



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 194

Financial requirements for custodial or depository service providers

November 2012

About this paper

This consultation paper sets out ASIC's proposed financial requirements for custodial or depository service providers (providers).

It also sets out requirements that apply to responsible entities of registered managed investment schemes and platform operators that hold scheme or other property and assets.

The purpose of this paper is to seek feedback on these proposals from providers, their advisers, counterparties and other interested parties.

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 14 November 2012 and is based on the Corporations Act as at that date.

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 custodians. 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 E, '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 14 January 2013 to:

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What will happen next?

Stage 1	14 November 2012	ASIC consultation paper released
Stage 2	14 January 2013	Comments due on the consultation paper
	March 2013	Updates to Regulatory Guide 166 <i>Licensing: Financial requirements</i> (RG 166) drafted
Stage 3	April 2013	Updated RG 166 released

A Background to the proposals

Key points

Australian financial services (AFS) licensees are subject to licensee conduct obligations, generally including the obligation to maintain adequate financial resources and risk management systems.

Carrying on a business of providing a custodial or depository service is generally a financial service that requires authorisation under an AFS licence. Providers required to hold an AFS licence must meet licensee conduct obligations.

We have decided to review the financial requirements that apply to providers to ensure that they are appropriate for this industry sector.

We have also decided to review financial requirements for the following AFS licensees that hold scheme property and other assets under the relevant managed investment schemes with a view to achieving consistency for providers:

- responsible entities, including responsible entities of IDPS-like schemes; and
- operators of investor directed portfolio services (IDPS) that are responsible for holding IDPS property or other assets.

This review forms part of our broader review of financial requirements for all AFS licensees.

Our review of financial requirements for AFS licensees

- 1 All Australian financial services (AFS) licensees, unless they are a body regulated by the Australian Prudential Regulation Authority (APRA), are subject to the 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)).

Note: A draft of the Superannuation Legislation Amendment (Further Measures) Bill 2012 was published by Treasury on 18 October 2012. It would subject bodies regulated by APRA to these requirements if they are responsible entities of registered schemes and also registrable superannuation entity (RSE) licensees as defined in the *Superannuation Industry (Supervision) Act 1993*. Such bodies would not be subject to the requirement to have adequate risk management systems in relation to risks solely relating to the operation of a regulated superannuation fund by the licensee.

- 2 ASIC determines minimum financial requirements that an AFS licensee must meet. These are set out in Regulatory Guide 166 *Licensing: Financial*

requirements (RG 166). They apply to AFS licensees by way of conditions on their AFS licence, or by the application of modified provisions of the *Corporations Act 2001* (Corporations Act) applying under ASIC class order (e.g. Class Order [11/1140] *Financial requirements for responsible entities*).

- 3 RG 166 states that ASIC imposes financial requirements on AFS licensees to help 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 RG 166 explains that various financial requirements are imposed on AFS licensees according to the types of financial services they provide. Many of the requirements set out in RG 166 were set in 2002 when the current financial services regime was implemented. Some were implemented earlier—the \$5 million net tangible assets (NTA) requirement for responsible entities that hold most kinds of scheme property themselves was set in 1998. These requirements have not been revised since they were first implemented.
- 5 We are now progressively reviewing the financial requirements applying to AFS licensees in various industry sectors.
- 6 Our purpose in conducting these reviews is to ensure that the financial requirements applying to each industry sector are appropriate and represent the most suitable mechanisms for achieving the objectives set out in paragraph 3.
- 7 Table 1 sets out the current status of our consultation on financial requirements for AFS licensees.

Table 1: Recent consultation on financial requirements

Responsible entities of registered managed investment schemes	Consultation Paper 140 <i>Responsible entities: Financial requirements</i> (CP 140) was released in September 2010. Amended requirements for responsible entities commenced on 1 November 2012: see Appendix 2 of RG 166.
Issuers of retail over-the-counter (OTC) derivatives	Consultation Paper 156 <i>Retail OTC derivative issuers: Financial requirements</i> (CP 156) was released in May 2011. Amended requirements for OTC derivative issuers will commence from 31 January 2013: see Appendix 8 of RG 166.
Persons providing financial services in relation to the carbon pricing mechanism and other carbon markets	We consulted on the financial requirements that should apply to persons providing financial services in emissions units in March 2012: see Consultation Paper 175 <i>Carbon markets: Training and financial requirements</i> (CP 175). We concluded that we should apply RG 166 to emissions units, unchanged: see Report 283 <i>Response to submissions on CP 175 Carbon markets: Training and financial requirements</i> (REP 283).
Investor directed portfolio service (IDPS) operators	Consultation Paper 176 <i>Review of ASIC policy on platforms: Update to RG 148</i> (CP 174), released in March 2012, sets out proposals for revising our guidance on platforms in Regulatory Guide 148 <i>Investor directed portfolio services</i> (RG 148). Feedback on CP 174 is currently being reviewed.
Electricity derivative market participants	Consultation Paper 177 <i>Electricity derivative market participants: Financial requirements</i> (CP 177) was released in May 2012. Feedback on CP 177 is currently being reviewed.
Managed discretionary accounts	We are undertaking a review of the managed discretionary account services sector and will consult with industry on revising Regulatory Guide 179 <i>Managed discretionary account services</i> (RG 179) later in 2012.
Custodial or depository services and holding assets of managed investment schemes	We are undertaking a review of Regulatory Guide 133 <i>Managed investments: Scheme property arrangements</i> (RG 133). This review will include consultation about the definitions of special custody assets and Tier \$500,000 assets.

