



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 156

Retail OTC derivative issuers: Financial requirements

May 2011

About this paper

This consultation paper sets out ASIC's proposals on the financial requirements to apply to issuers of over-the-counter (OTC) derivatives to retail clients.

The purpose of this paper is to seek the views of issuers and their clients, investors, legal advisers and other interested parties on the proposals we have developed about financial requirements for issuers.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 9 May 2011 and is based on the Corporations Act as at 9 May 2011.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

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

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on financial requirements for retail OTC derivative issuers. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section D, Regulatory and financial impact.

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 4 July 2011 to:

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What will happen next?

Stage 1	9 May 2011	ASIC consultation paper released
Stage 2	4 July 2011	Comments due on the consultation paper
Stage 3	October 2011	Regulatory guide released

A Background to the proposals

Key points

Over-the-counter (OTC) derivatives, such as contracts for difference and margin foreign exchange products, are regulated as financial products under the *Corporations Act 2001* (Corporations Act). Issuers of such derivatives to retail clients must hold an Australian financial services (AFS) licence covering that activity.

AFS licensees are subject to conduct obligations, including the obligation to have adequate financial resources and risk management systems, unless they are a body regulated by the Australian Prudential Regulation Authority (APRA).

This consultation paper sets out our proposals on the financial requirements that should apply to issuers of OTC derivatives to retail clients.

Financial requirements for issuers of retail OTC derivatives

- 1 The licensing provisions of the *Financial Services Reform Act 2001* commenced on 11 March 2002. Under this regime, entities which offer financial products to retail clients must obtain an Australian financial services (AFS) licence. AFS licensees are subject to the conduct obligations of Ch 7 of the *Corporations Act 2001* (Corporations Act), including, among other things, obligations to have:
 - (a) adequate resources available to provide the financial services covered by the licence and to carry out supervisory arrangements (s912A(1)(d)); and
 - (b) adequate risk management systems (s912A(1)(h)).
- 2 As part of our role as regulator of the financial services industry, we are responsible for setting the financial requirements that an AFS licensee must meet. These are set out in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) and apply to AFS licensees by way of conditions on their AFS licence.
- 3 RG 166 states that ASIC imposes financial requirements on AFS licensees to ensure that:
 - (a) they have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act (including carrying out supervisory arrangements);
 - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and

- (c) there are incentives for owners to comply with the Corporations Act through risk of financial loss.

4 Under their current licence conditions, issuers of retail OTC derivatives are generally subject to three levels of financial requirements. These are:

- (a) the base level requirements of cash-flow and balance sheet solvency and the cash needs requirement: see RG 166.22–RG 166.62 and paragraph 11 below for details of how AFS licensees can meet the cash needs requirement;
- (b) the requirement to hold \$50,000 in surplus liquid funds (SLF): see RG 166.109–RG 166.114. This requirement applies because issuers typically hold client money or property of \$100,000 or more; and
- (c) the requirement to hold adjusted surplus liquid funds (ASLF) equal to the sum of:
 - (i) \$50,000; plus
 - (ii) 5% of adjusted liabilities between \$1 million and \$100 million; plus
 - (iii) 0.5% of adjusted liabilities for any amount of adjusted liabilities exceeding \$100 million.

There is a maximum requirement of \$100 million in ASLF: see RG 166.115–RG 166.141. This requirement applies because issuers transact with clients as principal and generally have current liabilities included in their adjusted liabilities equal to or in excess of \$100,000: see RG 166.118–166.119 for a full explanation of what liabilities are included in this assessment.

5 As noted in our report *Contracts for difference and retail investors* (REP 205), the market for contracts for difference (CFD), the principal type of retail OTC derivative in Australia, has grown rapidly in recent years, driven by intensive marketing by CFD issuers, including extensive advertising in the financial and general press (on television, in print and online) and via seminars. Because of this growth, and also as result of our ongoing surveillance of issuers of retail OTC derivatives, we are concerned to ensure that the financial requirements applicable to issuers are appropriate. To this end, we have considered the current financial requirements for issuers and those applicable to equivalent entities in Australia's peer jurisdictions and developed the proposals in this consultation paper to alter the requirements.

