



**ASIC**

Australian Securities & Investments Commission

## REGULATION IMPACT STATEMENT

# Holding scheme property and other assets: Update to RG 133

November 2013

### About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals for revising and updating our guidance on:

- custody in Regulatory Guide 133 *Managed investments: Scheme property arrangements* (RG 133) (proposed to be renamed *Managed investments and custodial or depository services: Holding assets*) and accompanying class orders; and
- special custody assets in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) and accompanying class order.

## What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses ASIC's proposals for revising and updating our guidance on holding scheme property in Regulatory Guide 133 *Managed investments: Scheme property arrangements* (RG 133) (which we propose to rename *Managed investments and custodial or depository services: Holding assets*) and accompanying class orders. In addition, the RIS addresses ASIC's proposal to revise Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) and issue the accompanying class order.
- 2 This follows a consultation paper published in December 2012, setting out our proposals and supporting rationale for reviewing our regulatory approach to holding scheme property and other assets: see Consultation Paper 197 *Holding scheme property and other assets* (CP 197). A summary of key submissions made in response to CP 197 and our consideration of those responses can be found in Report 376 *Response to submissions on CP 197 Holding scheme property and other assets* (REP 376).
- 3 A review of ASIC's policy on the regulation of asset holders and the holding of scheme property was initiated to address existing and emerging issues in the managed investment scheme and custodial industry, both of which have changed and grown significantly since our policy was first developed.
- 4 Further, in the report of the Parliamentary Joint Committee on Corporations and Financial Services (PJC) on the collapse of Trio Capital<sup>1</sup> there was discussion of an 'expectation gap' between the custodian's obligations and the public's expectation of them. We understand this gap arises because of a misunderstanding by retail investors about:
  - what custodians actually do (act only on authorised instructions from their client or their client's agent); and
  - what an investor might expect them to do (have any investment decision-making responsibility or oversight/supervisory functions of their own).<sup>2</sup>
- 5 Given the industry changes and the PJC's focus on custody, we recognised a corresponding need to review and update our guidance.
- 6 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

<sup>1</sup> PJC, *Inquiry into the collapse of Trio Capital*, report, May 2012.

<sup>2</sup> In response, ASIC is requiring responsible entities to explain the role of custodians in their disclosure material.

- promoting confidence in the managed investment scheme and custodial industry, including by:
  - ensuring that the assets held by asset holders—comprising responsible entities, custodians and sub-custodians—are held in ways that will minimise the risks to those assets; and
  - through appropriate regulation of asset holders; and
- increasing the burden on industry through increased costs of compliance and ultimately investors.

7 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It covers:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

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## A Introduction

### Background

#### Managed investment schemes

- 8 Managed investment schemes are a type of pooled or collective investment scheme used in Australia. Investors' money is pooled together in the scheme (generally known as a 'managed fund') to acquire the underlying assets, such as shares, bonds, property or, less frequently, primary production schemes like agribusiness schemes.
- 9 Investors may choose to invest via a scheme rather than directly for various reasons, such as:
- (a) the scheme operator or, if relevant, its fund manager may have greater expertise in investment management;
  - (b) the scheme operator can carry out investment management more cost effectively and efficiently than the investor can individually; or
  - (c) the scheme operator can achieve greater diversification of the underlying assets and obtain access to wholesale products (those that are only accessible to wholesale investors such as fund managers rather than retail investors).
- 10 In Australia, schemes offered to retail investors are generally required to be registered with ASIC under s601ED of the *Corporations Act 2001* (Corporations Act) and are referred to as 'registered managed investment schemes' (registered schemes) and the operators of such schemes are referred to as 'responsible entities'. Registered schemes must comply with the requirements of Ch 5C of the Corporations Act and related ASIC regulatory guides, including RG 133.
- 11 The responsible entity may have the investment expertise in-house or may elect to outsource investment management, in whole or in part, to a related or unrelated investment manager. Similarly, the responsible entity may have the required financial resources and expertise to hold the scheme assets itself or may outsource custody of the scheme assets to a related or unrelated custodian.

#### Requirements of the current form of RG 133

- 12 Currently, RG 133 sets out our guidance on operational standards for the holding of scheme property. Compliance with RG 133 is a condition of the Australian financial services (AFS) licence of responsible entities.<sup>3</sup>

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<sup>3</sup> See Pro Forma 209 *Australian financial services licence conditions* (PF 209), conditions 34 and 35.

- 13 RG 133 also applies to certain other issuers that are exempt from the requirement to hold an AFS licence authorising them to act as a responsible entity (exempt issuers).<sup>4</sup>
- 14 Broadly, due to the application of RG 166, if a responsible entity does not hold \$10 million net tangible assets (NTA),<sup>5</sup> it must appoint a licensed custody provider to hold the client assets, to comply with the terms of its AFS licence. Compliance with RG 133 is a condition of a custodian's own licence. Incidental providers are also subject to RG 133—and, similarly, compliance with RG 133 is a condition of the incidental provider's own licence.
- 15 In addition, a responsible entity may elect to appoint a custodian to hold the client assets even when it is not required to do so by the terms of its AFS licence. For example, a custodian may be engaged when the responsible entity does not have the expertise to provide certain back-office or 'investment administration' functions, such as trade settlement, proxy voting, unit pricing and mandate monitoring. It may be more cost effective and efficient for the responsible entity to engage a custodian in this manner.
- 16 As part of our role as regulator of the financial services industry, we are responsible for setting out how scheme assets should be held either by a responsible entity or its custodian. The objective of the current version of RG 133 is to ensure that:
- (a) scheme property is not exposed to unnecessary risks because of the way it is held; and
  - (b) efficient operational arrangements exist for holding and dealing with scheme property.

## Industry characteristics

### Responsible entities

- 17 ASIC data shows that there are currently 529 AFS licensees with the authorisation to be a responsible entity. Of these licensees, ASIC data indicates that 509 responsible entities manage an aggregate of approximately 4,166 registered schemes.
- 18 The amount of assets held in managed funds (including wholesale funds and registered schemes) is referred to as 'funds under management' (FUM).

<sup>4</sup> This exemption applies to investor directed portfolio services (IDPS) (see Regulatory Guide 148 *Platforms that are managed investment schemes* (RG 148)) and managed discretionary account (MDA) services (see Regulatory Guide 179 *Managed discretionary account services* (RG 179)).

<sup>5</sup> This minimum has been raised from \$5 million NTA. The change was implemented through amendments to RG 166 and the release of Class Order [CO 13/760] *Financial requirements for responsible entities and operators of investor directed portfolio services*, which establish the financial requirements of different types of AFS licensee.

Australia's FUM is now ranked the third largest in the world,<sup>6</sup> recording \$1.95 trillion in the September 2012 quarter.<sup>7</sup> The Commonwealth/Colonial Group continues to dominate the market (\$104 billion in FUM), followed by State Street Global Advisors (approximately \$69 billion in FUM) and the AMP Group (\$65 billion in FUM).<sup>8</sup>

- 19 Some responsible entities operate in the retail sector, others operate in the wholesale sector and many operate in both. Responsible entities operate in a diverse range of markets, with registered schemes falling into eight main classes, including unlisted managed schemes,<sup>9</sup> listed and quoted managed investments (exchange-traded funds and listed investment trusts), Australian-listed real estate investment trusts, unlisted property schemes, mortgage schemes, infrastructure schemes, agribusiness schemes, and timeshare and serviced strata schemes.<sup>10</sup>

### Custodians

- 20 A diverse range of businesses are involved in providing asset-holding services. Approximately 668 AFS licensees currently provide custodial or depository services or are asset holders for registered schemes. Of these, approximately 20 are custodians, 513 are incidental providers, and the remainder (some 135 licensees) are asset holders for registered schemes or investor directed portfolio services (IDPSs).
- 21 Custodians currently play a significant role in the safekeeping of client assets for a number of key reasons:
- (a) As at 30 June 2013, approximately \$2.16 trillion<sup>11</sup> of assets of Australian investors were held in custody. This is expected to triple over the next 15 years to \$6.4 trillion (in nominal terms),<sup>12</sup> in part due to the increase in superannuation guarantee contributions.<sup>13</sup>

<sup>6</sup> See Investment Company Institute's statistics on worldwide mutual funds and long-term mutual fund flows (available at <http://ici.org/research/stats>). 'Assets held in custody' includes the FUM of managed funds, and also the assets of other types of financial services provider, such as superannuation trustees, broker-dealers, charities, friendly societies, high net-worth individuals, and assets of foreign clients and foreign managed funds. They may also include assets where the custodian is acting as sub-custodian to an offshore custodian.

<sup>7</sup> Australian Bureau of Statistics (ABS) data.

<sup>8</sup> Morningstar's calculation of FUM accounts for in-house managed money, including retail and wholesale funds, listed funds and discrete mandates.

<sup>9</sup> The main categories of managed funds are cash, cash-enhanced, equities, specialist equities, bonds, yield, alternative and multi-sector. About 3600 fall into this sector.

<sup>10</sup> There are approximately 62 Australian-listed real estate investment trusts, 650 unlisted property schemes, 124 pooled mortgage schemes, 44 contributory mortgage schemes, 22 infrastructure funds listed on ASX, 410 agribusiness schemes, and 40 timeshare and serviced strata schemes.

<sup>11</sup> Australian Custodial Services Association (ACSA), *Australian investor assets under custody*, ACSA website: [www.custodial.org.au/public\\_panel/industrystats\\_investor.php](http://www.custodial.org.au/public_panel/industrystats_investor.php).

<sup>12</sup> Excluding other types of custodial arrangements, such as 'incidental custody' (see RG 166 and PF 209 for an explanation of 'incidental' services). See Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011. The Australian Government has announced changes that, if agreed to by Parliament, will increase the superannuation guarantee rate from 9% to 12% from 2013–14 to 2019–20.

<sup>13</sup> ACSA *Australian investor assets under custody*, ACSA website, [www.custodial.org.au/public\\_panel/%20industrystats\\_investor.php](http://www.custodial.org.au/public_panel/%20industrystats_investor.php); Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011.

- (b) In Australia, custody of a substantial majority of these assets is concentrated with a small number of custodians: see Table 1.
- (c) There have been a number of incidents in the financial services industry, such as the collapse of Opes Prime<sup>14</sup> and Trio/Astarra,<sup>15</sup> that have led to questions about:
  - (i) from an operational perspective, the safety of assets that custodians hold;
  - (ii) the duty of care custodians exercise; and
  - (iii) whether custodians have appropriate internal controls to ensure the safety of assets held for others.

However, it is important to note that there have been no instances of custodian failure in Australia.