The custodial or depository services sector

- 8 A provider is a person who is responsible for safekeeping financial products or a beneficial interest in financial products on trust for or on behalf of another person (the client) in certain circumstances. Typically, management powers and responsibilities over the assets are undertaken by the client or a separate manager, rather than the provider. Importantly, the provider ordinarily only acts on properly authorised instructions from its direct client or authorised agent.¹
- 9 Providers can be classified into three main groups:
- (a) ‘Custodians’—see paragraphs 18–20;

¹ Unlike other providers, responsible entities for managed investment schemes engaging in self-custody do not receive their instructions from a third party client.

Note: In this paper, we use the term ‘Custodian’, with a capital, to describe providers that are set up mainly to provide custodial or depository services, as opposed to, for example, businesses where these services are merely incidental.

- (b) providers holding IDPS property or assets (asset holders for IDPS)—see paragraphs 25–27; and
 - (c) incidental custodial or depository service providers (incidental providers)—see paragraphs 28–30.
- 10 The operation of a registered scheme or holding of assets of a registered scheme is explicitly excluded from the definition of providing a custodial or depository service. However, the proposals in this consultation paper relating to custodial or depository service providers also apply to responsible entities of managed investment schemes that hold scheme property or assets.
- 11 The term ‘custodial or depository service’ is given specific statutory definition in the Corporations Act. The Corporations Act states that a person provides custodial or depository services to another person if, under an arrangement between the provider and the client or between the provider and another person with whom the client has an arrangement, a financial product or a beneficial interest in a financial product is held by the provider in trust for, or on behalf of, the client or another person nominated by the client: s766E. Certain conduct is excluded from this definition—for example, the operation of a registered scheme or holding of assets of a registered scheme.
- 12 The precise duties and responsibilities of a provider will depend on the terms of its appointment and, in the context of a managed investment scheme, the exact legal relationships between the beneficiaries of the trust or other clients, the manager (if any) and the provider. Unless specifically determined by regulatory requirements, the duties of the provider are expressly determined by contract between the provider and the client (e.g. the trustee of a regulated superannuation fund).
- 13 Providers play a significant role in the safekeeping of client assets. As at 31 December 2011, approximately \$1.82 trillion of assets of Australian investors are held in custody.² This is expected to more than triple over the next 15 years to \$6.4 trillion (in nominal terms),³ in part due to the proposed increase in superannuation guarantee contributions.⁴
- 14 The custodial or depository services industry in Australia is concentrated and dominated by local operations of international providers. Custody of a substantial majority of client assets is concentrated with a few major

² Australian Custodial Services Association (ACSA), *Australian investor assets under custody*, ACSA website, www.custodial.org.au/public_panel/industrystats_investor.php. This figure excludes other types of custodial arrangements, such as ‘incidental custodial or depository services’: see Proposal C1.

³ Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011.

⁴ 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.

providers: see Report 291 *Custodial and depository services in Australia* (REP 291) at Table 3.

- 15 Providers are important gatekeepers in the financial services industry because they ensure that appropriate processes to authorise transactions are observed and records kept.
- 16 ASIC authorises certain entities to provide custodial or depository services for financial products. A licensed provider must demonstrate compliance with the financial requirements of its AFS licence.
- 17 The financial requirements for providers are set out in RG 166. Under their current licence conditions, providers are generally subject to two levels of financial requirements. These are:
- (a) the base level financial requirements of solvency and positive net assets, cash needs and audit (see Section B of RG 166); and
 - (b) a minimum of \$5 million NTA if the provider has custody of ‘financial products or beneficial interests in financial products’ *other than incidentally* to the provision of financial services by them or a related body corporate or act as a custodian asset holder for an IDPS (see RG 166.226).

Additionally, RG 166 requires that AFS licensees that hold client money or property must hold at least \$50,000 in surplus liquid funds (SLF) unless the value of the money and property for all clients is less than \$100,000.

Custodians

- 18 Some businesses are set up mainly to provide custodial or depository services, as opposed to businesses where these services are merely incidental: see paragraphs 28–30. We use the term ‘Custodian’ to describe these operators. A Custodian requires custodial or depository services authorisation on its AFS licence.
- 19 Clients of a Custodian characteristically place significant trust in the Custodian to safeguard and administer their assets. Substantial operating capacity is usually required for these businesses. It is particularly important that there is opportunity for an orderly winding up of these providers to prevent client loss, because the Custodian may hold assets of many different clients coming from different sources.
- 20 A Custodian must meet the base level financial requirements in RG 166 and the additional \$5 million NTA requirement in RG 166.226. A Custodian that holds client money or property must also meet the SLF requirement unless the value of the money and property for all clients is less than \$100,000.

Responsible entities holding scheme property or assets

21 A responsible entity is a licensed entity or body that operates a registered managed investment scheme (scheme). The operation of a registered scheme or the holding of assets of a registered scheme does not constitute a custodial or depository service and therefore custodial or depository service authorisation is not required.