The purpose of our proposals

- 6 In developing these proposals we have been mindful of the fundamental purpose of the financial requirements for AFS licensees and focused on the most suitable mechanisms for achieving this purpose in the context of the retail OTC derivatives market. These proposals align with the underlying principles outlined in RG 166.11–RG 166.13 and seek to:
- (a) ensure that equity owners of an issuer have sufficient ‘skin in the game’ to warrant that they are committed to the success of the business and compliance with the issuer’s obligations under the Corporations Act;
 - (b) ensure that an issuer makes adequate provision for expected expenses and carries sufficient financial resources against operational risk that could lead to unexpected losses or expenses;
 - (c) update the financial buffer held by an issuer to decrease the risk of a disorderly or non-compliant wind-up if the business fails, so that it is adequate to meet the contemporary administration costs of smaller issuers;
 - (d) align Australia’s financial requirements for issuers with the requirements for equivalent entities in Australia’s peer jurisdictions; and
 - (e) simplify the financial requirements to decrease compliance and regulatory costs and burdens.
- 7 These proposals do not seek to:
- (a) prevent issuers from becoming insolvent;
 - (b) prevent issuers from failing due to poor business models or cash flow problems; or
 - (c) provide compensation to retail clients holding OTC derivatives who suffer a loss because the issuer fails.
- 8 As outlined in RG 166, in setting AFS licence conditions for financial requirements, we seek to set minimum standards that are framed as clearly and simply as possible so as to provide certainty.
- 9 The proposals would apply to any AFS licensee that both holds an AFS licence that permits them to make a market in derivatives to retail clients and actually owes liabilities or contingent liabilities by entering into derivatives with retail clients. We intend that this scope of application will capture all AFS licensees that are in the business of issuing OTC derivatives to retail clients. The proposals do not apply to bodies regulated by APRA or to participants in a licensed market or a clearing participant in a licensed clearing and settlement facility as long as we are satisfied that the market’s or facility’s financial requirements are an adequate substitute for our financial requirements.

B Our proposals

Key points

Our proposals are aimed at ensuring issuers are appropriately capitalised so that equity owners of the business have a sufficient financial interest in the health of the business and its compliance with the law, and so that the business has the financial strength to cope with anticipated expenses and with costs and losses arising from unexpected operating risks. We propose to:

- require rolling 12-month cash flow projections to increase the visibility of cash flow issues in a 'business as usual' situation (see paragraphs 10–16); and
- change both the quantum and liquidity of the financial resources requirement by requiring a minimum level of net tangible assets (NTA) that must be held in liquid form and pairing this requirement with a reporting framework which encourages issuers to maintain adequate financial resources (see paragraphs 17–36).

Our proposals would replace the cash needs requirement in RG 166.22(c) and the SLF and ASLF requirements in Sections E and F of RG 166 respectively. The base level financial requirements in RG 166.22(a), (b) and (d) would remain unchanged.

Requiring rolling 12-month cash flow projections

- 10 Cash flow projections are an important tool in identifying potential risks to a business. We propose the introduction of a requirement for longer cash flow projections for issuers.

Proposal

- B1** We propose that any AFS licensee that both holds an AFS licence that permits them to make a market in derivatives to retail clients and owes liabilities or contingent liabilities by entering into derivatives with retail clients (an 'issuer') be required to:
- (a) prepare, on a quarterly basis, rolling cash flow forecasts with anticipated revenue and expenses over at least 12 months at an individual entity level in a 'business-as-usual' situation;
 - (b) make the cash flow forecasts available to ASIC upon request; and
 - (c) have the cash flow forecasts approved by the directors of the issuer.

Similar to what is currently the case with Option 2 in RG 166 to meet the cash needs requirement, an issuer will need to:

- (a) document its calculations and assumptions, and describe in writing why they are the appropriate assumptions;

- (b) update the projection of cash flows if it has reason to suspect that an updated projection would show it were not meeting its licence conditions; and
- (c) show, based on the projection of cash flows, that it will have access as needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months, including any additional liabilities it might incur during that term.

This requirement would replace all five options currently available to issuers to meet the cash needs requirement: see RG 166.24.