- (d) Globally, there has been an increased regulatory focus on the safety of client assets and a number of international initiatives are being developed.<sup>16</sup>
- (e) Custodians are key service providers in the financial services industry. The growth of the custodial industry in Australia over the past two decades is closely correlated to the introduction of compulsory superannuation in the early 1990s. The industry has evolved significantly over this period, including:
  - (i) through consolidation and the entry of new participants;
  - (ii) to provide ancillary services in addition to the pure safekeeping of assets held in custody; and
  - (iii) in response to new products and regulatory requirements.
- (f) The introduction of new products and regulatory requirements can itself increase the operational risk to custodians as they adapt or devise new systems and processes to be able to hold such new products and meet revised regulatory requirements.

22 In Australia, the main users of custodial services are:

- (a) superannuation fund trustees (excluding trustees of self-managed superannuation funds);
- (b) responsible entities of managed investment schemes (including registered schemes);
- (c) insurance companies;

<sup>14</sup> Opes Prime Group Limited was a major Australian securities lending and stockbroking firm that collapsed in 2008.

<sup>15</sup> Trio Capital Limited, formerly known as Astarra Capital Limited, was a boutique funds management and superannuation firm that collapsed in 2009.

<sup>16</sup> These international initiatives include the EU Alternative Investment Fund Managers Directive (AIFMD), the US *Dodd–Frank Wall Street Reform and Consumer Protection Act 2010* and various International Organization of Securities Commission (IOSCO) principles (to the extent that a comparison can be made with the Australian market and regulatory framework).



- (d) endowment funds and charities;
- (e) broker–dealers; and
- (f) federal and state governments.

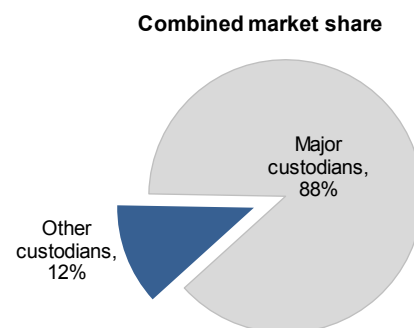
23 Currently, the industry in Australia is dominated by a small number of major custodians: see Table 1.

**Table 1: Assets held in custody in Australia as at 30 June 2013**

Major custodians	Assets in custody (\$bn)	Approx. market share
National Australia Bank Asset Servicing	\$566.80	26%
JP Morgan Treasury and Security Services	\$394.39	18%
BNP Paribas Securities Services	\$313.36	14%
Citi Global Transaction Services	\$213.28	10%
State Street Global Services	\$182.58	8%
Northern Trust Company	\$135.03	6%
HSBC Securities Services	\$123.10	6%

Other significant custodians	Assets in custody (\$bn)
BNY Mellon	\$86.77
Bond Street Custodians Ltd	\$63.72
RBC Investor Services	\$53.46
Asteron	\$17.71
Ausmaq	\$ 8.36
Netwealth	\$ 4.00



24 The safekeeping of assets is a core custodial service. Other services that may be considered core services include:

- (a) trade and transaction settlement—facilitating the trade and settlement of transactions, with third parties on behalf of the client, for assets held in custody;
- (b) corporate actions—aggregating clients’ instructions for participating in any rights or obligations arising from assets held in custody;

- (c) proxy voting—helping clients exercise their voting rights on the securities held in custody; and
- (d) reconciliations—reconciling the records held by the custodian with another provider’s records, such as the fund administrator or investment manager. This service provides some assurance regarding the accuracy of records and can be a means to identify discrepancies, potential fraud or other problems.

Other core services include record keeping and reporting, tax reclamations, cash management, and income and distribution processing.

25 Custody is also associated with a large number of additional products and services. Other services offered by custodians are provided independently of the core services and fall under the broad heading of ‘investment administration’.

26 Investment administration may include:

- (a) mandate monitoring—monitoring, on behalf of the client, the investment managers’ compliance with the investment mandate set by the client; and
- (b) fund accounting—preparing the financial accounts for the managed funds, for which the custodian holds assets on behalf of the client. This also involves calculating net asset values and unit pricing.

Other investment administration services include calculating crediting rates, performance monitoring and reporting, tax reporting, and unit registry.

27 There may be other services provided in addition to core services and investment administration, such as foreign exchange, risk measurement, and monitoring and securities lending.

28 The operation of a registered scheme, including holding scheme property and associated activities (such as dealing in financial products that are scheme property), is a financial service under the responsible entity’s AFS licence. Holding assets of a registered scheme is not a custodial or depository service (s766E(3)(b)), although dealing in those assets that are financial products may be a financial service covered under the custodian’s AFS licence. Outside the context of registered schemes, we recognise that not all ancillary and investment administration services provided by custodians are performed under their licence. However, we understand that it is normal practice for these services to be provided under a formal outsourcing arrangement with the clients, typically the custody agreement.

29 We expect that the nature and type of services that may be offered by custodians will continue to evolve and expand over time. For example, as consolidation in the superannuation industry continues, it is possible that

certain investment administrative services and compliance monitoring are brought back in-house.

- 30 Obviously, there is considerable variation in the extent to which a custodian is engaged to provide services in addition to core services. This will depend on various factors, including the client's specific needs, sophistication of the client's own systems and the cost-benefit analysis of the proposed outsourcing.

### **Industry developments: Responsible entities and custodians**

- 31 Since the introduction of the *Managed Investments Act 1998*, various regulatory guides as well as the *Financial Services Reform Act 2001*, there have been a number of significant developments in relation to responsible entities and custodians, including:
- (a) a substantial increase in the amount of assets managed by responsible entities in Australia<sup>17</sup> and held in custody. This is particularly relevant to the ongoing compliance costs and the law relevant to these schemes and the financial resources needed to meet those costs;
  - (b) the managed investment scheme and custody sectors continue to expand, consolidate and develop (see paragraph 32);
  - (c) significant growth in the number of registered schemes;<sup>18</sup>
  - (d) diversification in the size, complexity and nature of the types of schemes managed by responsible entities and hence assets held in custody;
  - (e) substantial consolidation in the custodial industry; and
  - (f) a number of recent high-profile collapses of responsible entities<sup>19</sup>—although not directly related to the manner in which scheme property was held, additional focus was placed on custodians and their role to ensure the safety of assets held in custody.
- 32 As discussed, as at 30 September 2012, the managed fund industry had \$1.95 trillion in FUM.<sup>20</sup> As at 30 June 2013, the Australian custodial industry had \$2.16 trillion assets under custody.<sup>21</sup> This figure is expected to triple over the next 15 years to \$6.4 trillion (in nominal terms), in part due to

<sup>17</sup> ABS data.

<sup>18</sup> In 2002, the number of registered schemes was 1,806. In 2013, this number has increased to 4,166 schemes registered with ASIC.

<sup>19</sup> Over the last five years there have been over 40 responsible entities placed into external administration. Some high-profile examples include Trio, Allco Wholesale Investment Limited, Fincorp Financial Services Limited and, more recently, LM Investments Limited.

<sup>20</sup> ABS data.

<sup>21</sup> ACSA data.

the proposed increase in superannuation guarantee contributions.<sup>22</sup> We anticipate that demand for custodial services will grow in line with the expected growth in funds under management.

## Current requirements

### Responsible entities

- 33 The licensing provisions of the *Financial Services Reform Act 2001* commenced on 11 March 2002. Under this regime, a responsible entity of a registered managed investment scheme must obtain an AFS licence that authorises it to operate registered managed investment schemes.
- 34 All AFS licensees are subject to the conduct obligations of Ch 7 of the Corporations Act, including obligations to:
- (a) do all things necessary to ensure that the financial services covered by their AFS licence are provided efficiently, honestly and fairly (s912A(1)(a));
  - (b) have in place adequate arrangements for the management of conflicts (s912A(1)(aa));
  - (c) comply with the conditions on their AFS licence (s912A(1)(b)), including the prescribed conditions under reg 7.6.04 of the Corporations Regulations 2001 (Corporations Regulations);
  - (d) have adequate risk management systems (s912A(1)(h)); and
  - (e) maintain the competence to provide those financial services (s912A(1)(e)).
- 35 Responsible entities, being one type of AFS licensee, are also subject to the compliance and governance requirements of Ch 5C of the Corporations Act, which prescribe, among other things:
- (a) the powers of a responsible entity to appoint agents (including, for example, custodians and investment managers);
  - (b) the duties of a responsible entity (e.g. to act in the best interests of members);
  - (c) the duties of the officers of the responsible entity;
  - (d) the requirements for changing the responsible entity;
  - (e) the requirements of the constitutive document of the scheme (which, by law, is a trust structure); and
  - (f) the requirements for winding up and deregistering a scheme.

<sup>22</sup> The *Superannuation Guarantee (Administration) Act 1992* has been amended to increase gradually the superannuation guarantee rate from 9% to 12% from 2013–14 to 2019–20.

- 36 Through the operation of s601FC(2), a responsible entity is deemed to hold scheme property on trust for members. Under s601FB(2), a responsible entity appoints an agent to hold scheme property separately from other property.
- 37 As stated, a responsible entity must also comply with the operational standards: RG 133 sets out ASIC's policy for the holding of scheme property. Compliance with RG 133 is required as a condition of a responsible entity's AFS licence: see Pro Forma 209 *Australian financial services licence conditions* (PF 209), condition 35.<sup>23</sup>
- 38 As part of our role as regulator of the financial services industry, we are responsible for administering the minimum financial resource requirements that an AFS licensee must meet. These requirements are set out in s912A(1)(d) and clarified in the licence conditions. The pro forma licence conditions are set out in PF 209 and are further explained in RG 166.
- 39 Broadly, under RG 166, a responsible entity must hold the greater of \$10 million NTA or 10% of average responsible entity revenue, unless all scheme property, for each scheme:
- (a) is held by a person, such as a custodian, that does hold \$10 million NTA or is an authorised deposit-taking institution<sup>24</sup> (ADI); and
  - (b) comprises special custody assets or Tier \$500,000 class assets, each of which are held by the responsible entity or a person appointed by the responsible entity.

Similarly, compliance with RG 133 is a condition of a custodian's own AFS licence: PF 209, conditions 34 and 35.

### **Custodians**

- 40 We use the term 'custodian' for a person providing custodial or depository services (s766E) for which an AFS licence is required (s766A and 911A) or a person who is holding scheme property of a registered scheme (other than as responsible entity or superannuation trustee). ASIC is responsible for granting the AFS licence covering these financial services and monitoring the custodian's compliance with its AFS licence conditions, the Corporations Act and related regulatory guidance.
- 41 The term 'custodial or depository services' is given specific statutory definition in Ch 7 of the Corporations Act. Critically, the term 'custodial or depository services' refers only to the holding, in certain circumstances, of financial products or a beneficial interest in financial products (other than as

<sup>23</sup> Similar provisions apply to custodians of superannuation funds under the Australian Prudential Regulation Authority's (APRA's) Cross Industry Circular No. 1, *Custodian requirements for APRA supervised entities*, and Superannuation Guidance Note 130.1 *Outsourcing* (SGN 130.1).

