have:
 - i) an organisational structure that supports compliance with the above requirement for property to be held separately and must segregate custodial staff in a way that minimises any potential conflict of interests and have a documented policy to support this; and
 - ii) the necessary capacity and resources to perform core administrative activities.

The custodian must also do all things necessary to ensure that any sub-custodian also complies with the above minimum standard requirements.

- d) The custodian must keep for 7 years records demonstrating how it ensures that it complies with the above requirements.

- e) If the custodian has engaged a sub-custodian, the custodian must set out in writing and implement a reasonable process to monitor and assess the sub-custodian's performance, and to do all things necessary to ensure that the sub-custodian sets out in writing and implements a reasonable process to monitor and assess the performance of obligations of any person appointed by the sub-custodian to hold custodial property for that sub-custodian;
- f) The custodian must do all things necessary to ensure that if it or a sub-custodian is involved in discretionary decisions concerning a deposit account, it has set out in writing and implements reasonable processes for determining which account to use, monitoring performance of the issuer's obligations and taking action as appropriate;
- g) The custodian must keep records of custodial property in a way that enables the holding of the custodial property to be conveniently and properly audited by an auditor acting for the client and do all things necessary to ensure that such records are kept in relation to custodial property that is held by a person it directly or indirectly engages.

Paragraph 912AAC(5)(b) permits the limited use of omnibus account structures on the conditions set out in subsection 912AAC(6).

A custodian that complies with these minimum standards is taken to comply with the conditions (if any) of its Australian financial services (*AFS licence*) that refer to ASIC Policy Statement 133 or ASIC Regulatory Guide 133 as applying on a certain date.

Section 912AAD specifies the content requirements for the custodian's agreement with each sub-custodian.

These requirements include the following:

- a) The custodian must ensure that it has a written agreement (*custody agreement*) with its sub-custodian that satisfies certain minimum content requirements, subject to limited exceptions for overseas property and for a sub-custodian that it controls.
- b) Among other things the custody agreement must have provisions specifying rights that the custodian has for the ongoing review and monitoring of the sub-custodian and any sub-subcustodians, specifying how instructions will be given and to the effect that the sub-custodian must not take a security interest over scheme property unless it is permitted under the agreement and does not cover the custodian's unpaid fees.
- c) The custodian must ensure that the custody agreement has reasonable liability provisions and if appropriate contains reasonable indemnity provisions in relation to losses caused to the custodian by the sub-custodian's acts and omissions that relate to that agreement.
- d) The custody agreement must require the sub-custodian to certify to the custodian in writing at least every 13 months that the sub-custodian believes on reasonable grounds that the sub-custodian and each sub-subcustodian has met the terms of the agreement and certain minimum custodial standards that apply in relation to the sub-custodian and sub-subcustodians under section 912AAC, other than as disclosed in writing to the custodian or that the sub-custodian reasonably believes are trivial. The custody agreement must also provide the custodian with a right to terminate in certain specified circumstances including in circumstances that involve the custodian having reasonable grounds for believing that the sub-custodian or a sub-subcustodian has not complied with or is unlikely to comply with the minimum custodial standards.

A custodian that complies with this section in relation to an arrangement with a sub-custodian is taken to comply with any condition on its Australian financial services licence concerning the arrangement.

Section 912AAE specifies content requirements of the custodian's agreement with a retail client for arrangements with the retail client entered into or varied on or after 1 November 2015. These include provisions:

- a) to the effect that the custodian is liable to the client if there is a loss to the client due to a failure by the custodian or a person it engages to hold custodial property;
- b) to the effect that the custodian is prohibited from taking or granting a security interests in relation to the assets, subject to certain exceptions;
- c) specifying how instructions will be given to the custodian.

4. Consultation

On 20 December 2012, ASIC released Consultation Paper 197 *Holding scheme property and other assets (CP 197)* seeking feedback on our proposals to update our guidance for responsible entities of registered managed investment schemes on holding custodial property and other assets. These proposals were also relevant for licensed custody providers, MDA operators, and IDPS operators. The consultation period closed on 28 February 2013.

ASIC received 8 non-confidential responses to the proposals in CP 197 from lawyers, industry bodies, custodians, banks and one compliance specialist. CP 197 can be found on ASIC's website.

The Office of Best Practice Regulation has approved the attached Regulation Impact Statement for regulation to implement the policy in the replacement of RG 133.

Statement of Compatibility with Human Rights

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

ASIC Class Order [CO 13/1410]

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

Paragraph 912A(1)(a) of the *Corporations Act 2001* (the *Act*) requires an Australian financial services (*AFS*) licensee to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly.

The managed investments and custodial industries have experienced significant growth in the past decade. The general purpose of the class order is to strengthen the regulation of AFS licensees authorised to provide a custodial or depository service (*custodian*) to ensure that custodial property is not exposed to unnecessary risks by the way it is held or dealt with by a custodian. In addition, the custodian must do all things necessary to ensure that any sub-custodian complies with the same minimum standards that apply to the custodian, subject to certain exceptions.

Developed in consultation with industry, the class order specifies the minimum standards that a custodian must satisfy in holding clients' assets or arranging for those assets to be held by a sub-custodian.

Key aspects of these standards are:

- a) The custodian must do all things necessary to ensure that all custodial property held by it or by a sub-custodian it engages is ultimately held on trust for the relevant client and is held separately from any other property, subject to certain limited exceptions.
- b) The custodian must have, or do all things necessary to ensure that any sub-custodians have, an organisational structure that supports compliance with the requirement for custodial property to be held separately.
- c) The custodian must segregate custodial staff from non-custodial staff, in a way that minimises the potential for conflict.
- d) The custodian must have, or do all things necessary to ensure that any sub-custodians have, the knowledge and skills necessary to perform their duties.

The class order also establishes minimum requirements that apply to agreements between custodians and sub-custodians and between custodians and retail clients.

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.