

ASIC CLASS ORDER [CO 13/1413]

EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (*ASIC*) makes ASIC Class Order [CO 13/1413] *Amendment of Class Order [CO 13/760]* under paragraph 926A(2)(c) of the *Corporations Act 2001* (the *Act*).

Paragraph 926A(2)(c) of the Act provides that ASIC may declare that provisions of Part 7.6 of the Act (other than Divisions 4 and 8) apply in relation to a person or financial product, or a class of persons or financial products, as if specified provisions were omitted, modified or varied as specified in the declaration.

1. Background

Section 912A of the Act sets out the obligations of an Australian financial services (*AFS*) licensee, including that the licensee has available adequate resources (including financial) to provide the financial services covered by the licence (paragraph 912A(1)(d)) and to carry out supervisory arrangements and have adequate risk management systems (paragraph 912A(1)(h)). This requirement does not apply to bodies regulated by the Australian Prudential Regulation Authority (*APRA*).

ASIC imposes specific financial requirements on AFS licensees that are not regulated by APRA in accordance with ASIC Regulatory Guide 166 *Licensing: Financial requirements (RG 166)*. The financial requirements that apply to AFS licensees vary depending on the nature of the financial service activities conducted by the licensee. For example, the operation of registered managed investment schemes attracts specific financial requirements. In November 2011, ASIC released Class Order [CO 11/1140] which, among other things, enforced the financial requirements set out in RG 166 in relation to responsible entities and investor directed portfolio services (*IDPS*) operators. More recently, Class Order [CO 13/760] revoked and replaced [CO 11/1140] in order to maintain the existing requirements and impose new requirements in a single class order. Class Order [CO 13/760] notionally inserted section 912AA into the Act and prescribes minimum standards a responsible entity and an IDPS operator (other than a market participant or clearing participant) must satisfy in order to comply with its obligation to have available adequate resources under paragraph 912A(1)(d). These financial requirements commenced on 1 July 2013, subject to various transitional provisions.

NTA requirement

Class Order [CO 13/760] requires a responsible entity and IDPS operator, in certain circumstances, to hold an amount in net tangible assets (*NTA*) as prescribed under subsection 912AA(4). Where the responsible entity or IDPS operator does not meet the relevant NTA requirement, it must ensure that all of the scheme property or IDPS property, other than

‘special custody assets’ or ‘Tier \$500,000 class assets’, are held by a person that meets the relevant NTA requirement.

The object of the NTA requirement is to ensure that only responsible entities or IDPS operators with substantial financial resources are permitted to hold scheme property or IDPS property. A responsible entity or IDPS operator that relies on a custodian to meet reduced NTA requirements must ensure that all (rather than only part) of the scheme or IDPS property, other than ‘special custody assets’ or ‘Tier \$500,000 class assets’, is held by a custodian. This is to ensure that the holder of the assets has the incentive through risk of financial loss and the access to resources necessary to promote compliance and safeguard members’ interests.

Special custody assets

Based on our industry liaison and consultation, it appears to be industry practice for a responsible entity to hold certain types of assets that do not currently fall within the definition of ‘special custody assets’, even if the responsible entity does not have the required NTA, and that there may be practical benefits in doing so: see Report 291 *Custodial and depository services in Australia (REP 291)*. This is also the practice for an IDPS operator in relation to some of these assets.

These assets include derivatives, private equity interests and certain bank accounts.

In light of our extensive consultation, ASIC considers it appropriate to revise the definition of special custody assets to include these types of assets, as well as associated choses in action, subject to certain conditions. We consider that these additional assets should be permitted as special custody assets on the basis that the risk of not using a custodian to hold such assets is managed by requiring that the responsible entity, or in the case of certain bank accounts, the responsible entity or IDPS operator, complies with requirements that will ensure adequate protection. Risks relating to appropriate record keeping resulting from the absence of separate involvement by a complying custodian in making transactions can be adequately addressed through custody standards with, in some cases, particular safeguards that are relevant to the type of asset. In the case of derivatives and private equity interests, the associated risks are also reduced because, in the case of potential fraud, the assets cannot readily be transferred or encumbered at close to their market value and so transactions would be likely to attract scrutiny.

2. Purpose of [CO 13/1413]

Class Order [CO 13/1413] amends [CO 13/760] by expanding the definition of *special custody assets* which affects NTA calculations of responsible entities and IDPS operators under [CO 13/760] to allow extended classes of assets to be held by responsible entities and IDPS operators subject to certain conditions being satisfied.

New subsections 912AA(7A) and (7B) inserted by the class order clarify the time by which certain custodians engaged by a responsible entity or IDPS operator must obtain an audit report and the period to which the report must relate.

Finally, the class order amends subsection 912AA(4) to confirm the NTA requirements that apply to a licensee that does not operate any registered schemes or IDPSs.

3. Operation of [CO 13/1413]

Class Order [CO 13/1413] amends [CO 13/760] by amending notional subsection 912AA(4) of the Act to confirm the NTA requirements that apply to a licensee that does not operate any registered schemes or IDPSs. This amendment is for clarification purposes only and is not intended to change the NTA requirements applying to such a licensee.

Class Order [CO 13/1413] also amends [CO 13/760] by notionally inserting subsections (7A) and (7B), which set out when certain custodians engaged by a licensee must obtain an auditor's report on whether the custodian has complied during the relevant period with the financial requirements for an Australian financial services licensee that is authorised to act as a custodial services provider and to which period the report must relate.