Your feedback

- B1Q1 Do you agree with this proposal? If not, why not?
- B1Q2 What additional costs will be incurred by your business as a result of these proposals?
- B1Q3 Are there any drawbacks in limiting the options issuers have to meet the cash needs requirement?
- B1Q4 Are there any practical problems with the implementation of this proposal? Please give details.
- B1Q5 Do you agree with the definition of 'issuer'? Will this capture, and only capture, all AFS licensees that are in the business of issuing OTC derivatives to retail clients?

Rationale

11 Cash flow forecasting is an important tool which demonstrates that an issuer can meet anticipated expenses. This proposal would replace the current cash needs requirement set out in RG 166.22(c). Currently, as part of the base level financial requirements, an AFS licensee must comply with one of the following options (broadly stated):

- (a) show, based on the projection of cash flows and on an individual or in certain cases group basis, that it will have access to enough financial resources to meet its liabilities over the projected term of at least the next three months, including any additional liabilities that may be incurred during this time;
- (b) show that an authorised deposit-taking institution (ADI) has given the AFS licensee an enforceable and unqualified commitment to meet the AFS licensee's financial obligations; or
- (c) if the AFS licensee is a subsidiary of an Australian ADI, or an entity approved for this purpose in writing by us, show:
 - (i) it reasonably expects (based on funds from related bodies corporate) that it will have adequate resources (when needed) to meet its liabilities (including any additional liabilities that may be incurred during that period) for at least the next three months; and
 - (ii) the basis for the expectation is appropriately documented.

- 12 Requiring rolling 12-month cash flow forecasting addresses expected operating expenses and should, in many cases, result in a higher level of focus and governance around cash flow forecasts and cash planning than currently exists. We acknowledge that forecasts such as these are only as sound as the assumptions on which they are based and the rigour with which they are prepared. For this reason, we think it is important for directors of an issuer to review them.
- 13 We believe that longer cash flow forecasts will assist the directors of an issuer identify potential cash flow problems at an earlier stage, providing the opportunity to take corrective action.
- 14 Cash flow forecasts will need to be updated when material changes occur to the cash flow forecast assumptions.
- 15 We will maintain the right to request a copy of the cash flow forecasts at any time and will exercise this right when appropriate. This should increase the likelihood that forecasts are prepared with the requisite detail and provide us with a useful tool to more fully understand the workings of an issuer that finds itself in distress.
- 16 RG 166 provides substantial guidance on the audit requirements for cash flow forecasts. Currently, there is a requirement for positive assurance on compliance with financial conditions of the AFS licence other than the cash needs requirement. For cash flow projections, negative assurance is required on the reasonableness of assumptions used and positive assurance on their calculation. It is our intention to maintain this approach to the audit requirements.

Changing the financial resource requirements

- 17 Issuers should be appropriately capitalised so that equity owners of the business have a sufficient financial interest in the health of the business and its compliance with the law, and so that the business has the financial strength to cope with costs and losses arising from expected and unexpected operating risks. We are proposing to amend AFS licence conditions to achieve this.
- 18 The requirements specified below would replace the requirements for issuers to hold SLF and ASLF in Sections E and F of RG 166 respectively.
- 19 If you are an AFS licensee who would be required by Section G of RG 166 to have \$10 million of tier one capital, you may choose instead to comply with the requirements specified below when you apply for your AFS licence or when you apply for a variation of your AFS licence. You will then have to comply with these requirements at all times. If you choose instead to comply

with Section G of RG 166, which requires you to have \$10 million of tier one capital, then the requirements below will not apply to you.

Proposal

B2 We propose that:

- (a) An issuer should be required to hold net tangible assets (NTA) equal to the greater of:
 - (i) \$1 million; and
 - (ii) 10% of average revenue (as defined in the key terms).
- (b) An issuer should be required to hold 50% of the required NTA in cash and cash equivalents (excluding cash in client segregated or trust accounts) and 50% in liquid assets, with 'liquid assets' being defined as assets that are:
 - (i) money in an account or money on deposit with a bank (excluding cash in client segregated or trust accounts) that is available for withdrawal immediately, or otherwise upon maturity of a fixed term not exceeding six months during the normal business hours of the bank;
 - (ii) a bank bill with a maturity date not exceeding six months; or
 - (iii) an asset the issuer can reasonably expect to realise for its market value within six months; and

free from encumbrances and, in the case of receivables, free from any right of set off.