22 A responsible entity must meet the minimum \$5 million NTA requirement itself unless, for each registered scheme it operates, all the scheme property or assets of the scheme not held by members are:

- (a) held by a person (appointed by the responsible entity) that holds at least \$5 million NTA or is an authorised deposit-taking institution (ADI) or a market or clearing participant (or subcustodian appointed by either); or
- (b) special custody assets or Tier \$500,000 class assets *as defined in RG 166*, each of which are held by the responsible entity or a person appointed by the responsible entity (or subcustodian of that Custodian).

A responsible entity that holds client money or property must also meet the SLF requirement unless the value of the money and property for all clients is less than \$100,000.

23 A responsible entity that holds financial products under an unregistered managed investment scheme or acts as a provider of a custodial or depository service in other ways not related to its responsible entity function will require custodial or depository service authorisation from ASIC.

24 From 1 November 2012, new financial requirements apply to responsible entities. The new requirements are set out in Appendix 2 to RG 166.

Asset holders for IDPS

25 An IDPS is a scheme for acquiring and holding investments that involves custody arrangements and consolidated reporting to investors.

26 Where the IDPS operator is responsible for holding IDPS property and assets, the IDPS operator must meet the minimum \$5 million NTA requirement itself unless the IDPS property is held by a person who meets our requirements for Custodians or is an ADI or a market or clearing participant (or subcustodian appointed by either). A person can only be treated as an eligible custodian on the basis they are appointed as an asset holder by an ASX 24 participant, if they hold IDPS property that relates to the financial services business of the ASX participant on ASX 24 or incidental business.

27 An IDPS operator that provides a custodial or depository service in relation to clients' assets of the IDPS must meet our requirements for Custodians.

IDPS operators that hold client money or property must also meet the SLF requirement unless the value of the money and property for all clients is less than \$100,000.

Incidental providers

- 28 We use the term ‘incidental providers’ to refer to AFS licensees that are authorised to provide custodial or depository services but are exempt from the \$5 million NTA requirement specified in RG 166, on the basis that their custodial or depository services are merely ‘incidental’ to other financial services they provide. An incidental provider must still comply with the base level financial requirements of its AFS licence. It must also meet the SLF requirement for holding client assets if it holds client money or assets unless the value of the money and property for all clients is less than \$100,000.
- 29 Characterising a service as incidental recognises that, in certain circumstances:
- (a) it is less likely that the provider will be dealing with a multiplicity of clients and assets;
 - (b) custodial or depository services are necessitated by the provision of other financial services;
 - (c) revenue from custodial or depository services comprises a small proportion of total revenue; and
 - (d) the custodial systems for some scheme property need not be as rigorous as for other schemes.
- 30 RG 166.227 does not currently define ‘incidental custodial or depository services’ but sets out two examples of custodial functions that are performed incidentally:
- (a) the more limited role undertaken by nominee services provided in conjunction with stockbroking; or
 - (b) the custodial functions that will be performed in wholesale trusts incidentally to the dealing involved in investment management.

These examples are intended as a guide only. Whether or not individual services fall within the incidental exclusion depends on the nature of the service provided and other relevant circumstances.

Carbon market participants

- 31 Carbon market participants holding emissions units are a subcategory of provider that has recently emerged following the introduction of Australia’s carbon pricing mechanism in July 2012. We are consulting on the financial requirements for carbon market participants as part of our review of the financial requirements for providers.

- 32 Australia's carbon pricing mechanism commenced operation on 1 July 2012. Emissions units recognised under the Clean Energy Legislative Package are financial products under the Corporations Act. Carbon market participants holding emissions units on trust for a client will generally require a custodial and depository service authorisation.

Note 1: The types of emissions units that are financial products in Australia are carbon units, Australian carbon credit units and eligible international emissions units: see Regulatory Guide 236 *Do I need an AFS licence to participate in carbon markets?* (RG 236) for more details on how emissions units and carbon market participants are regulated.

Note 2: The Clean Energy Legislative Package includes the *Clean Energy Act 2011* (Clean Energy Act), the *Carbon Credits (Carbon Farming Initiative) Act 2011* (CFI Act), and the *Australian National Registry of Emissions Units Act 2011* (ANREU Act).

- 33 To date, 173 individuals and companies have registered their intention to provide financial services in emissions units. Registrants had until 31 October 2012 to apply for an AFS licence or seek a licence variation in order to provide these services from 1 January 2013 (unless they are exempt). Some registrants have applied for custodial and depository service authorisation to hold emissions units as part of this process. From 1 January 2013, all persons will require an AFS licence to provide financial services in emissions units, unless exempt.
- 34 Emissions units are represented as an electronic entry in the Australian National Registry of Emissions Units (ANREU), a statutory body established to hold emissions units. A person must have an ANREU account to be issued or hold emissions units. Many persons participating in carbon markets are likely to hold their emissions units in their own ANREU account. However, there may be situations where custodial or depository services are provided in relation to regulated emissions units. This may occur when a person holds units in their own account on behalf of another.⁵

Revised financial requirements for providers

- 35 We have decided to review the financial requirements for providers. In line with our other reviews of the financial requirements for AFS licensees in different industry sectors, our purpose is to ensure that the financial requirements that apply to the custodial or depository industry sector are appropriate and represent the most suitable mechanisms for achieving the

⁵ Some exemptions apply—for example, the general licensing exemption for a custodian that has no more than 20 clients in aggregate for all custodial or depository services that it provides: reg 7.1.40(1)(c) of the Corporations Regulations 2001. Additionally, a custodial or depository service will not be provided in relation to an ACCU issued to (a) a special native title account in accordance with s49 of the CFI Act or (b) a nominee account in accordance with s141 of the CFI Act: reg 7.1.40(2).

objectives listed in paragraph 3. More broadly, our intention is to promote the orderly operation of this industry sector.