<sup>24</sup> See s64 of the *Banking Act 1959* and the APRA website for the current list of Australian ADIs.

responsible entity or superannuation trustee). It does not cover the numerous ancillary services that custodians typically provide, such as unit pricing, stock lending and compliance monitoring. Note that custodians will generally require an AFS licence authorising dealing (unless they do not deal in financial products).

- 42 Typically, a custodian is responsible for the holding of property for another person who is generally the beneficial owner.<sup>25</sup> A custodian is often referred to in circumstances where an entity is charged with the responsibility of holding the legal title in certain trust property but where management powers and responsibilities for the trust property are given to, and undertaken by, another person.
- 43 Except in limited circumstances (e.g. a potential breach of law), the custodian is usually required to act on all authorised instructions of the registered superannuation entity licensee or the responsible entity, or their authorised agents—for example, an investment manager or administrator. It is the responsibility of the custodian to ensure that it only acts on authorised instructions. Generally, the custodian does not have any discretion on how a client’s assets are to be invested or administered—it can only deal with the assets on the instructions from the client and in accordance with those instructions.
- 44 As discussed at paragraph 40, a custodian must obtain an AFS licence issued by ASIC. Custodians, as AFS licensees, are also subject to the conduct obligations of Ch 7 of the Corporations Act, including obligations referred to in paragraph 34.
- 45 ASIC has also provided guidance on the minimum financial requirements that a custodian should satisfy: see RG 166. An entity providing a custodial or depository service that is other than incidental to the provision of another financial service provided by it or a related body corporate, should at all times have NTA of \$10 million. This is intended to ensure that the custodian has sufficient financial resources to operate and to meet operational liabilities. The minimum NTA requirement is also imposed to ensure that there is an opportunity for an orderly wind-up of a custodian’s business in order to prevent client loss. Additional financial requirements may also apply, depending on the other financial services businesses of the custodian. However, where the custodian is regulated by the Australian Prudential Regulation Authority (APRA) because it is also an ADI, it is exempt from ASIC’s financial requirements.
- 46 In addition, licensed custodial services providers:

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<sup>25</sup> A custodian holds the legal title and the client has an equitable interest.

- (a) must prepare each financial year a true and fair profit and loss statement and balance sheet and lodge the prescribed Form FS70 *Australian financial services licensee profit and loss statement and balance sheet* with ASIC; and
- (b) have obligations in relation to client property imposed under Pt 7.8, Divs 2 and 3 of the Corporations Act (client money provisions).

47 As discussed at paragraph 14, a custodian must also comply with operational standards: RG 133 sets out ASIC's policy for the holding of scheme property. Compliance with RG 133 is required as a condition of a custodian's AFS licence: PF 209, condition 35.<sup>26</sup>

### **Incidental providers**

48 RG 166 requires custodians to have at least \$10 million NTA if they have custody of client assets 'other than incidentally' to financial services provided by them or their related body corporate. We use the term 'incidental providers' to describe AFS licensees that are authorised to provide custodial or depository services but are exempt from the \$10 million NTA requirement, on the basis that these services are merely 'incidental' to other financial services they provide.

49 The concept of incidental custodial or depository services is defined in RG 166. RG 166 defines an 'incidental provider' as an AFS 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;
  - (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.

50 Similarly, compliance with RG 133 is a condition of an incidental provider's own AFS licence: PF 209, conditions 34 and 35.

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<sup>26</sup> Similar provisions apply to custodians of superannuation funds under APRA's Cross Industry Circular No. 1 and SGN 130.1.

## Assessing the problem

### Inadequacy of current policy: Responsible entities and custodians

- 51 We established the regulatory framework for holding scheme property when we issued the first version of RG 133 in August 1998. The framework has not been updated or modified in the intervening period, despite the changes and developments in the financial services industry, and the risks and issues that consequently arise. While the financial services industry could take, and is expected to take, some measures to voluntarily improve its standards, it is appropriate that ASIC reconsider the minimum standards expected of asset holders to ensure the sector appropriately addresses emerging risks and issues it faces to ensure confident and informed investors and consumers, and licensing that fosters commercial dealings.
- 52 While there have been no instances of regulatory failure directly attributable to the inadequacy of the current policy, the role of custodians and the safekeeping of assets was the subject of intense focus following the collapse of Trio and the subsequent PJC inquiry. Following this, we consider that a proactive approach is justified to prevent losses that may result from inadequate policy for the holding of custodial property and potential collapses of responsible entities and custodians. We consider that the custodial standards set out in RG 133 are no longer appropriate due to the significant changes in the industry and the nature of the custodial service. Further, an AFS licensee that complies with them will not necessarily comply with its obligations under the Corporations Act to:
- (a) provide financial services ‘efficiently, honestly and fairly’;
  - (b) manage conflicts of interest;
  - (c) maintain the competence to provide those financial services; and
  - (d) have adequate risk management systems.
- 53 The PJC, in its report *Inquiry into the collapse of Trio Capital*, expressed strong support for ASIC’s program to review custodian businesses and identify issues requiring regulatory reform.
- 54 A recent International Monetary Fund (IMF) review of Australia’s implementation of the International Organization of Securities Commissions (IOSCO) Principles of Securities Regulation concluded that Australia’s safeguards for ensuring adequate segregation of client assets are not strong enough, as scheme assets may be held by a responsible entity itself or by its related entity.<sup>27</sup> The custodial industry in Australia is concentrated so that

<sup>27</sup> IMF *Australia: IOSCO Objectives and Principles of Securities Regulation—Detailed assessment of implementation*, IMF Country Report No. 12/314, November 2012, p. 26.



failure of even one major custodian could have a negative impact on a large number of AFS licensees and their clients, as well as confidence in the sector overall.

- 55 In July 2012, we released Report 291 *Custodial and depository services in Australia* (REP 291). This followed a review of the industry that identified a number of key risks to the safety of client assets. In REP 291 we recommended some matters of ‘good practice’ that providers may need to consider and noted that a separate review of the financial requirements for providers was underway.
- 56 Following the work in REP 291, in December 2012, we released CP 197, which set out ASIC’s proposed strengthening of RG 133. A detailed description of the consultation process is set out in Section D.

### Deficiencies of the current RG 133 and related RG 166 provisions

- 57 REP 291 identified a number of key risks to the safety of client assets. A build-up of these risks could raise the likelihood of regulatory failures and ensuing losses to investors. We consider that a proactive approach to emerging and established market practices and developments is justified as opposed to reacting to existing demonstrated problems. Therefore, our proposed reforms should be considered precautionary in nature. The relevant findings from REP 291 are set out in Table 2.

**Table 2: Issues relevant to responsible entities, certain AFS licensee clients and custodians**

Issue	Description
1 <b>Assets are held outside of custodial arrangements</b>	<p>It appears that several responsible entities hold some assets outside of the custodial arrangements, in the name of the responsible entity or a broker who does not have the required NTA, rather than in the name of the custodian or its nominee.</p> <p>As set out in RG 166, under its AFS licence conditions, a responsible entity that relies on a custodian to meet reduced NTA requirements must ensure that all scheme property (apart from certain assets and scheme property that are excluded under the terms of the licence) is held by the custodian.</p>
2 <b>Scheme property, specifically cash, may be held on trust</b>	<p>Cash is in some cases held on deposit at the custodian rather than on trust.</p> <p>AFS licence conditions generally require a responsible entity that does not have \$5 million<sup>28</sup> NTA to ensure that cash should be held <i>on trust</i> by a custodian that does meet the NTA requirements or is an eligible custodian.</p>

<sup>28</sup> At the time of release of REP 291, the minimum NTA was \$5 million for custodians. This has since been raised to \$10 million: see RG 166 and [CO 13/760].

Issue	Description
<p><b>3 High levels of operational risk and opportunities for fraud are present</b></p>	<p>Custodians appear to have established risk management arrangements and a compliance culture. However, a high level of operational risk and opportunities for fraud remain, such as in the continuing practice of accepting written, faxed 'authorised instructions'.</p>
<p><b>4 Assets and records may not be accurately transferred from one custodian to another on a change of custodian</b></p>	<p>There has been increasing consolidation within the superannuation, managed funds and custodial industry, and this is expected to continue. As assets are transferred between different funds and different custodians, we consider that there is an opportunity for fraud and 'leakage' of assets and records.</p>
<p><b>5 Clients may not adequately consider the outsourced services (particularly offshore) of the custodian in their risk management arrangements, introducing additional threats to the safety of client assets</b></p>	<p>We have observed an increasing practice of outsourcing key functions to offshore, lower cost jurisdictions.</p> <p>Where services have been outsourced, responsible entities and clients licensed to deal in financial products may need to consider the risks arising from these outsourced services when developing their risk management arrangements—for example, in structuring a business continuity plan and internal and external audit functions.</p>
<p><b>8 Information technology (IT) systems may not be stable or secure from unauthorised access or use, thereby threatening the safety of custodian systems and client assets</b></p>	<p>We understand from consultations with custodians that IT security is critical to the integrity and stability of the custodial business. As custodians continue to outsource (particularly offshore) significant functions such as unit pricing, we consider that this may increase the challenge to data integrity and security, which should not be compromised.</p>
<p><b>9 Operational risks may be introduced by not upgrading manual and disparate systems</b></p>	<p>Custodians continue to invest in systems that automate their day-to-day functions; however, our review found there is still a reliance on manual and disparate systems which may be out-of-date, slow and cumbersome. Not upgrading these systems can introduce new operational risks.</p> <p>Custodians should consider whether their systems are able to meet the needs of the business and assess the benefit of investing in new or improved systems.</p>
<p><b>10 Custodians are at risk of ignoring or not identifying misconduct and suspected misconduct if they do not understand the extent of the AML/CTF Act or foster a 'whistleblowing' culture and framework</b></p>	<p>Custodians have reporting obligations under the <i>Anti-Money Laundering and Counter-Terrorism Financing Act 2006</i> (AML/CTF Act) in respect of designated services under this Act and, specifically, the obligation to lodge suspicious matter reports (SMRs) with the Australian Transaction Reports and Analysis Centre (AUSTRAC).</p> <p>Suspicious matter reporting relating to designated services extends to information that may be relevant to the investigation or prosecution of an offence of a law of the Commonwealth or state or territory. Therefore, SMRs should not be limited to matters relating to potential money laundering or terrorism financing.</p> <p>In addition to these legislative requirements, we consider that it is good practice for custodians, and other participants in the financial services industry, to foster a whistleblowing culture and framework, where misconduct, or suspected misconduct, of clients or the custodian and its staff is reportable to ASIC under its risk management arrangements.</p>

Source: Tables 1–2 in REP 291.