- (c) Eligible undertakings that may be included in the NTA calculation be limited to those provided by an ADI or which are otherwise approved by us.
- (d) Additionally, an issuer should report its NTA position, together with detailed workings, to ASIC as part of its annual submission of Form FS70 *Australian financial services licensee profit and loss statement and balance sheet*.

Your feedback

- B2Q1 What benefits and disadvantages do you consider will result from proposal B2(a)?
- B2Q2 What benefits and disadvantages do you consider will result from proposal B2(b)?
- B2Q3 What effect will this proposal have on the capital currently held by your business? Please quantify these amounts.
- B2Q4 Do you agree that this proposal will achieve our aims specified in paragraphs 3 and 6? If not, why not?
- B2Q5 Do you think there is a more appropriate method for calculating financial requirements that would meet our aims specified in paragraphs 3 and 6? Please give details.
- B2Q6 What impact will this proposal have on your business costs? How will you manage these changes?

- B2Q7 Will this proposal result in increased costs for investors?
- B2Q8 What impact will this proposal have on competition?
- B2Q9 Will this proposal impact on issuers using different pricing models (i.e. market maker or direct market access) in different ways?
- B2Q10 Are there any practical problems with the implementation of this proposal?

Rationale

- 20 It is important that issuers maintain adequate financial resources to ensure that the equity owners of the issuers have a financial incentive to comply with the Corporations Act and are sufficiently invested in the business to take measures to see that the business succeeds.
- 21 Derivatives businesses are exposed to the risk of financial expense or loss due to operational failures (such as information technology system malfunction or documentation errors). One reason for our proposals is that we think issuers should hold financial resources to help cover off against this operational risk. Setting the required level of NTA at the greater of \$1 million and 10% of revenue (determined as the average per annum of annual revenue over the past two years and the amount of 12-month revenue predicted in the then current cash flow forecast) will ensure that as the business of an issuer grows, and its operational risk exposure consequentially increases, it holds a corresponding level of financial resources.
- 22 To ensure that the issuer holds financial resources that can be used effectively to meet unexpected losses and expenses, we believe that the NTA must be held in a highly liquid form. Requiring that the NTA be held in 50% cash and cash equivalents and 50% in liquid assets will ensure that the issuer can use the financial resources as and when required (excluding cash in client segregated accounts).
- 23 A current objective of the financial requirements is to ensure there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails. We believe this should be a continuing objective of the requirements, but believe increasing the required minimum amount of the financial resources better aligns the requirements with their objective, given the contemporary costs of administration of financial services businesses, such as those carried on by issuers.
- 24 The proposed financial resource requirements will also align Australia more closely with comparable regimes applicable to retail OTC derivative issuers such as Singapore (a minimum of S\$1 million) and the United Kingdom (a minimum of €730,000). While the US Commodity Futures Trading Commission requires a much higher minimum requirement (US\$20 million),

we believe this amount would impose an overly onerous requirement on issuers.

- 25 Lastly, we are seeking to simplify the financial resource requirements. The current requirements can be complex and the proposed requirements are simpler in nature. This should decrease compliance costs for issuers and make it easier for ASIC to verify compliance.
- 26 The proposals do not have the monetary thresholds that are applicable currently to either the requirements to hold SLF or ASLF (i.e. the requirement to hold either \$100,000 in client money or the requirement to have \$100,000 in current liabilities included within adjusted liabilities). This is because we believe that if an AFS licensee holds a licence that permits it to make a market in derivatives to retail clients and is entering into OTC derivatives with retail clients, those facts alone are sufficient to warrant holding the required level of NTA.