- 36 The Parliamentary Joint Committee on Corporations and Financial Services (in its ‘Inquiry into the collapse of Trio Capital’) has expressed strong support for ASIC’s program to review custodian businesses and identify issues requiring regulatory reform.⁶

Note: The Committee stated that it considers the word ‘custodian’ inappropriate and recommended that ASIC consider changing it to a name that better reflects the current role of a custodian. We are currently considering this recommendation.

- 37 Earlier this year, we released a report (REP 291) into custodial or depository services in Australia. This followed a review of the industry that identified a number of key risks to the safety of client assets. In the report 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.
- 38 More broadly, we are undertaking a review of custody standards other than financial requirements. As part of this we plan to consult with industry on revising RG 133.
- 39 Our proposed financial requirements do not seek to prevent AFS licensees from becoming insolvent or failing because of poor business models or cash flow problems. Rather, they seek to help ensure that:
- (a) licensees have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act;
 - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and
 - (c) there are incentives for owners of the licensees to comply with the Corporations Act, through risk of financial loss.

Scope of our proposed financial requirements

- 40 We propose to introduce new financial requirements for providers. The amount of NTA proposed to be held will differ depending on the nature of the provider.
- 41 The new financial requirements would apply to the following providers:
- (a) Custodians;
 - (b) asset holders for an IDPS that are responsible for holding IDPS property and assets;

⁶ Parliamentary Joint Committee on Corporations and Financial Services, ‘Inquiry into the collapse of Trio Capital’, May 2012, p. xxiii.

- (c) responsible entities of registered managed investment schemes;
 - (d) incidental providers; and
 - (e) carbon market participants holding emissions units.
- 42 For all providers (but not responsible entities or, following requirements that are to apply later, IDPS operators), new requirements would replace the current cash needs, audit, minimum NTA and SLF requirements (excluding any requirement that applies to a provider or asset holder as a retail OTC derivatives dealer under Class Order [12/752] *Financial requirements for retail OTC derivative investors*). For responsible entities and IDPS operators, the requirements would replace the additional requirements which apply if they do not meet certain requirements concerning holding of scheme property.
- 43 New requirements for cash flow projections, reporting, and cash and liquid funds would apply to all providers.
- 44 If any other requirement contained in RG 166 applies to these AFS licensees because of other activities they undertake, these licensees would also have to meet the other requirement. However assets used to meet one requirement may be used to meet another requirement.
- 45 Bodies regulated by APRA are not required by the Corporations Act to have adequate resources. ASIC also excludes certain market participants and clearing participants from its financial requirements under RG 166, within certain limits. We are not proposing to apply any changes for AFS licensees covered by these exclusions and our proposals in this consultation paper should be read as not applying to them.

Rationale

- 46 A diverse range of operators are involved in providing custodial or depository services. For some, custodial or depository services represent the main offering of their business. For others, the custodial or depository service is supplementary to their core business operations.
- 47 The proposed changes recognise that there is a degree of risk associated with providing any asset holding service. It is important that all providers have the necessary experience, systems and controls in place to support their authorisation, irrespective of the nature of other services for which they may be authorised.
- 48 As discussed in paragraphs 31–34, carbon market participants are a relatively new group of AFS licensee that may be providing custodial and depository services. We do not propose to apply a different approach to financial requirements for these licensees. That is, if such services were provided incidentally, licensees would need to meet the financial

requirements for incidental providers. Alternatively, if these services were provided other than incidentally, licensees would need to meet the general financial requirements for Custodians. However, we welcome feedback on whether there are any particular characteristics of custodial and depository services in emissions units that warrant us taking a different approach to financial requirements.

B Proposed financial requirements for Custodians

Key points

We propose to:

- amend the current financial requirements to impose a more rigorous NTA requirement on Custodians, including holding a portion of this NTA in cash or cash equivalents; and
- introduce a requirement for longer cash flow projections.

The proposed NTA requirement would also apply to responsible entities of registered managed investment schemes in relation to the person holding scheme property or other assets of the registered scheme (with certain exceptions) and IDPS operators responsible for holding IDPS property, including those that have appointed an external person to hold the assets.

Increasing the NTA capital requirement

Proposal

- B1** We propose that a Custodian be required to hold NTA equal to the greater of:
- (a) \$10 million; or
 - (b) 10% of average revenue.

An-ASX listed parent would not be an eligible provider for the purpose of inclusion in calculating NTA (unless it is an eligible provider for another reason).

For the purpose of calculating the NTA, the adjusted liabilities would include (as added to total liabilities) the maximum potential liability of any personal guarantee the Custodian has provided, with certain exceptions for stapling agreements.

Your feedback

- B1Q1 What benefits do you consider will result from this proposal?
- B1Q2 What disadvantages do you consider will result from this proposal?
- B1Q3 Do you think a requirement to hold NTA equal to 10% of average revenue is unreasonable? If so, why?
- B1Q4 For AFS licensees with low or zero revenue, what would be the best alternative proxy measure for operating risk?