- 58 The matters set out in Table 2 were identified in our industry surveillance and liaison.
- 59 Our work over the past few years on primary production schemes has highlighted concerns that:
- (a) despite the registration of an interest, the scheme's ability to operate is adversely affected by, among other things, the rights of other parties outside the scheme; and
  - (b) in addition, the business models implemented by many responsible entities of these schemes fail to ensure adequate financial resources are available to secure continuing compliance with the financial obligations under leases.

Therefore, it is our view that the current requirements are not sufficiently robust to ensure that members' interests in land used in primary production schemes are adequately protected.

- 60 We had the benefit of extensive consultation following release of REP 291. We also released CP 197, which proposed some significant changes to RG 133. We received 10 submissions, two of which were confidential. As a result of the thorough and informative responses, we were able to refine our final proposed changes to RG 133. See Section D, Table 8, for a more detailed discussion.

- 61 The matters identified in REP 291 may result in harm to client assets and may be indicative of the following issues, which RG 133 does not currently address:
- (a) Asset holders may not be maintaining adequate and appropriate systems and processes in relation to:
    - (i) organisational structure;
    - (ii) staff capabilities;
    - (iii) capacity and resources;
    - (iv) checks on the asset holder's own clients; and
    - (v) holding custodial property on trust.
  - (b) Persons engaging an asset holder may not obtain liability or indemnity provisions in the agreement.
  - (c) Responsible entities do not currently enter into agreements with the asset holders they engage that oblige the asset holders to have adequate arrangements to ensure that they will make a breach report to ASIC if they suspect that the responsible entity has failed to report breaches to ASIC as required by s912D or 601FC(1)(l).
  - (d) Certain primary production schemes do not currently provide sufficient legal protections for investors.

- (e) Current industry practice by responsible entities is to hold certain types of assets—derivatives, private equity interests and certain types of bank accounts—in breach of the responsible entity’s own NTA requirements.

62 As discussed, we consider that a proactive approach to emerging and established market practices and developments is justified, as opposed to reacting to existing demonstrated problems. Our proposed reforms should be considered precautionary in nature. If the status quo is maintained, the issues and risks that we have identified with industry are likely to continue and potentially be exacerbated, resulting in increased regulatory risk. Without clear regulatory guidance and accompanying class orders (as required) on how we expect asset holders to address these issues, there are likely to be potential adverse impacts on client assets and ultimately investors.

63 In addition, if the definition of ‘special custody assets’ is not expanded in RG 166 to include derivatives, private equity interests, certain bank accounts and associated contracts, we understand that it is likely that:

- (a) responsible entities may not be able to find a licensed custodial provider willing, for a commercially reasonable fee, to hold such assets. For example, if a custodian became the legal owner of a derivative contract, rather than the responsible entity, the custodian may have full legal and financial liability under the derivative. Although the custodian may be able to obtain from the responsible entity an indemnity from the scheme’s assets, the liability may exceed the amount recovered by the custodian under that indemnity;
- (b) custody costs would substantially increase across the industry; and
- (c) certain responsible entities would either restructure so that their funds did not hold these types of assets or, ultimately, exit the retail managed investment industry.

## ASIC’s objectives

64 The *Australian Securities and Investments Commission Act 2001* (ASIC Act) requires, among other things, ASIC to promote confident and informed participation by investors and consumers in the financial system. To meet this objective, we aim to ensure that we mitigate the risks around inappropriate custody of assets that may undermine the confident and informed participation by investors and consumers.

65 In addition, we seek to ensure confident and informed participation by investors and consumers in the financial system by requiring that:

- (a) scheme property and the property of retail investors is held through other non-scheme structures such as managed discretionary accounts

(MDAs) and IDPSs, or non-scheme arrangements such as incidental providers; and

- (b) efficient operational arrangements exist for holding and dealing with client property.

66 Our overriding objectives are to apply the minimum appropriate regulation to asset holders consistent with the framework for the regulation of financial services in the Corporations Act.

67 We aim to strike an appropriate balance between:

- (a) not unduly interfering with the operation and regulation of asset holding; and
- (b) promoting efficiency and appropriate safekeeping of assets in the financial services industry.

## B Options

68 ASIC considers the following as possible options to meet our objectives:

**Option 1:** Current regulatory approach continues to apply (maintain the status quo).

**Option 2:** Retain key aspects of our current regulatory approach and strengthen our regulatory approach where warranted to address key existing and emerging issues and risks in the industry while ensuring efficient operational arrangements exist for holding and dealing with client assets, including scheme property (preferred option).

### Option 1: Current regulatory approach continues to apply (maintain the status quo)

69 Under this option, we would continue to apply our existing regulatory approach, relying on our guidance in RG 133 and accompanying class orders. It is important to recognise that a number of related regulatory measures are in train or have been implemented, such as:

- (a) the increase in financial requirements for responsible entities and custodial or depository services providers; and
- (b) a proposed regulatory guide on the adequacy of risk management systems (s912A(1)(h)).

However, we do not consider that these specifically address the issues identified in REP 291 and the compliance and operational risks in relation to custody and the custodial industry.

70 This option would see no change in our policy in this area and, therefore, no modification to address existing and emerging issues and risks in the managed investment scheme and custodial industry: see paragraphs 57–63. While the financial services industry could take, and is expected to take, some measures to voluntarily improve its standards through general market forces, it is unlikely that this will be adequate to ensure confident and informed participation by investors and consumers in the financial system, specifically the custodial industry.

**Option 2: Retain key aspects of our current regulatory approach and strengthen our regulatory approach where warranted to address key existing and emerging issues and risks in the industry while ensuring efficient operational arrangements exist for holding and dealing with client assets, including scheme property (preferred option)**

- 71 Under this option, we would retain key aspects of our current regulatory approach and provide additional guidance to asset holders to address the existing and emerging issues and risks facing the financial services and custodial industry. This option would strengthen our regulatory guidance in RG 133 and accompanying class orders to ensure that our regulatory approach is up to date and sets minimum standards expected of asset holders so that the sector appropriately addresses emerging risks and issues it faces to promote confidence in the holding of client assets.
- 72 Under Option 2, we would change our current regulatory approach to include some enhanced operational and legal requirements: see Table 3.

**Table 3: New requirements under Option 2**

<b>Requirement 1</b>	An asset holder must comply with new minimum standards in relation to: (a) organisational structure; (b) staff capabilities; (c) capacity and resources; (d) checks on the other party; and (e) holding custodial property on trust.
<b>Requirement 2</b>	Any person engaging an asset holder must secure liability and, if appropriate, indemnity provisions in the agreement that provide reasonable safeguards against risks to the client arising from the provision of the custodial services.
<b>Requirement 3</b>	Responsible entities must only enter into agreements with asset holders that oblige the asset holder to have adequate arrangements to ensure that it will report to ASIC within 10 business days if it suspects that the responsible entity has failed to report breaches to ASIC, as required by s912D or 601FC(1)(l).
<b>Requirement 4</b>	Certain primary production schemes offered on or after 2 January 2014 must have additional legal protections for investors.
<b>Requirement 5</b>	Responsible entities may hold certain types of assets—derivatives, private equity interests and certain types of bank accounts without meeting the relevant NTA requirements.

**Requirement 1(a)–1(d): Minimum standards for asset holders**

- 73 As stated at paragraph 34, there are broad requirements for AFS licensees under Ch 7 of the Corporations Act, including obligations to:

- (a) do all things necessary to ensure that the financial services covered by their AFS licence are provided efficiently, honestly and fairly (s912A(1)(a));
  - (b) have in place adequate arrangements for the management of conflicts (s912A(1)(aa));
  - (c) have adequate risk management systems (s912A(1)(h)); and
  - (d) maintain the competence to provide those financial services (s912A(1)(e)).
- 74 There are also many existing regulatory guides that set out ASIC’s policy for compliance with these general obligations, such as, relevantly:
- (a) Regulatory Guide 104 *Licensing: Meeting the general obligations* (RG 104);
  - (b) Regulatory Guide 105 *Licensing: Organisational competence* (RG 105);
  - (c) Regulatory Guide 167 *Licensing: Discretionary powers* (RG 167); and
  - (d) Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181).
- 75 Our surveillance indicates that the managed investment scheme and custodial industry generally understands its existing compliance obligations and has systems and processes in place to enable compliance. However, we consider that the findings in REP 291 are indicative that the existing framework may not provide adequate prescription in some areas—it may be overly ‘high level’ or principles-based, given the industry changes since the original RG 133 was released. Therefore, an AFS licensee that complies with RG 133 will not necessarily comply with its obligations under the Corporations Act.
- 76 Given the lack of legal prescription in this area, there is a risk that industry practices may change, exposing the client to loss of assets through poor risk management systems, including through fraud or abuse of conflicts of interest. Further, given the substantial amount of assets being held by asset holders, including responsible entities, and the continuing consolidation of the industry, we consider that there ought to be some clarification of the general compliance obligations referred to above. We are concerned to ensure that the entity that holds client assets complies with minimum standards regarding capacity and competence.
- 77 Under Option 2, there would be minimum standards governing:
- (a) organisational structure of the asset holder (see paragraph 79);
  - (b) staff capabilities (see paragraph 80);
  - (c) the asset holder’s capacity and resources (see paragraph 81); and



(d) checks on the other party (see paragraphs 82–85).

78 These four requirements are intended to address the problems identified at paragraphs 61(a)(i)–61(a)(iv).

**Requirement 1(a): Organisational structure**

79 An asset holder must:

- (a) maintain an organisational structure that supports the identification and segregation of client assets from the asset holder’s own assets;
- (b) ensure that staff involved in back-office custodial functions are physically separated from staff involved in the front-office trading functions;
- (c) that managers of both back-office and front-office staff can report directly to the board of directors of the governing body or, for a registered scheme, the compliance committee; and
- (d) maintain a policy designed to ensure that, if a conflict of interest arises, staff involved in custody are not influenced to act outside their duties (this may be part of the conflicts of interest policy that all AFS licensees are currently required to maintain: see s912D and RG 181).

**Requirement 1(b): Staff capabilities**

80 An asset holder must ensure that staff involved in custody have the knowledge and skills necessary to perform their functions properly, which may require:

- (a) ongoing training and educational programs; and
- (b) appropriate measures to address fraud—for example, background checks, mandatory absence periods, and dual approval processes for staff involved in the transfer of money and assets.

**Requirement 1(c): Capacity and resources**

81 An asset holder must ensure that systems and processes—for example, computer systems and business continuity programs—are adequate to perform the asset holding function.