About NTA

- 27 NTA is a measure of financial strength currently used in the financial resource requirements applicable to responsible entities, operators of investor directed portfolio services, providers of custodial or depository services, issuers of margin lending facilities and trustee companies providing traditional services: see Section C of RG 166.
- 28 NTA is essentially all tangible assets less liabilities (excluding certain related party receivables and subordinated debt). This is a simpler measure of financial resources than either SLF or ASLF. While SLF is NTA excluding non-current assets and liabilities, the ASLF calculation requires issuers to make certain adjustments for the riskiness of certain assets and liabilities. Replacing ASLF with NTA is intended to reduce compliance costs for issuers and make it easier for ASIC and others to assess whether issuers are complying with their licence conditions.

Consolidation and rationalisation of sector

- 29 Implementation of these proposals may lead to some consolidation and rationalisation of the sector. Some issuers may be forced to restructure to raise the requisite capital or may merge with others in order to meet the financial requirements. There are potential benefits in reducing the number of issuers if those that remain are well capitalised and more stable as a result.

The reporting requirements

- 30 We believe that the financial resource requirements can be supported by establishing a reporting framework that ensures both ASIC and investors are informed at appropriate points of an issuer's financial resources and also allows an issuer to use those resources when needed, but encourages them to quickly replenish the resources after they have been drawn upon.

Proposal

- B3** We propose that the following reporting framework apply to issuers. If an issuer's NTA is:
- (a) 110% or less of its required NTA, the issuer must report this to ASIC and continue reporting on a monthly basis until the NTA is above 110% of its required NTA;
 - (b) less than 100% of its required NTA, the issuer must replenish the NTA to above 100% within two months of the date the deficiency arose and, failing this, the issuer must make a prescribed disclosure of the deficiency available to its clients, principally by a prominent statement on its website and trading platform and/or direct communication with its clients; or
 - (c) 75% or less of its required NTA, the issuer must not enter into any transactions with clients that could give rise to financial obligations, until its governing body has certified in writing that, having conducted reasonable inquiry into its financial position, there is no reason to believe that it may fail to meet its AFS licensee obligations (the certification requirement).

Your feedback

- B3Q1 Do you agree with this proposal? If not, why not?
- B3Q2 Do you think that this proposal is likely to see issuers using their liquid NTA when required (e.g. when losses arising from operational risk factors occur)?
- B3Q3 Is 110% of required NTA a reasonable level below which reporting to ASIC must occur?
- B3Q4 If an issuer must use its liquid NTA to meet unexpected expenses or losses, is two months sufficient time to replenish NTA to 100% of the required NTA?
- B3Q5 Do you agree with the requirement to inform clients of the deficiency in NTA? If not, why not?
- B3Q6 Setting the certification requirement at 75% allows issuers to use 25% of their required NTA before they face the risk of being unable to trade with their clients. Is 25% of required NTA a sufficient amount to allow issuers to address unexpected losses or expenses that may arise from operational risk factors?
- B3Q7 What impact will this proposal have on your business costs? Please quantify your response where appropriate.

- B3Q8 How will you manage any change to your business costs?
- B3Q9 What impact will this proposal have on competition?
- B3Q10 Are there any practical problems with the implementation of this proposal?

Rationale

- 31 Under current licence conditions, if an issuer:
- (a) has between \$1 million and \$100 million in adjusted liabilities and the level of ASLF drops below 5.5% of adjusted liabilities; or
 - (b) has more than \$100 million in adjusted liabilities and does not hold \$100 million in ASLF, when the ASLF is less than \$500,000 in excess of the amount that it is required to hold,
- it must not enter into any transactions with clients that could give rise to financial obligations, until its governing body has certified in writing that, having conducted reasonable inquiry into its financial position, there is no reason to believe that it may fail to meet its licensee obligations.
- 32 If the certification requirement applies in a similar way to the proposed financial resource requirements, then issuers would be unable to use any of their held NTA without this triggering the requirement that they cease transacting with clients. This would contradict our objective of allowing issuers to use some of their NTA to meet unexpected expenses or losses arising from operational risk.
- 33 Requiring issuers to notify ASIC when their held NTA is 110% or less of required NTA gives early notification to ASIC of those issuers that may be experiencing financial difficulty. Having this advance knowledge will permit ASIC to monitor and, where appropriate, work with issuers to ensure they remain in compliance with their AFS licence conditions.
- 34 As previously stated, we intend that issuers be able to use some of their NTA to meet unexpected expenses or losses which may arise from operational risk. Where issuers draw down on their NTA, however, we want to ensure they have an appropriate incentive to replenish those funds within a timely manner. Accordingly, where an issuer's NTA is less than 100% of required NTA, we are proposing that it have two months to replenish its NTA to 100% or more of the required NTA. If an issuer fails to do this, it must notify its clients of the deficiency by making a prescribed disclosure. This is proposed both to give issuers an incentive to replenish their NTA in a timely fashion and to ensure that clients are informed as to the issuer's compliance with the financial resource requirements.
- 35 We intend to specify the text of the prescribed disclosure and will do so cognisant of the requirement to give clients all the information they need to