- B1Q5 Should there be a deemed minimum revenue from the holding of any kind of asset to prevent diversion of revenue to related bodies to minimise the NTA requirement? If not, why not? If so, what amount should this be? Would two basis points of the average value of the property held be appropriate?
- B1Q6 Are the remuneration practices in this industry such that an alternative proxy measure for operating risk should be considered, such as one based on the value of assets held?
- B1Q7 Should there be an additional requirement to hold NTA of a certain percentage of the value of the relevant property held under custodial or depository services or as an asset holder or master custodian of a registered scheme? If so, what should this amount be? Would two basis points of the value of the property held be appropriate?
- B1Q8 Would complying with this proposal require you to restructure your business in any way?
- B1Q9 What impact will this proposal have on your business costs? How will you manage these changes?
- B1Q10 Are there any practical problems with the implementation of this proposal?
- B1Q11 Will this proposal have any impact on competition?
- B1Q12 Are there any characteristics specific to providing custodial and depository services in emissions units that warrant us taking a different approach to financial requirements for AFS licensees that only provide this type of service?

Responsible entities and IDPS operators

- B2** We propose that the NTA requirement for a Custodian, set out in proposal B1, also apply to:
- (a) a responsible entity holding scheme property or assets (other than special custody assets or Tier \$500,000 assets) unless it appoints an asset holder who it reasonably believes does meet the requirement or is an eligible custodian. If the asset holder is a provider, the responsible entity may assume, unless it is aware to the contrary, that the asset holder meets the custody financial requirements if it has an audit report lodged by the asset holder in Form FS71 *Australian financial services licensee audit report* for the last financial year in respect of compliance as a Custodian that has no qualification; and
 - (b) an operator of an IDPS that is responsible for holding IDPS property unless it arranges for the IDPS property to be held by a Custodian or an eligible custodian.

Your feedback

- B2Q1 What benefits do you consider will result from this proposal?

- B2Q2 What disadvantages do you consider will result from this proposal?
- B2Q3 Would complying with this proposal require you to restructure your business in any way?
- B2Q4 What impact will this proposal have on your business costs? How will you manage these changes?
- B2Q5 Are there any practical problems with the implementation of this proposal?
- B2Q6 Will this proposal have any impact on competition?

Rationale

- 49 NTA is a measure of financial strength currently used in the financial requirements applicable to responsible entities, IDPS operators, Custodians, issuers of margin lending facilities and trustee companies providing traditional services: see Appendices 2–4 and 6 of RG 166.
- 50 NTA essentially includes all tangible assets less liabilities (excluding certain related party receivables and subordinated debt).
- 51 The focus of the new approach to financial requirements is on operating risk, with average revenue used as a proxy for operating risk.
- 52 Providers operate in an environment with inherently high levels of operating risk. This is due to the large volume of daily transactions, the diversity of assets and the number of jurisdictions involved, the complexity of systems and products, and the high level of manual intervention required to perform many processes. AFS licensees operating in these markets may be exposed to a risk of financial loss due to operational failures.
- 53 Setting the required level of NTA at 10% of average revenue will help to ensure that the level of financial resources each provider holds corresponds to the size of its business, and therefore to the size of its operating risk exposure.
- 54 As a result of ongoing consolidation in this industry, Custodians are getting bigger and the industry has become increasingly concentrated. The proposal to link the buffer to the size of operations also takes into account this increased consolidation.
- 55 Inflation, the significant growth of funds under management and the increasing complexity of product offerings since the financial requirements for this sector were introduced have all had an impact on the ability of the financial requirements to achieve the objectives of RG 166: see paragraphs 3–4. Consequently, we think that it is appropriate to increase the NTA capital requirement for Custodians.

- 56 Some AFS licensee providers are structured to record very low or zero revenue. Therefore, we have proposed a minimum of \$10 million NTA, because 10% of average revenue would not reflect operating risk for these entities.
- 57 Excluding ASX-listed parents from eligible undertakings for the purpose of inclusion in calculating NTA aims to better insulate the Custodian's capital base from the impact of parent collapses. In some cases an ASX-listed parent would be able to demonstrate that it should be approved by ASIC as an eligible provider because it is of undoubted financial substance.
- 58 We consider that where Custodians are providing financial commitments to other parties (personal guarantees), these potential liabilities need to be reflected in the assessment of whether a Custodian holds adequate capital financial resources.
- 59 Currently, responsible entities holding scheme property or assets and persons responsible for holding IDPS property must meet the minimum \$5 million NTA requirement, subject to certain exemptions. Extending the proposed NTA requirement for Custodians to responsible entities holding scheme property and to assets or asset holders (including master custodians) in respect of scheme property or other assets and persons responsible for holding IDPS property would ensure consistent application of the financial requirements and their underlying policy.
- 60 Responsible entities holding scheme property or assets must meet the increased financial requirements for Custodians unless all scheme property or assets (other than those excluded under existing policy) are held by a Custodian appointed by the responsible entity that the responsible entity believes on reasonable grounds meets the financial requirements or is an eligible custodian. The existing exemption from the NTA requirement for responsible entities holding special custody assets and Tier \$500,000 class assets will remain. This exemption recognises that, in certain circumstances:
- (a) it would be unreasonably costly for operators of schemes to retain a custodian that can meet the \$5 million NTA requirement;
 - (b) the custodial systems for some scheme property need not be as sophisticated as for other schemes; and
 - (c) the prospect of loss of certain types of assets due to custodial failure is less than for others, and there is a low risk of misappropriation of those asset types.
- Note: Exemptions from the NTA requirement for responsible entities will be considered as part of our review of RG 133: see paragraph 38.
- 61 IDPS operators responsible for holding IDPS property or assets must meet the increased financial requirements for Custodians, unless all IDPS property or assets are held by a Custodian or an eligible custodian.