Finally, Class Order [CO 13/1413] amends the definition of *special custody assets* in notional subsection 912AA(11) by specifying that special custody assets include:

- (a) in relation to a responsible entity of a registered scheme, derivatives under which the holder may be liable for future payments and rights under associated margin accounts, on certain conditions including that:
 - (i) the responsible entity has directed the counterparty in writing—or in case of exchange traded derivatives, the market participant acting for the responsible entity—that any related amounts payable by the counterparty or market participant to or at the direction of the responsible entity are to be made only into a deposit taking facility or to or at the direction of a Complying Custodian (as defined);
 - (ii) if there is an associated margin account, the responsible entity has directed that amounts payable are only to be made to, or at the direction of, a Complying Custodian;
 - (iii) the Complying Custodian has copies of the written direction and has reasonable daily access to information about transactions in the derivatives or on the margin account; and
 - (iv) the Complying Custodian has contracted in writing with the responsible entity to keep a copy of records of all transactions involving the derivative or the margin

account for seven years and to check whether those transactions are properly authorised and if not, notify the responsible entity in writing and keep a record of the notification for seven years;

- (b) in relation to a responsible entity of a registered scheme, certain private equity interests and associated choses in action where the holder may have a liability and it is not reasonably practicable to ensure the exclusion of liability of the holder, provided that, among other things:
- (i) the responsible entity has given a written direction to the issuer and any counterparty that any payments to be made to the responsible entity must be paid to or at the direction of a Complying Custodian; and
 - (ii) copies of the written direction and certificates or other title documents must be held by the Complying Custodian or its agent; and
 - (iii) the Complying Custodian has agreed to keep for seven years a copy of the records of transactions of the private equity interests and associated choses in action, and to check whether those transactions are properly authorised, and if not, notify the responsible entity in writing and keep a record of the notification for seven years; and
- (c) in relation to a responsible entity of a registered scheme, deposit-taking facilities with an Australian authorised deposit-taking institution (*ADI*) or certain bodies outside of Australia provided that:
- (i) the issuer of the facility and the responsible entity have a written arrangement that payments under the facility should only be made to a person approved by a Complying Custodian and that the issuer can disclose at any time the status of that arrangement to the Complying Custodian;
 - (ii) copies of the written arrangement are held by the Complying Custodian;
 - (iii) the Complying Custodian has reasonable daily access to information about transactions that occurred during at least the last two years, and access to all information that the responsible entity has a right to be given in relation to the facility;
 - (iv) the Complying Custodian has agreed to keep all records relating to transactions to which access is given and to check whether those transactions are properly authorised and if not, notify the responsible entity and keep a copy of the notification for seven years;

- (d) in relation to a responsible entity of a registered scheme, deposit taking facilities with an Australian ADI or certain bodies outside of Australia on certain conditions, including that:
 - (i) the responsible entity reasonably considers that it would be operationally difficult or impractical for another person to hold the facility;
 - (ii) the responsible entity intends to use the facility only to pay the Complying Custodian or scheme members;
 - (iii) the responsible entity does not permit payments to be made except to or at the direction of the Complying Custodian or on instruction from certain registry companies in respect of complying payments;
- (e) in relation to a responsible entity of a registered scheme or an IDPS operator, deposit taking facilities with an Australian ADI or certain bodies outside of Australia where the issuer of the facility:
 - (i) is a Complying Custodian holding other property of the scheme or IDPS and it has agreed that its custodial staff will check whether each transaction is properly authorised; and
 - (ii) keeps a copy of each transaction and how it was authorised for seven years;
- (f) in relation to a responsible entity of a registered scheme or an IDPS operator certain related choses in action that are not reasonably practicable to assign.

4. Consultation

On 20 December 2012, ASIC released Consultation Paper 197 *Holding scheme property and other assets (CP 197)* seeking feedback on our proposals to update our Regulatory Guide 133: *Managed investments and custody: Holding scheme property and other assets (RG 133)*. These proposals would also be relevant for licensed custody providers, managed discretionary account operators, and investor directed portfolio service operators. The consultation period closed on 28 February 2013.

CP 197 sets out, among other proposals, ASIC's proposed addition of derivatives, private equity interests and certain bank accounts, to the definition of *special custody assets*. ASIC received 8 non-confidential submissions from lawyers, industry bodies, custodians, banks and one compliance specialist. We also met with the Australian Custodial Services Association to discuss the proposals in CP 197. All submissions and industry participants were strongly supportive of ASIC's proposals. CP 197 can be found on ASIC's website.

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

Statement of Compatibility with Human Rights

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

ASIC Class Order [CO 13/1413]

This class order is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the class order

Existing ASIC Class Order [CO 13/760] requires responsible entities of registered managed investment schemes and the operators of certain investment platforms known as ‘IDPSs’ to hold a minimum amount in net tangible assets (*NTA*). A lower requirement applies to the responsible entity or IDPS operator if another person (e.g. a custodian) who satisfies this minimum NTA requirement holds all of the scheme or IDPS property other than ‘special custody assets’ or ‘Tier \$500,000 class assets’.

ASIC Class Order [CO 13/1413] extends the list of ‘special custody assets’ a responsible entity or IDPS operator is permitted to hold and still obtain the benefit of the lower NTA requirement, subject to certain conditions being satisfied. It also clarifies the time by which certain custodians engaged by a responsible entity or IDPS operator are required to obtain an auditor’s report and the time period for which these reports must be obtained.

Based on our industry consultation and liaison, it appears to be industry practice for a responsible entity to hold certain types of assets that do not currently fall within the definition of special custody assets and Tier \$500,000 class assets and that there may be practical benefits in doing so. ASIC considers it appropriate to revise the definition of special custody assets to include these types of assets, as well as associated choses in action, subject to certain conditions being satisfied.

Human rights implications

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

Conclusion

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