make informed investment decisions and of the imperative that they receive this information in a prudent manner that will not cause undue alarm among clients and in the market.

- 36 We think that the floor on the amount of NTA an issuer holds should be 75% of required NTA. If an issuer draws down on NTA below this level to meet unexpected expenses or losses, the issuer must not enter into any transactions with clients that could give rise to financial obligations until its board or governing body has certified in writing that, having conducted reasonable inquiry into its financial position, there is no reason to believe that it may fail to meet its AFS licence obligations.

C Proposed implementation process

Key points

We consider it appropriate for the proposed reforms to be implemented as soon as practicable. Some businesses may require restructuring or recapitalisation to meet the revised requirements. A staged implementation process may therefore be appropriate.

Proposal

- c1** We propose a staged implementation as follows:
- (a) after 12 months, the cash flow requirements, the reporting requirements and 50% of the financial resources requirements would apply so that issuers would need to hold the greater of:
 - (i) \$500,000; and
 - (ii) 5% of average revenue (as defined in the key terms); and
 - (b) after 24 months, the proposed changes would apply in full.

Your feedback

C1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this consultation paper?

C1Q2 Do you require a staged implementation to ensure that adequate arrangements are in place to meet the proposed requirements? If so, is the level of NTA proposed to apply after 12 months appropriate? If not, what would be?

Rationale

- 37 We believe our proposals are important to ensure the stability of the market for retail OTC derivatives and as such should be implemented as soon as practicable. We acknowledge the possibility that some businesses may either choose to restructure or need to recapitalise as a result of the proposals.
- 38 A staged implementation process allows issuers the ability to put in place appropriate arrangements over time. At the same time, requiring compliance with 50% of the financial resource requirements sets a clear interim hurdle for issuers and will allow each issuer, its clients and ASIC to gauge the issuer's ability to meet the full requirements after the 24-month implementation period elapses.

D Regulatory and financial impact

- 39 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) protecting consumers by ensuring that businesses that offer OTC derivatives to retail clients have adequate financial resources to conduct their business in compliance with the Corporations Act and in a responsible manner; and
 - (b) implementing financial requirements in a way that is not overly burdensome.
- 40 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:
- (a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;
 - (b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and
 - (c) if our proposed option has more than minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).
- 41 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 42 To ensure that we are in a position to properly complete any required RIS, we ask you to provide us with as much information as you can about:
- (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits,
- of our proposals or any alternative approaches: see 'The consultation process' p. 4.

Key terms

Term	Meaning in this document
adjusted liabilities	Has the meaning given in RG 166.151
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASLF	Adjusted surplus liquid funds
Australian ADI	Has the meaning given in s9 of the Corporations Act
average revenue	For issuers up to and including the second year of operation—means the average per annum of: <ul style="list-style-type: none"> • the actual annualised revenue for the current year; and • the amount of 12-month revenue predicted in the then current cash flow forecast. For issuers after the first two years of operation—means the average per annum of: <ul style="list-style-type: none"> • the actual revenue for the preceding two years; and • the amount of 12-month revenue predicted in the then current cash flow forecast
body regulated by APRA	Has the meaning given in s3(2) of the <i>Australian Prudential Regulation Authority Act 1998</i>
cash and cash equivalents	Has the meaning given in the Australian accounting standards—that is, cash is cash on hand and demand deposits, and cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value
CFD	Contract for difference
Ch 7 (for example)	A chapter of the Corporations Act (in this example numbered 7)
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act