Requiring 12-month cash flow projections

Proposal

- B3** We propose that a Custodian should be required to:
- (a) prepare a cash flow projection based on a reasonable estimate of its revenue and expenses over at least 12 months;
 - (b) update the cash flow projection if:
 - (i) the cash flows cease to cover the next 12 months;
 - (ii) there is a material change; or
 - (iii) the Custodian has reason to suspect that an updated projection would show it was not meeting its AFS licence conditions;
 - (c) document its calculations and assumptions, and describe in writing why they are the appropriate assumptions;
 - (d) have the cash flow projection approved at least quarterly by the directors of the provider as satisfying ASIC's requirements;
 - (e) show, based on the cash flow projection, 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;
 - (f) demonstrate, based on the projection of its cash flows, that it will hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or greater than the current amount it is required to hold in cash or cash equivalents; and
 - (g) make the cash flow projection available to ASIC on request.

This requirement would replace all five options currently available to meet the cash needs requirement: see Table 3 in RG 166.

A tailored audit requirement would apply based on the cash flow projection requirement, on a corresponding basis to that now applying to responsible entities, as set out in [CO 11/1140].

This requirement already applies to responsible entities. However, if a responsible entity is relying on a person that it appoints to hold scheme property or other assets to avoid having to meet the financial requirements that would apply if the responsible entity held that property or assets, then the responsible entity must have reasonable grounds to believe that the person meets this cash flow projection requirement. We would expect that this would include obtaining and retaining a copy of the required projections and audit reports reflecting the requirements that apply to Custodians.

Your feedback

- B3Q1 Do you agree with this proposal? If not, why not?
- B3Q2 What additional costs will be incurred by your business as a result of this proposal? Will there be any cost savings?
- B3Q3 Are there any issues with limiting the options Custodians have to meet the cash needs requirement?
- B3Q4 Are there any practical problems with the implementation of this proposal? Please give details.

Rationale

- 62 Cash flow projections are an important tool in identifying potential risks to a business. Our proposal would introduce a requirement for longer cash flow projections for Custodians and some asset holders in relation to registered schemes. The proposed requirements would closely reflect those now applying to responsible entities.
- 63 This proposal would replace the current cash needs requirement set out in RG 166.36–RG 166.63. Currently, as part of the base level financial requirements, an AFS licensee must either (broadly stated):
- (a) show (based on the cash flow projection and on an individual basis or, in certain cases, on a group basis) that it will have access to sufficient 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 Australian ADI has given the licensee an enforceable and unqualified commitment to meet the licensee’s financial obligations; or
 - (c) if the licensee is a subsidiary of an Australian ADI, or an entity approved by ASIC for this purpose in writing, show:
 - (i) that it reasonably expects (based on funds from related bodies corporate) that it will have adequate resources, when needed, to meet its liabilities for at least the next three months, including any additional liabilities that may be incurred during this time; and
 - (ii) that the basis for the expectation is appropriately documented.
- 64 Requiring 12-month cash flow projections addresses expected operating expenses and should, in many cases, result in a higher level of focus and governance around cash flow projections and cash planning than may currently exist.
- 65 A projection is only as sound as the assumptions on which it is based and the rigour with which it is prepared. For this reason, we think it is important for the directors of a Custodian or asset holder of a registered scheme to review its cash flow projections. Additionally, we think that longer cash flow projections would help the directors of a Custodian or asset holder identify

potential cash flow problems at an earlier stage than they otherwise would under the current financial requirements, providing greater opportunity to take corrective action.

- 66 Cash flow projections would need to be updated when material changes occur to the cash flow projection assumptions.
- 67 AFS licensees are required to prepare certain annual financial reports and to have these audited. RG 166 provides guidance on the audit requirements for cash flow projections. 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, however, negative assurance is required on the reasonableness of the assumptions used and positive assurance on their calculation. We intend to maintain this approach to the audit requirements, reflecting policy now applying to responsible entities.
- 68 We will maintain the right to require that a copy of the cash flow projections and an audit report be given to us at any time and will exercise this right when appropriate.
- 69 We expect responsible entities that rely on an asset holder to meet the financial requirements—on the basis that the asset holder or master custodian meets the relevant financial requirements—to include in their agreement with the asset holder or master custodian (as appropriate) adequate provision for information to be given to the responsible entity on demand to demonstrate compliance with the financial and cash projection requirements. This will be necessary to help the responsible entity to have reason to believe that the custodian is complying.
- 70 In addition, we expect the responsible entity will have a right to obtain cash flow projections and audit reports reflecting the audit reports that are required to be lodged with ASIC for Custodians, and to require and keep those audit reports. 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 asset holder that finds itself in distress.
- 71 We will maintain the right to require that a copy of the cash flow projections and an audit report be given to us at any time and will exercise this right when appropriate. This applies to the documents required of Custodians and documents we expect responsible entities to have in order to demonstrate compliance.

NTA liquidity requirements and reporting

Proposal

B4 We propose that:

- (a) at least 50% of the required NTA (as set out in proposal B2) should be held by a Custodian in cash or cash equivalents, with 100% being held in liquid assets (as defined in the 'Key terms'); and
- (b) a Custodian 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*.