**Requirement 1(d): Checks on the other party**

82 Asset holders and clients should conduct pre-contract inquiries into the counterparty to the custody contract.

83 The client should follow and document an appropriate process in selecting an appropriate asset holder and, where appropriate, carry out subsequent inquiries during the term of the contractual relationship. Inquiries may include, for example, understanding the process of providing instructions to

the asset holder (including from a third party fund manager and investment administrator) and an assessment of whether the asset holder is in fact able to carry out the mandate of the client. We expect this process would address, among other factors:

- (a) compliance with the minimum standards;
- (b) competency;
- (c) the adequacy of financial, human and IT resources; and
- (d) the risk management systems of the asset holder.

84 Similarly, the asset holder should carry out initial and subsequent inquiries of the asset holder. Inquiries may also include, for example, understanding the process of accepting instructions from the client or their authorised third parties and an assessment of whether the asset holder is in fact able to carry out the mandate of the client.

85 This should reduce the risk of avoidable operational risks and issues during the term of the contract.

#### **Compliance with and application of these requirements**

86 We expect all asset holders to comply with the minimum standards. If an asset holder engages another asset holder to hold some or all of the client assets on its behalf, the first asset holder must ensure that the second asset holder complies with the minimum standards—for example, through a provision in the custody agreement between the first and second asset holder and through routine or ad hoc audits of compliance with that custody agreement.

87 We consider the minimum standards in Requirements 1(a)–1(d) as already part of the existing obligations of AFS licensees to provide financial services efficiently, honestly and fairly, and to maintain adequate risk management systems. It is apparent from our liaison with industry that many of the entities contacted would already be in compliance with these requirements.

88 Under Option 2, we would modify the Corporations Act by class order so that, from 2 January 2015, existing asset holders must comply with Requirements 1(a)–1(d). If the asset holder is first authorised to hold client assets on or after 2 January 2014, the new requirements will apply to that asset holder from 2 January 2014.

#### **Requirement 1(e): Holding property on trust**

89 It is important to differentiate between responsible entities and custodians in this context. Under the operation of s601FC(2) of Ch 5C of the Corporations Act, a responsible entity is deemed to hold scheme property on trust. It is ASIC's view that condition 34(d) in PF 209 implies a requirement that

custodial property should be held on trust. However, there are no other express legal requirements governing the manner in which scheme and non-scheme property ought to be held. This may include, for example, the property of a wholesale fund or superannuation fund or even direct assets.

- 90 If custodial property is not held on trust or at least segregated, it is possible that it will be merged with the asset holder's own property. In the event of the insolvency of the asset holder, the custodial property will simply form part of the assets of the asset holder and will, at worst, not be returned to the client or, at best, take some time to be identified and returned to the client.
- 91 We consider that there is substantial protection afforded to clients when a custodian holds client assets under a trust (which may be a bare or directed trust, since the custodian will have no active or fiduciary powers other than as prescribed in the custody agreement with its client). In the event of insolvency of the custodian, the client assets will be segregated from the custodian's own assets, easily identifiable as the assets of the client and therefore able to be returned to the client expeditiously. This means that the custodian will have no rights to use the client property for its own purposes. As stated at paragraph 21(a), there is currently \$2.16 trillion in assets under custody in the Australian financial services industry—we consider it to be critical to the safekeeping of those assets that they are held in a manner that ensures the optimal legal and practical safeguards.
- 92 In the case of client assets comprising cash, we consider that it is the bank account rather than the cash itself that must be held on trust for the client. If the custodian is also an ADI, it is not legally possible for it to hold cash on deposit as banker (and debtor) and purport to hold it on deposit as an ADI.
- 93 For assets held by a sub-custodian offshore, it may not be possible for the sub-custodian to hold client assets on trust when directed to do so by the asset holder (e.g. responsible entity or custodian) appointing it. This is because a trust structure may not be recognised in such jurisdictions, although our understanding is that client assets will be segregated from the sub-custodian's own property.
- 94 Our surveillance shows that custodians typically hold assets on trust for clients. However, given the lack of legal prescription in this area, there is a risk that industry practices may change or new entrants may adopt different practices—for example, in order to save costs as profit margins tighten through increased downward pressure on fees and industry competition. This could expose clients to risk of loss in the event that the custodian becomes insolvent.

- 95 Under Option 2, we would modify the Corporations Act by class order so that, from 2 January 2015,<sup>29</sup> an asset holder that is authorised to hold assets before 2 January 2014 would be required to hold the relevant assets on trust for its client and separately from its own assets, or the assets of any other scheme or any other person, subject to the permitted use of omnibus accounts. The requirement to hold client assets on trust would not apply to assets held outside of Australia where a trust structure is not recognised or the client, on behalf of whom such assets are custodially held, has documented that they are satisfied that the assets are held in a manner that, having regard to the laws of that jurisdiction, provides effective protection in the case of insolvency of the asset holder.
- 96 Requirement 1(e) is intended to address the problem discussed in paragraph 61(a)(v).
- 97 This requirement builds on the existing provisions for responsible entities, to ensure that arrangements for holding assets that are held by custodians generally are effective to address the risk of insolvency.
- 98 We would consider this to be a legal clarification. As custodians are likely to hold client assets on trust, this should not represent a major structural change for custodians.

## **Requirement 2: Liability and indemnity provisions**

- 99 Currently, condition 34 of PF 209 requires that the custody agreement between the client and the asset holder contains certain terms—for example, covering the liability position of both parties and the termination rights of both parties. Specifically, the custody agreement must explain how the client of the AFS licensee will be compensated if the client suffers any loss due to a failure by the asset holder, or any sub-custodian, to comply with its duties or to take reasonable care based on the standards applying in the relevant markets.
- 100 There is a risk that a client, such as a responsible entity, may neglect to obtain an appropriate liability or indemnity provision, leaving scheme members exposed to loss of assets if a contractual claim for damages is not sufficient to compensate the scheme. Our surveillance and industry liaison indicate custody is a low-margin, high-volume business and, as a result of many external factors, there is significant downward pressure on fees from the custodian to the client, and therefore from the client to the scheme member. A lower management–expense ratio (MER) in the scheme ultimately means better net returns (or, conversely, higher MERs can mean lower net returns) for members.

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<sup>29</sup> If the asset holder is first authorised to hold client assets on or after 2 January 2014, the new requirements will apply to that asset holder from 2 January 2014.

101 Clients may be motivated by lower custody costs without understanding the total exposure of the client in the event of breach by or negligence of the custodian. We aim to ensure that the client engaging the asset holder is protected, as far as commercially possible, from the acts and omissions of the asset holder.

102 Under Option 2, we would clarify the existing requirements for agreements with third-party asset holders so that any client engaging an asset holder must secure liability and, if appropriate, indemnity provisions in the agreement that provide reasonable safeguards against risk to the scheme arising in relation to the provision of custodial services. We expect that this would not involve any broad exclusion of any liability for direct losses that would apply for the failure to take reasonable care under general law.

103 The final terms of the contract will depend on many variables, including the size and financial standing of the parties, size of the custody mandate, fees and level of complexity (and therefore risk) associated with it.

104 However, we consider it important that users of asset-holding services are in the best position possible to ensure the safety of client assets in the custody of the asset holder. Therefore, we would introduce Requirement 2 under Option 2. Based on our understanding of industry practice in relation to such terms, we would consider this to be codification of a current industry practice—that is, we would expect a client to negotiate liability or indemnity provisions in the agreement that are as favourable to that client as can be reasonably negotiated.

105 Proposal B3 in CP 197 required that the asset holder provide a full indemnity to the client in respect of its own acts and omissions and those of its sub-custodians. However, there was uniformly strong objection from industry:

- (a) from clients, who were aware that it would not always be possible to obtain any kind of indemnity from custodians; and
- (b) from custodians, who noted that this would result in a significant increase in the cost of custody, without changing the total amount of risk in the system.

In response, we modified our requirement to that set out in paragraph 102.

106 Requirement 2 is in response to the problems identified at paragraph 61(b).

### **Requirement 3: Reporting of failure to lodge breach reports**

107 Providers of designated services, including responsible entities, licensed custody providers, MDA operators and IDPS operators, have reporting obligations under the AML/CTF Act and, specifically, the obligation to lodge suspicious matter reports with AUSTRAC. We consider that there may be circumstances where suspicious activity in financial services may not be

required to be reported under the AML/CTF Act. This may be the case, for example, if the suspicious activity relates to services that are not designated services, or the reporting entity does not consider, even though it is concerned about the activity, that its suspicion meets the requirements to report to AUSTRAC.

108 The PJC stated that:

Custodians appear to have a limited role in managed investment schemes of the kind conducted by Trio, and by many legitimate financial services providers ... the committee urges ASIC to consider the safeguards that a custodian could put in place to ensure it is able to identify and report suspicious transfers that do not trigger the anti-money laundering provisions.<sup>30</sup>

109 Under Option 2, we would require that responsible entities only enter into custody agreements that oblige the custodian to have adequate arrangements to ensure that it will report to ASIC within 10 business days if it suspects that the responsible entity has failed to report breaches to ASIC, as required by s601FC and 912D. Requirement 3 is intended to facilitate and promote an open dialogue with ASIC about matters that may be of concern and that may not otherwise be brought to our attention. We consider that our proposal will bridge any barriers to an open dialogue with ASIC, as identified in our surveillance of the custodial industry, notwithstanding the AML/CTF Act and ‘whistleblower protection’ in the Corporations Act.

110 Industry raised a number of concerns about Proposal B4 in CP 197: see REP 376. However, we would not impose any positive duty on inquiry on the custodian in relation to the responsible entity. Rather, the requirement is intended to capture matters that the custodian becomes aware of in relation to its client *in the ordinary course of its business*, including through anything detected via its existing AML/CTF Act program (governed by AUSTRAC).

111 We consider there may be some deterrence benefits to this requirement, as some entities who may be considering committing or not reporting significant breaches may not do so if they are aware that their custodian may identify such a breach and report it to ASIC (if the custodian believes that the entity did not report it themselves).

112 Requirement 3 is intended to address the problem identified at paragraph 61(c).

#### **Requirement 4: Primary production schemes**

113 Many investors have lost all of their investment in some of Australia’s primary production schemes, including agribusiness schemes. Operators of schemes that have collapsed or experienced financial difficulties include

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<sup>30</sup> PJC, *Inquiry into the collapse of Trio Capital*, report, May 2012, p. xxiii.

Great Southern Managers Australia Limited, Timbercorp Securities Limited, Environinvest Limited, Palandri Wines Pty Ltd, Australian Bight Abalone Pty Ltd, Forestry Enterprises Australia (FEA) Limited, Rewards Group Limited, Willmott Forests Ltd and, more recently, Gunns Plantations Limited.