Term	Meaning in this document
financial product	<p>Generally, a facility through which, or through the acquisition of which, a person does one or more of the following:</p> <ul style="list-style-type: none"> • makes a financial investment (see s763B); • manages financial risk (see s763C); • makes non-cash payments (see s763D) <p>Note: See Div 3 of Pt 7.1 of the Corporations Act for the exact definition.</p>
financial service	Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act
issuer	<p>An AFS licensee that:</p> <ul style="list-style-type: none"> • holds an AFS licence that permits it to make a market in derivatives to retail clients; and • owes liabilities or contingent liabilities by entering into derivatives with retail clients
liquid assets	<p>Assets that are:</p> <ul style="list-style-type: none"> • money in an account or money on deposit with a bank that is available for withdrawal immediately, or otherwise upon maturity of a fixed term not exceeding six months during the normal business hours of the bank; • a bank bill with a maturity date not exceeding six months; or • an asset the issuer can reasonably expect to realise for its market value within six months, and <p>free from encumbrances, and in the case of receivables, free from any right of set off</p>
NTA (net tangible assets)	Means the AFS licensee's adjusted assets less adjusted liabilities, as defined in RG 166
OTC	Over the counter
revenue	<p>Has the meaning given in the Australian accounting standards. For the purposes of this consultation paper, it includes revenue arising from:</p> <ul style="list-style-type: none"> • the sale of goods; • the rendering of services (e.g. fee income); • interest; • royalties; • dividends; • commissions; • rental income; and • construction contract revenue
RG 166 (for example)	An ASIC regulatory guide (in this example numbered 166)
SLF	Surplus liquid funds

List of proposals and questions

Proposal	Your feedback
<p>B1 We propose that any AFS licensee that both holds an AFS licence that permits them to make a market in derivatives to retail clients and owes liabilities or contingent liabilities by entering into derivatives with retail clients (an 'issuer') be required to:</p> <ul style="list-style-type: none"> (a) prepare, on a quarterly basis, rolling cash flow forecasts with anticipated revenue and expenses over at least 12 months at an individual entity level in a 'business-as-usual' situation; (b) make the cash flow forecasts available to ASIC upon request; and (c) have the cash flow forecasts approved by the directors of the issuer. <p>Similar to what is currently the case with Option 2 in RG 166 to meet the cash needs requirement, an issuer will need to:</p> <ul style="list-style-type: none"> (a) document its calculations and assumptions, and describe in writing why they are the appropriate assumptions; (b) update the projection of cash flows if it has reason to suspect that an updated projection would show it were not meeting its licence conditions; and (c) show, based on the projection of cash flows, that it will have access as needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months, including any additional liabilities it might incur during that term. <p>This requirement would replace all five options currently available to issuers to meet the cash needs requirement: see RG 166.24.</p>	<p>B1Q1 Do you agree with this proposal? If not, why not?</p> <p>B1Q2 What additional costs will be incurred by your business as a result of these proposals?</p> <p>B1Q3 Are there any drawbacks in limiting the options issuers have to meet the cash needs requirement?</p> <p>B1Q4 Are there any practical problems with the implementation of this proposal? Please give details.</p> <p>B1Q5 Do you agree with the definition of 'issuer'? Will this capture, and only capture, all AFS licensees that are in the business of issuing OTC derivatives to retail clients?</p>
<p>B2 We propose that:</p> <ul style="list-style-type: none"> (a) An issuer should be required to hold net tangible assets (NTA) equal to the greater of: <ul style="list-style-type: none"> (i) \$1 million; and (ii) 10% of average revenue (as defined in the key terms). (b) An issuer should be required to hold 50% of the required NTA in cash and cash 	<p>B2Q1 What benefits and disadvantages do you consider will result from proposal B2(a)?</p> <p>B2Q2 What benefits and disadvantages do you consider will result from proposal B2(b)?</p> <p>B2Q3 What effect will this proposal have on the capital currently held by your business? Please quantify these amounts.</p> <p>B2Q4 Do you agree that this proposal will achieve our aims specified in paragraphs 3 and 6? If not, why not?</p>