If a responsible entity is relying on a person that it appoints to hold scheme property or other assets to avoid having to meet the financial requirements that would apply if the responsible entity held that property or assets, then the responsible entity must have reasonable grounds to believe that the person meets the requirements in proposal B4(a).

Your feedback

- B4Q1 What benefits do you consider will result from this proposal?
- B4Q2 What disadvantages do you consider will result from this proposal?
- B4Q3 Would complying with this proposal require you to restructure your business in any way?
- B4Q4 What impact will this proposal have on your business costs? How will you manage these changes?
- B4Q5 Are there any practical problems with the implementation of this proposal?
- B4Q6 Will this proposal have any impact on competition?

Rationale

72 To ensure providers hold financial resources that can be used effectively to meet unexpected financial losses, we think that there is a need for sufficient assets to be held in a highly liquid form. We consider that the current arrangements do not set a standard that gives adequate assurance that sufficient funds will be available on call to assist a custody business address unexpected and immediate expenses.

73 Requiring an amount equal to at least 50% of the required NTA to be held in cash or cash equivalents, with 100% being held in liquid assets, will ensure that these AFS licensees can make appropriate use of their financial resources as and when required. Liquid assets that are cash or cash equivalents can be counted towards both requirements.

- 74 Provision of workings demonstrating compliance to ASIC will help us to assess the level of financial resources and will promote compliance.
- 75 Responsible entities and IDPS operators that are responsible for holding client property and assets that do not meet all the financial requirements for a Custodian must appoint a person who does meet the financial requirements or is an eligible custodian. It would not be permissible for a responsible entity or IDPS operator to meet some of the requirements itself and appoint another party to meet others.

C Proposed financial requirements for incidental providers

Key points

We propose to:

- define ‘incidental custodial or depository services’;
- introduce a requirement for longer cash flow projections for incidental providers; and
- amend the current financial requirements to impose an NTA requirement on incidental providers, including holding a portion of this NTA in cash or cash equivalents.

Definition of ‘incidental custodial and depository services’

Proposal

- c1** We propose to define the terms ‘incidental custodial or depository services’ as follows. An AFS licensee provides ‘incidental custodial or depository services’ if:
- (a) the custodial or depository services are a need of the client because of, or in order to obtain, the provision of other financial services by the licensee or its related bodies corporate;
 - (b) the custodial or depository services do not form part of an IDPS; and
 - (c) the revenue of the licensee and its related bodies corporate reasonably attributable to the custodial or depository services (which at least includes the cost of providing those services) comprise less than 10% of the total revenue derived from the financial services business of the licensee and its related bodies corporate in the last financial year.

Only businesses that provide custodial or depository services in accordance with this definition would be eligible for the reduced minimum NTA requirement relative to Custodians.

An incidental provider that does not have at least the NTA required of a Custodian would be required to disclose that it is a provider of ‘incidental custodial or depository services’ and as such is not required to and may not meet the financial requirements required by ASIC for custodians generally. This must be stated in each Financial Services Guide (FSG) relating to the custodial and depository service and any Statement of Advice (SOA) it gives which relates to financial products that involve the provision of the custodial or depository service, which is given to its retail clients (if these documents are required to be given).

An incidental provider that does not meet the financial requirements applying to a Custodian would be required to lodge with ASIC a statement in the audit report provided on the licensee's accounts (FS 71) for each financial year in which the incidental provider was authorised to provide custodial and depository services stating that, having reviewed the financial statements of each related body corporate of the licensee, the auditor has no reason to believe that the incidental provider did not meet part (c) of the definition of incidental custodial and depository services (audit opinion requirement) for the relevant financial year.

Your feedback

- C1Q1 Do you agree with this proposal? If not, why not?
- C1Q2 Do you think limiting the definition of incidental custodial or depository services in this way is reasonable in light of the proposed implications? If not, why not?
- C1Q3 Are there any difficulties with identifying the proportion of revenue reasonably attributable to custodial or depository services? In such cases, what other method could be used to value the custodial or depository service?
- C1Q4 What additional processes would you need to implement to meet the proposed audit opinion requirement?
- C1Q5 Are there other practical problems with the implementation of this proposal? Please give details.
- C1Q6 What impact will this proposal have on your business?
- C1Q7 Is there a better way to evaluate the significance of custodial or depository services provided by an AFS licensee?

Rationale

- 76 The concept of incidental custodial or depository services is not defined in the Corporations Act. It was applied by ASIC for the purposes of determining how the financial requirements would apply to different providers. The word 'incidental' was chosen to limit the application of the NTA requirement to Custodians, but there is confusion about what it means so we have decided to define it.
- 77 To be considered an incidental provider, and therefore eligible to meet the reduced minimum NTA requirement, an AFS licensee must satisfy each of the circumstances listed in the proposed definition.
- 78 We consider that only custodial or depository services that are provided because of the provision of other financial services by the AFS licensee or its related body corporate could be regarded as incidental. An example of what may often meet part (a) of the definition is the holding of financial products as part of an unregistered managed investment scheme (other than an IDPS) by an operator of the scheme on behalf of a client, which occurs after the

operator or a related body corporate has provided financial product advice and/or dealing services in respect of those interests on behalf of the client. This example will form part of our guidance in RG 166 on financial requirements for custodial or depository services.