114 Based on ASIC data, only a small number (143) primary production schemes currently remain in Australia.

115 We consider that such schemes can serve a useful purpose to the economy, facilitating investment in primary production that provides our country with food and produce. However, these schemes need to be appropriately managed.

116 Recent collapses of responsible entities of primary production schemes have highlighted concerns that:

- (a) despite the current requirement for the registration of an interest in the land on which the scheme is operated, the scheme's ability to operate is adversely affected by, among other things, the rights of other parties outside the scheme; and
- (b) the business models implemented by many responsible entities of these schemes fail to ensure adequate financial resources are available to secure continuing compliance with the financial obligations under leases.

117 Therefore, it is our view that the current requirements are not sufficiently robust to ensure that members' interests in land used in primary production schemes are adequately protected, and are not consistent with ASIC's objectives of promoting confident and informed participation by investors and consumers in the financial system. We consider that the existing legal protections need to be strengthened.

118 Under Option 2, we would modify the Corporations Act by class order so that certain additional requirements would apply from 1 July 2014 to responsible entities for interests in registered schemes involving primary production first offered on or after 2 January 2014. Under these requirements:

- (a) the responsible entity must ensure that registered interests in the land are held by members, on trust for members, or by an entity that is controlled by members for the duration of the scheme;
- (b) if the registered interest is a lease or an instrument that confers the right to use land which requires regular payments to be made:
  - (i) the constitution of the registered scheme must give the responsible entity the power to require members to make payments to ensure

continuing compliance with the obligations under the terms of any lease;

- (ii) the responsible entity must retain any amounts paid by members in relation to the lease as scheme property until the money is used to meet lease payments; and
  - (iii) the terms of the lease must not be less favourable to the scheme than those that would apply on an arm's length basis and must exclude any action by the lessor or a head lessor in connection with the lease that would adversely affect the interests of members without the responsible entity having at least three months written notice; and
  - (iv) on receipt of a notice under paragraph (b)(i), promptly notify all members in writing and advise them of members' rights to requisition a meeting; and
- (c) responsible entities will not be allowed to rely on interests in land they hold beneficially (unless the responsible entity is controlled by members). The purpose of this requirement is to reduce the risk of a scheme's ability to operate being affected by the inability of parties outside of the scheme to meet their obligations or the rights of other parties outside the scheme. This risk is not one that retail investors would ordinarily see as part of the risks they assume in investing in a primary production scheme. However, this protection is not complete in that the interest held may be a lease, and failure to meet obligations under a lease may result in the lease being terminated.

Note: In the case of primary production schemes, we have given guidance that this risk is an important matter for disclosure in any PDS for the scheme: see Regulatory Guide 232 *Agribusiness managed investment schemes: Improving disclosure for retail investors* (RG 232).

119 Requirement 4 is intended to address the problems identified at paragraph 61(d).

### **Requirement 5: Special custody assets**

120 Under Option 2, we would accommodate industry practice by permitting a responsible entity and IDPS operator to hold certain types of assets—derivatives, private equity interests and certain types of bank accounts and associated contracts—without meeting the relevant NTA requirements.

121 To hold scheme property, a responsible entity must generally have \$10 million NTA. If the responsible entity does not meet the relevant NTA requirement, it must ensure that all of the scheme property and other assets of registered schemes, other than 'special custody assets' or 'Tier \$500,000 class assets', are held by a person that meets the relevant NTA requirement. A similar requirement applies to IDPS operators.



- 122 Based on our industry liaison, it is apparent that, notwithstanding the current requirement, it is common industry practice for responsible entities to hold certain types of assets that are not special custody assets, even if the responsible entity does not have the required NTA: see REP 291.
- 123 Following extensive consultation, ASIC considers that it is appropriate to accommodate industry practice and permit certain types of assets to remain in the name of the responsible entity.
- 124 Under Option 2, we would extend the list of ‘special custody assets’ that a responsible entity and IDPS operator may hold without meeting the relevant NTA requirement in RG 166. These would include:
- (a) certain types of derivatives on certain conditions;
  - (b) a private equity interest on certain conditions;
  - (c) certain types of bank accounts, on certain conditions; and
  - (d) certain associated contracts.
- 125 If ASIC were not able to accommodate industry practice, we understand that certain responsible entities may not be able to comply with their AFS licence because the cost of engaging a custodian to hold such assets would be inappropriately burdensome and prohibitively expensive.
- 126 Requirement 5 is intended to address the problem identified at paragraph 61(e).

## C Impact analysis

### Affected parties

- 127 Parties affected by the proposed policy would include:
- (a) responsible entities and some other issuers where exempt from the requirement to be licensed;
  - (b) custody providers, IDPS operators and MDA operators;
  - (c) to some extent, sub-custodians and incidental providers;
  - (d) investors; and
  - (e) ASIC.

### Costs and benefits of each option

#### Option 1: Current regulatory approach continues to apply (maintain the status quo)

##### Impact on industry

- 128 The option to maintain the status quo means that the industry will not be faced with any new direct costs, as this option would mean that there are no changes to how asset holders will be regulated (other than through other regulatory changes, such as the implementation of the increase in financial requirements).
- 129 As stated at paragraphs 69–70, if the status quo is maintained, the issues and risks that we have identified with industry are likely to continue and potentially be exacerbated, resulting in increased regulatory risk. Without clear regulatory guidance and accompanying class orders (as required) on how we expect asset holders to address these issues, there is likely to be potential adverse impacts on client assets and ultimately investors.
- 130 In addition, if the definition of ‘special custody assets’ is not expanded in RG 166 to include derivatives, private equity interests, certain bank accounts and associated contracts, we understand that it is likely that:
- (a) responsible entities may not be able to find a licensed custodial provider willing, for a commercially reasonable fee, to hold such assets. For example, if a custodian became the legal owner of a derivative contract, rather than the responsible entity, the custodian may have full legal and financial liability under the derivative. Although the custodian may be able to obtain from the responsible entity an indemnity from the

scheme's assets, the liability may exceed the amount recovered by the custodian under that indemnity;

- (b) custody costs would substantially increase across the industry; and
- (c) certain responsible entities would either restructure so that their funds did not hold these types of assets or, ultimately, exit the retail managed investment scheme industry.

131 We became aware of industry non-compliance with RG 166 through surveillances conducted as part of our custodial industry review. If this change to special custody assets were not made by ASIC to accommodate industry practice, industry would have to make significant and costly restructures without commensurate benefit to scheme members. ASIC would have to conduct extensive surveillance to ensure compliance.

#### **Impact on investors**

132 We consider that there may be a long-term cost on investors because maintaining the status quo will not adequately address the problems identified in Section A. For example, we consider that investors will continue to be exposed to risk of loss as the general AFS licence obligations and current form of RG 133 are insufficiently prescriptive to prevent matters identified in REP 291 and our surveillances and consultation. We have identified these issues as:

- (a) the high levels of operational risk and opportunities for fraud that are present in the business of asset holders;
- (b) IT systems that may not be stable or secure from unauthorised access or use, and operational risks that may be introduced by not upgrading manual and disparate systems;
- (c) scheme property that may not be held on trust, exposing the client to credit risk of the custodian;
- (d) custodians that are at risk of not reporting to ASIC matters of concern in relation to their clients;
- (e) custodial clients that may be exposed to loss if they have not negotiated favourable liability provisions in their contracts with custodians; and
- (f) investors in primary productions schemes who may be exposed to unnecessary investment losses because the requirements for such schemes may not adequately protect investors.

#### **Impact on ASIC**

133 If the status quo were maintained, we would continue to regulate the custodial industry by applying the existing regulatory approach, as set out in RG 133 and accompanying class orders, as part of our business-as-usual activities. We would allocate resources to addressing issues on a case-by-

case basis and undertake surveillance activities, particularly concerning compliance by responsible entities with RG 166 in relation to the custody of derivatives, private equity interests and bank accounts and associated contracts.

- 134 However, we are concerned that maintaining the status quo may adversely affect our ability to regulate the custodial industry over time as it continues to develop and consolidate, especially as the amount of assets under custody continues to grow exponentially. Without review and update, our existing approach will be unlikely to maintain strength and relevance in a changing industry and regulatory environment.

**Option 2: Retain key aspects of our current regulatory approach and strengthen our regulatory approach where warranted to address key existing and emerging issues and risks in the industry while ensuring efficient operational arrangements exist for holding and dealing with client assets, including scheme property (preferred option)**

**Impact on industry**

- 135 Our strengthened regulatory guidance would effectively address the objectives of ensuring confidence in the safekeeping of custodial property by asset holders, by applying an appropriate level of regulation to asset holders. This may also improve the reputation of the financial services industry and result in a lesser likelihood of loss to client assets held by a responsible entity or custodian. As has been described at paragraph 21, total funds under management (FUM) in the entire managed investment scheme and custodial industry exceeds \$2.16 trillion and is expected to triple over the next 15 years to \$6.4 trillion (in nominal terms).<sup>31</sup>
- 136 As part of our consultation process, we sought feedback on the quantifiable impact of our proposals. Most submissions drew attention to additional compliance costs, although none quantified the amount or provided a cost estimate.
- 137 Generally, while the direct cost impact of Option 2 would vary from entity to entity—depending on the size of the entity, the number of managed investments, the total FUM impacted and the level of change required to comply with the proposed changes—we expect that compliance costs to meet the new requirements are likely to be as set out at paragraphs 138–153.

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<sup>31</sup> Excluding other types of custodial arrangements, such as ‘incidental custody’ (see RG 166 and PF 209 for an explanation of ‘incidental’ services). See Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011. The *Superannuation Guarantee (Administration) Act 1992* was amended to increase gradually the superannuation guarantee rate from 9% to 12% from 2013–14 to 2019–20.

*Licensed custody providers*

138 We think that the costs to the major custodians (those custodians whose primary business is the provision of custodial or depository services) and their clients will be minor. Table 4 provides an estimate of the possible additional costs in dollars for custodians under Option 2. These costs may be subject to significant variation depending on the AFS licensee's individual circumstances. The licensee will need to take into account:

- (a) any education and training needed to meet the additional or different requirements in our guidance and accompanying class orders, including:
  - (i) the minimum standards on:
    - (A) holding custodial property on trust;
    - (B) organisational structure;
    - (C) staff capabilities; and
    - (D) capacity and resources;
  - (ii) our expectation to conduct client checks (custodians may wish to carry out certain further checks on their clients and vice versa, in addition to any inquiries conducted as part of an AML/CTF program);
  - (iii) renegotiation of custody contracts to include liability and breach reporting provisions;
  - (iv) the conditions on new 'special custody assets' and the legal and operational arrangements required by a responsible entity without \$10 million NTA;
- (b) changes to existing compliance processes to comply with the new regulatory framework set out in our guidance and accompanying class orders;
- (c) the need for the board and senior staff to consider policy changes (e.g. changes to the conflict of interest policy regarding organisational structure and, possibly, updates to the AML/CTF Act policy regarding our expectation to conduct client checks);
- (d) changes to existing custody agreements to incorporate some specific content requirements, including in relation to indemnity and breach reporting; and
- (e) in some cases, additions or other changes to staff required as a result of the minimum standards governing organisational structure, staffing capabilities, and capacity and resources.