Proposal	Your feedback
<p>equivalents (excluding cash in client segregated or trust accounts) and 50% in liquid assets, with 'liquid assets' being defined as assets that are:</p> <ul style="list-style-type: none"> (i) money in an account or money on deposit with a bank (excluding cash in client segregated or trust accounts) that is available for withdrawal immediately, or otherwise upon maturity of a fixed term not exceeding six months during the normal business hours of the bank; (ii) a bank bill with a maturity date not exceeding six months; or (iii) an asset the issuer can reasonably expect to realise for its market value within six months; and <p>free from encumbrances and, in the case of receivables, free from any right of set off.</p> <p>(c) Eligible undertakings that may be included in the NTA calculation be limited to those provided by an ADI or which are otherwise approved by us.</p> <p>(d) Additionally, an issuer should report its NTA position, together with detailed workings, to ASIC as part of its annual submission of Form FS70 <i>Australian financial services licensee profit and loss statement and balance sheet</i>.</p>	<p>B2Q5 Do you think there is a more appropriate method for calculating financial requirements that would meet our aims specified in paragraphs 3 and 6? Please give details.</p> <p>B2Q6 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>B2Q7 Will this proposal result in increased costs for investors?</p> <p>B2Q8 What impact will this proposal have on competition?</p> <p>B2Q9 Will this proposal impact on issuers using different pricing models (i.e. market maker or direct market access) in different ways?</p> <p>B2Q10 Are there any practical problems with the implementation of this proposal?</p>
<p>B3 We propose that the following reporting framework apply to issuers. If an issuer's NTA is:</p> <ul style="list-style-type: none"> (a) 110% or less of its required NTA, the issuer must report this to ASIC and continue reporting on a monthly basis until the NTA is above 110% of its required NTA; (b) less than 100% of its required NTA, the issuer must replenish the NTA to above 100% within two months of the date the deficiency arose and, failing this, the issuer must make a prescribed disclosure of the deficiency available to its clients, principally by a prominent statement on its website and trading platform and/or direct communication with its clients; or (c) 75% or less of its required NTA, the issuer must not enter into any transactions with clients that could give rise to financial obligations, until its governing body has 	<p>B3Q1 Do you agree with this proposal? If not, why not?</p> <p>B3Q2 Do you think that this proposal is likely to see issuers using their liquid NTA when required (e.g. when losses arising from operational risk factors occur)?</p> <p>B3Q3 Is 110% of required NTA a reasonable level below which reporting to ASIC must occur?</p> <p>B3Q4 If an issuer must use its liquid NTA to meet unexpected expenses or losses, is two months sufficient time to replenish NTA to 100% of the required NTA?</p> <p>B3Q5 Do you agree with the requirement to inform clients of the deficiency in NTA? If not, why not?</p> <p>B3Q6 Setting the certification requirement at 75% allows issuers to use 25% of their required NTA before they face the risk of being unable to trade with their clients. Is 25% of</p>

Proposal	Your feedback
certified in writing that, having conducted reasonable inquiry into its financial position, there is no reason to believe that it may fail to meet its AFS licensee obligations (the certification requirement).	required NTA a sufficient amount to allow issuers to address unexpected losses or expenses that may arise from operational risk factors?
	B3Q7 What impact will this proposal have on your business costs? Please quantify your response where appropriate.
	B3Q8 How will you manage any change to your business costs?
	B3Q9 What impact will this proposal have on competition?
	B3Q10 Are there any practical problems with the implementation of this proposal?
<p>C1 We propose a staged implementation as follows:</p> <p>(a) after 12 months, the cash flow requirements, the reporting requirements and 50% of the financial resources requirements would apply so that issuers would need to hold the greater of:</p> <p>(i) \$500,000; and</p> <p>(ii) 5% of average revenue (as defined in the key terms); and</p> <p>(b) after 24 months, the proposed changes would apply in full.</p>	<p>C1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this consultation paper?</p> <p>C1Q2 Do you require a staged implementation to ensure that adequate arrangements are in place to meet the proposed requirements? If so, is the level of NTA proposed to apply after 12 months appropriate? If not, what would be?</p>