139 Some of these costs are likely to be passed on to clients. However, the incremental costs are likely to be negligible to such clients. Custody costs are generally charged on the basis of the value of assets held in custody, subject to some minimum or fixed costs that are likely to represent a larger

cost to smaller clients (i.e. the cost of custody is likely to decrease relative to size).

140 For example, the management–expense ratio (MER) of a managed fund is usually in the region of 1–2% of the amount invested, but the amount of that MER attributable to custody is likely to be only a few basis points. In turn, the costs discussed below are likely to represent a minimal, if negligible, increase to the overall cost of custody for each client.

**Table 4: An estimate of possible additional costs per entity for major licensed custody providers under Option 2**

<b>Estimated number of AFS licensees</b>	20
<b>Cost of education and training to meet Requirements 1, 2, 3 and 5</b>	\$15,500 (one-off cost)
<b>Cost of implementing required changes to compliance framework</b>	\$20,000, if not already compliant (one-off cost)
<b>Cost of additional directors' meeting to review updates to policies</b>	\$1,875, if not already implemented (one-off cost)
<b>Cost of amending custody agreements to incorporate the new requirements</b>	\$50,000, if not already compliant—although this may increase if external legal advice is obtained (one-off cost)
<b>Cost of amending sub-custody agreements where relevant</b>	\$5,000, if not already compliant (one-off cost)
<b>Cost of each new full-time staff member to ensure the requirements regarding organisational structure and staffing capabilities are met</b>	\$180,000 p.a., on average, depending on the seniority and role

Note: Estimates have been prepared on the basis of the assumptions in each of the relevant paragraphs. Individual custodians will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by individual AFS licensees in response to the proposals.

*Responsible entities that have outsourced custody*

141 We think that the costs to responsible entities and their clients will be minor. Table 5 provides an estimate of the possible additional costs in dollars for responsible entities that have outsourced custody under Option 2. These costs may be subject to significant variation depending on the AFS licensee's individual circumstances. The licensee will need to take into account:

- (a) any education and training needed to meet the additional or different requirements of our guidance and accompanying class orders, including:
  - (i) the minimum standards on:
    - (A) holding custodial property on trust;

- (B) organisational structure;
  - (C) staff capabilities;
  - (D) capacity and resources; and
- (ii) our expectation to conduct client checks (responsible entities may wish to carry out certain further checks on their custodian and vice versa, in addition to any inquiries conducted as part of an AML/CTF program);
  - (iii) possible renegotiation of custody contracts to include liability and breach reporting provisions (noting that there is a transition period to 1 November 2015 if the licensee is authorised to hold client assets before 2 January 2014); and
  - (iv) the conditions on new ‘special custody assets’ and the legal and operational arrangements required by a responsible entity without \$10 million NTA;
- (b) changes to existing compliance processes to comply with the new regulatory framework provided by our guidance and accompanying class orders;
  - (c) the need for the board and senior staff to consider policy changes (e.g. updates to the AML/CTF Act policy regarding our expectation to conduct client checks); and
  - (d) changes to existing custody agreements to incorporate some specific content requirements, including in relation to indemnity and breach reporting.
- 142 There is unlikely to be any increase in staff since the minimum standards will apply directly to the asset holder and not the responsible entity (although it will need to ensure the asset holder’s compliance).
- 143 We understand that there are currently 509 active responsible entities: see paragraph 17. Separately, we are aware from ASIC data that 142 licensees are asset holders for registered schemes or IDPSs. Therefore, we have assumed that 367 responsible entities have outsourced asset holding. It would not be possible for us to determine this exactly without auditing all of the responsible entities and IDPSs in Australia, as many responsible entities will choose to outsource asset holding even when they have \$10 million NTA: see paragraph 14. Further, there is likely to be an increase in the number of responsible entities and IDPSs outsourcing custody when the financial requirements for both entities are increased.
- 144 As discussed, custody costs are generally charged on the basis of the value of assets held in custody, subject to some minimum or fixed costs that are likely to represent a larger cost to smaller responsible entities (i.e. the cost of custody is likely to decrease relative to size).

145 For example, the MER of a managed fund is usually in the region of 1–2% of the amount invested, but the amount of that MER attributable to custody is likely to be only a few basis points. In turn, the costs discussed in Table 5 are likely to represent a minimal if negligible increase to the overall cost of custody for each responsible entity.

**Table 5: An estimate of possible additional costs per entity for responsible entities that have outsourced custody under Option 2**

<b>Estimated number of AFS licensees</b>	367
<b>Cost of education and training on the new requirements their custodian will be required to comply with</b>	\$15,500 (one-off cost)
<b>Cost of implementing required changes to compliance framework (including amendments to compliance plans in the case of a responsible entity) to ensure that the custodian is complying with the minimum standards</b>	\$15,000, if not already compliant (one-off cost)
<b>Cost of additional directors' meeting to review updates to policies</b>	\$1,875, if not already implemented (one-off cost)
<b>Cost of amending custody agreements to incorporate the new requirements</b>	\$5,000, if not already compliant—assuming only a small number of custody agreements (one-off cost)

Note: Estimates have been prepared on the basis of the assumptions in each of the relevant paragraphs. Individual custodians will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by individual AFS licensees in response to the proposals.

*Responsible entities that act as an asset holder*

146 We think that the costs to such responsible entities will be minor. Table 6 provides an estimate of the possible additional costs in dollars for these types of responsible entity under Option 2. These costs may be subject to significant variation depending on the AFS licensee's individual circumstances. The licensee will need to take into account:

- (a) any education and training needed to meet the additional or different requirements of our guidance and accompanying class orders, including the minimum standards on:
  - (i) holding custodial property on trust;
  - (ii) organisational structure;
  - (iii) staff capabilities; and
  - (iv) capacity and resources;
- (b) our expectation to conduct client checks;
- (c) changes to existing compliance processes to comply with the new regulatory framework provided by our guidance and accompanying class orders;



- (d) the need for the board and senior staff to consider policy changes (e.g. changes to the conflict of interest policy regarding organisational structure and, possibly, updates to the AML/CTF Act policy regarding our expectation to conduct client checks); and
- (e) in some cases, additions or other changes to staff required as a result of the minimum standards governing organisational structure, staffing capabilities, and capacity and resources.
- 147 Such responsible entities will not be required to renegotiate custody agreements, except potentially in relation to some domestic sub-custodians (noting that there is a transition period to 1 November 2015 for those licensees who are authorised before 2 January 2014 to act as a responsible entity). These responsible entities are also unlikely to be affected by the changes to the definition of ‘special custody assets’.
- 148 We understand that there are currently 142 AFS licensees that are asset holders for registered schemes or IDPSs. It would not be possible for us to determine this exactly without auditing all of the responsible entities and IDPSs in Australia, as many responsible entities will choose to outsource asset holding even when they have \$10 million NTA: see paragraph 14. Further, there is likely to be an increase in the number of responsible entities and IDPSs outsourcing custody when the financial requirements for both entities are increased.
- 149 Responsible entities that act as an asset holder are likely to have significant scale and capital backing. Necessarily, they will have at least \$10 million NTA. The MER of a managed fund is usually in the region of 1–2% of the amount invested, but the amount of that MER attributable to custody is likely to be only a few basis points. In turn, the costs discussed in Table 6 are likely to represent a minimal, if negligible, increase to the overall cost to responsible entities that implement the changes in their own asset-holding business.

**Table 6: An estimate of possible additional costs per entity for responsible entities that act as asset holders under Option 2**

<b>Estimated number of AFS licensees</b>	142
<b>Cost of education and training in respect of the new requirements</b>	\$15,500 (one-off cost)
<b>Cost of implementing required changes to compliance framework</b>	\$20,000, if not already compliant (one-off cost)
<b>Cost of additional directors’ meeting to review updates to policies</b>	\$1,875, if not already implemented (one-off cost)
<b>Cost of amending sub-custody agreements where relevant</b>	\$5,000, if not already compliant (one-off cost)

**Cost of each new full-time staff member to ensure the requirements regarding organisational structure and staffing capabilities are met**

\$180,000 p.a., on average, depending on the seniority and role

*Incidental providers*

150 We think that the costs to incidental providers and their clients will be minor, primarily since the custody is, by definition, an incidental part of the AFS licensee's business and we would expect that the requirements could be implemented without incurring the full cost referred to in Table 4 (being appropriately 'scalable' to the licensee's incidental custody arm). Table 7 provides an estimate of the possible additional costs in dollars for incidental providers under Option 2. These costs may be subject to significant variation depending on the licensee's individual circumstances. The licensee will need to take into account:

- (a) any education and training needed to meet the additional or different requirements of our guidance and accompanying class orders, including:
  - (i) the minimum standards on:
    - (A) holding custodial property on trust;
    - (B) organisational structure;
    - (C) staff capabilities; and
    - (D) capacity and resources;
  - (ii) our expectation to conduct client checks;
  - (iii) possible renegotiation of custody contracts to include liability and breach reporting provisions (noting that there is a transition period to 1 November 2015 for those incidental providers that are authorised as such before 2 January 2014);
- (b) changes to existing compliance processes to comply with the new regulatory framework provided by our guidance and accompanying class orders;
- (c) the need for the board and senior staff to consider policy changes (e.g. changes to the conflict of interest policy regarding organisational structure and, possibly, updates to the AML/CTF Act policy regarding our expectation to conduct client checks);
- (d) changes to existing custody agreements to incorporate some specific content requirements, including in relation to indemnity and breach reporting; and
- (e) in some cases, additions or other changes to staff required as a result of the minimum standards governing organisational structure, staffing capabilities, and capacity and resources.

151 Since the custody service provided is, by definition, incidental to some other financial services, it is possible for the provider to pass on any increase in costs to the end user through the fees charged. However, given the minor cost of such changes and the incidental nature of the custody service, the incremental costs are likely to be negligible to such clients.

**Table 7: An estimate of possible additional costs per entity for incidental providers under Option 2**

<b>Estimated number of AFS licensees</b>	513
<b>Cost of education and training to meet Requirements 1, 2, 3 and 5</b>	\$5,166 (one-off cost)
<b>Cost of implementing required changes to compliance framework</b>	\$6,666, if not already compliant (one-off cost)
<b>Cost of additional directors' meeting to review updates to policies</b>	\$625, if not already implemented (one-off cost)
<b>Cost of amending custody agreements to incorporate the new requirements</b>	\$16,600, if not already compliant (one-off cost)
<b>Cost of some additional staff changes to ensure the requirements regarding organisational structure and staffing capabilities are met</b>	\$60,000 p.a.
<b>Cost of amending sub-custody agreements where relevant</b>	\$1,666, if not already compliant (one-off cost)

Note 1: We have assumed the costs would be no more than one-third of those of major custodians.

Note 2: Estimates have been prepared on the basis of the assumptions in each of the relevant paragraphs. Individual custodians will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by individual AFS licensees in response to the proposals.

#### *Primary production scheme operators*

152 Requirement 4 will only apply to primary production schemes offered on or after 2 January 2014 and will be in force from 1 July 2014. We expect the changes will add about \$10,000 for each new scheme offered and incrementally less for each scheme thereafter.

153 Given existing numbers of primary production schemes and the depressed state of the market, we would expect only two or three operators to be affected by the changes in the foreseeable future.

#### **Impact on investors**

154 By ensuring asset holders have appropriate capacity and competency to provide the financial services they are authorised to provide, we aim to reduce the risk of failure in the sector (notwithstanding that there have been no significant failures in the custodial industry to date).

### Impact on Government

- 155 We do not anticipate that our revised regulatory guidance for the custodial industry will result in a significant impact on ASIC, or the Australian Government more generally.
- 156 Proactive assistance to industry promoting implementation, ongoing review and surveillance in the custodial and managed investment scheme industry will form part of our business as usual. As such, no additional staff or funding will be required to promote implementation or stakeholder understanding. Minimal training will be required to ensure that staff are informed about, and understand, our revised regulatory approach, and setting out our clear expectations of what behaviour is required of asset holders may result in less need for ASIC to undertake enforcement action.

### Summary of analysis

- 157 On balance, ASIC considers that the benefits associated with strengthening the custodial requirements for asset holders outweigh any additional costs to these AFS licensees and their clients associated with Option 2.
- 158 We would provide a 12-month transition period for existing asset holders to 2 January 2015 (assuming a start date of 2 January 2014 of the new RG 133 and related class orders). In relation to compliance with the content requirements for existing custody agreements, we are proposing that there is a 22-month transition period for existing asset holders to 1 November 2015 (again, assuming a start date of 2 January 2014 of the updated RG 133 and related class orders).
- 159 Overall, while some of the new requirements may have a larger proportionate impact on smaller custodians and responsible entities, we do not anticipate that our revised regulatory approach will result in significant costs for industry. In contrast, our revised approach will have a net benefit because, while there has not been a failure in the custodial industry, it may reduce the risk of failure (including among new custodians). This would reduce any reputational damage to the industry as a whole, by ensuring asset holders have adequate capacity and competency to conduct their financial services businesses.

## D Consultation

### Consultation Paper 197

- 160 Throughout 2010–13 as part of our work involving custody, we have engaged with the custodial industry. We have visited approximately 18 custodians and invited them to voluntarily complete one or more questionnaires designed to explore existing and emerging issues. Following the comments received as a result of this engagement with the custodial industry, we released REP 291 in July 2012 and CP 197 in December 2012. CP 197 set out our proposals, focusing primarily on:
- (a) existing issues on which we consulted in 2011–12; and
  - (b) key emerging themes and issues arising from our stakeholder engagement with the custodial industry.
- 161 The consultation period for CP 197 ended, following extension, on 15 March 2013. We met also with representatives of the Australian Custodial Services Organisation (ACSA) to discuss the proposals in CP 197. ACSA is the peak industry body representing members of Australia’s custodial and administrative industry. Collectively, the members of ACSA hold securities and investments in excess of \$1.8 trillion in custody and under administration.
- 162 We received 10 submissions, including two confidential submissions (not detailed) and two from key industry bodies. The responses provided by industry associations were informed by the views of more than just the associations themselves. ASIC’s response to the feedback received in submissions on CP 197 is the subject of REP 376. Generally, industry bodies and representatives raised (in some cases, significant) concerns with aspects of our consultation proposals, other than in relation to ‘special custody assets’. As a result, some of our requirements under Option 2 differ from our original consultation proposals in CP 197, particularly in relation to the requirement for a responsible entity to obtain a full indemnity from its custodian.
- 163 Some of our original proposals have been significantly refined following the submissions received. For further detail, see REP 376.
- 164 The response to the changes is set out at Table 8.

**Table 8: Summary of responses to CP 197**

<b>Requiring a custodian to hold client assets on trust</b>	There was general support for this proposal, provided that RG 133 clarified that the role of the custodian is to act on proper instructions (as a bare or directed trustee) and that no fiduciary or oversight duties were imposed on the custodian that were contrary to the existing regime in Ch 5C (under Ch 5, the responsible entity, rather than its agents, have ultimate liability to investors).
<b>Imposing minimum standards, such as with respect to organisational capacity and conducting client checks</b>	<p>There was general support for this proposal, but there was some uncertainty about the scope and nature of the requirements, in part due to the drafting of the proposed RG 133. For example, we did not expressly require that the custodian perform certain checks (e.g. credit checks) on its clients—rather, we expected that the custodian would use its judgement in determining what inquiries into its client it might be appropriate for it to conduct before the contract is entered into.</p> <p>Following extensive consultation with ACSA, we have now refined the exact scope of the minimum standards so that they are capable of being complied with, taking into account industry practice.</p>
<b>Requiring that the agreement with the asset holder contains an indemnity from the asset holder in favour of the client</b>	<p>This was uniformly opposed as non-achievable and out of step with industry practice.</p> <p>Following extensive further consultation with ACSA, we have modified our expectations—we expect that the client will seek liability and, if appropriate, indemnity provisions in the agreement that provide reasonable safeguards against risk to the client, and, in the case of a responsible entity, the scheme, arising in relation to the provision of the custodial services.</p>
<b>Requiring that the agreement with the asset holder contains a provision requiring that the asset holder report to ASIC any breaches that it suspects the responsible entity has not reported</b>	<p>There was some opposition to this requirement on the basis that it would not be possible, in all circumstances, for the custodian to be aware of whether the responsible entity had lodged a breach report.</p> <p>However, following further consultation with ACSA, and considering the PJC's recommendations in its report on the collapse of Trio,<sup>32</sup> industry accepted that it would be able to comply with this requirement as long as no express duty to inquire was imposed on the asset holder (i.e. the asset holder would only have to report breaches it became aware of in the normal course of its business).</p> <p>More generally, industry considered that it might have the effect of deterring inappropriate behaviour at the responsible entity.</p>
<b>Imposing additional legal requirements on primary production schemes</b>	There was general support from industry. We have clarified that the rights of members to use land include the rights sufficient to enable access, cultivation, maintenance, and harvesting of a registered scheme.
<b>Increasing the types of special custody assets</b>	All submissions strongly supported this recommendation. In fact, many suggested other assets that ought to be included in the list (at this stage, we do not consider that sufficiently strong arguments were presented to include the additional assets). Industry explained how not permitting these assets as special custody assets would be significantly costly and problematic for responsible entities and custodians generally.

<sup>32</sup> PJC, *Inquiry into the collapse of Trio Capital*, report, May 2012.

## E Conclusion and recommended option

- 165 We recommend Option 2, comprising Requirements 1–5.
- 166 We recognise that there have been no systemic problems manifesting in institutional failure other than one collapse (Trio). While Trio involved managed investment schemes and the custody of scheme property, we consider that it is an isolated incident, attributable to fraudulent behaviour.
- 167 However, market surveillance has revealed some current and future trends in terms of industry conduct that might give rise to future risks. We consider that this, together with market developments in terms of the increasing size of the assets held in custody and their systemic importance, warrants a forward-looking and preventative approach, aimed at managing future risks that ASIC considers are likely to emerge.
- 168 The requirements that we will set out in the updated RG 133 and accompanying class orders under this option best achieve the objectives of promoting confident and informed participation by investors and consumers in the financial system. In this regard, we aim to ensure that, where an investor’s assets are held under custodial arrangements, the risks around inappropriate custody of assets that may undermine the confident and informed participation by investors and consumers are mitigated.
- 169 Option 2 achieves this by :
- (a) applying the minimum appropriate regulation to asset holders consistent with the framework for the regulation of financial services and products in the Corporations Act; and
  - (b) ensuring that the same standards are complied with whether the custodial property is held directly by the responsible entity or the responsible entity has engaged a third-party custodial provider.
- 170 Option 2 achieves these policy objectives without imposing an unreasonable burden on the managed investment scheme and custodial industry, and while achieving a net benefit for the end investor. In particular, our proposal reaffirms our existing guidance and addresses key emerging issues in the custodial industry. While the direct cost impact of our new requirements would vary from entity to entity, and may be proportionally larger for smaller asset holders, we expect that compliance costs to meet the new requirements will be limited.
- 171 We do not recommend Option 1 because it does not propose any solutions to the challenges raised by the existing and emerging issues and risks facing the managed investment scheme and custodial industry, which is undesirable given the growth of the sector over the last decade and its likely continued development in the future.

## F Implementation and review

172 Our proposed policy will be implemented by publishing the following documents:

- (a) updated regulatory guides—RG 133 (to be renamed *Managed investments and custodial or depository services: Holding assets*) and RG 166—explaining the new proposals and how and when we expect asset holders to comply;
- (b) new class orders containing our revised requirements and relief;
- (c) REP 376, summarising submissions received in response to CP 197; and
- (d) this RIS.

Further, the existing AFS licence conditions in PF 209 will be superseded by the revised RG 133 and related class orders—that is, the relevant conditions in paragraphs 34 and 35 will be moved from PF 209.

173 As stated, we are proposing transition periods as follows:

- (a) Responsible entities and custodians that currently hold assets or arrange for client assets to be held by another asset holder must comply with the new requirements from 2 January 2015. However, they have until 1 November 2015 to comply with the requirement regarding the content of custody agreements.
- (b) Responsible entities and custodians that start from 2 January 2014 to hold assets or arrange for client assets to be held by another asset holder must comply with the new requirements from 2 January 2014.
- (c) Responsible entities of registered schemes involving primary production that include rights to use land offered on or after 2 January 2014 must comply with Requirement 4 from 1 July 2014.

174 Over the transition period, we will:

- (a) work with current asset holders to ensure that the new requirements are understood and appropriately implemented; and
- (b) assess the relevance of our requirements on an ongoing basis to ensure they remain relevant.

175 Following the transition period, we are likely to undertake periodic reviews of the managed investment scheme and custodial industry to ensure compliance with our regulatory approach and the currency of our guidance and class orders, with the objective of ensuring they adequately address key existing and emerging issues and risks in the sector.