- 79 Custodial or depository services that are offered to clients independent of other financial services are not considered incidental by ASIC. Clients characteristically place a substantial degree of trust in providers in these circumstances, necessitating a greater buffer against operating risk exposure.
- 80 We also consider that only custodial or depository services that represent a minor source of the financial service business revenue of the economic entity of which the provider is part should be described as incidental. Activities that, although they are not the main offering of the group's financial services business, represent the provision of another substantial service should not be regarded as incidental. We consider that activities that generate more than 10% of total financial services business revenue are a substantial service and are therefore not incidental.
- 81 We require consideration of the cost of providing a service for which revenue is less than cost because we consider that cost in these circumstances is an appropriate indicator of the extent of operating risk.
- 82 For incidental providers, the introduction of a minimum NTA requirement acknowledges that there is a degree of risk associated with providing any custodial or depository service. It is important that these AFS licensees have the necessary experience, systems and controls in place to support their authorisation as a custodian, irrespective of the nature of other services for which they may be authorised, even if this financial service is provided only incidentally.
- 83 RG 166 recognises that in certain circumstances it would be unreasonably costly for AFS licensees to meet all of their financial requirements. For example, an exemption from holding \$5 million NTA is available to responsible entities where all of the scheme property or assets of the scheme are special custody assets or Tier \$500,000 assets. Accordingly, the proposed minimum \$150,000 NTA for incidental providers recognises that a lower minimum NTA is suitable for these providers.
- 84 We think that it is important for retail clients to be informed about the scope of the custodial or depository services they are being provided and the provider's financial resources. A statement in the incidental provider's FSG and SOA saying that it is providing incidental custodial or depository services, and may not meet the financial requirements for custodians generally, gives retail clients access to this information. This proposal does not envisage a requirement to provide an FSG or SOA in circumstances when it would not otherwise be required.

- 85 The audit opinion requirement will enable us to verify whether a provider has met the revenue threshold for incidental custodial or depository services and, provided the remainder of the definition is also met, is eligible to hold the reduced minimum NTA.

Increasing the NTA capital requirement

Proposal

- c2 We propose that incidental providers be required to hold NTA (calculated as for Custodians) equal to the greater of:
- (a) \$150,000; or
 - (b) 10% of average revenue.

Your feedback

- C2Q1 What benefits do you consider will result from this proposal?
- C2Q2 What disadvantages do you consider will result from this proposal?
- C2Q3 Do you think a requirement to hold NTA equal to 10% of average revenue is unreasonable? If so, why?
- C2Q4 For AFS licensees with low or zero revenue, what would be the best alternative proxy measure for operating risk?
- C2Q5 Would complying with this proposal require you to restructure your business?
- C2Q6 What impact will this proposal have on your business costs? How will you manage these changes?
- C2Q7 Are there any practical problems with the implementation of this proposal?
- C2Q8 Will this proposal have any impact on competition?
- C2Q9 Are there any characteristics specific to providing custodial and depository services in emissions units that warrant us taking a different approach to financial requirements for AFS licensees that only provide this type of service?

Requiring 12-month cash flow projections

Proposal

- c3 We propose that incidental providers be required to comply with the same requirements for cash flow projections and the audit report relating to the projections as apply to Custodians.

Your feedback

- C3Q1 Do you agree with this proposal? If not, why not?
- C3Q2 What additional costs will be incurred by your business as a result of these proposals? Will there be any cost savings?
- C3Q3 Are there any issues with limiting the options providers have to meet the cash needs requirement?
- C3Q4 Are there any practical problems with the implementation of this proposal? Please give details.

Rationale

- 86 Cash flow projections are an important tool in identifying potential risks to a business. Our proposal would introduce a requirement for longer cash flow projections for incidental providers. This proposal would replace the current cash needs requirement set out in RG 166.37–RG 166.63.
- 87 The rationale for introducing cash flow projection requirements for Custodians is discussed in greater detail at paragraphs 62–71, and is also relevant for incidental providers.

NTA liquidity requirements and reporting

- c4 We propose that:
- (a) at least 50% of the required NTA (as set out in proposal C2) should be held in cash or cash equivalents, with 100% being held in liquid assets (as defined in the 'Key terms'); and
 - (b) an incidental provider affected by this proposal should report its NTA position, together with detailed workings, to ASIC as part of its annual submission of Form FS70.

Your feedback

- C4Q1 What benefits do you consider will result from this proposal?
- C4Q2 What disadvantages do you consider will result from this proposal?
- C4Q3 Would complying with this proposal require you to restructure your business in any way?

- C4Q4 What impact will this proposal have on your business costs? How will you manage these changes?
- C4Q5 Are there any practical problems with the implementation of this proposal?
- C4Q6 Will this proposal have any impact on competition?

Rationale

- 88 The introduction of a minimum NTA requirement for incidental providers acknowledges that there is a degree of risk associated with providing any custodial or depository service. This proposal will ensure that incidental providers have sufficient financial resources to provide custodial or depository services in compliance with the Corporations Act.
- 89 It is likely that incidental providers may also be authorised to provide other financial services. If any other requirement contained in RG 166 applies to an incidental provider because of other activities it undertakes, it would have to meet the other requirement. Assets used to meet one requirement may be used to meet another requirement.
- 90 The rationale for imposing liquidity requirements on Custodians is discussed in greater detail at paragraph 72, and is also relevant to incidental providers.
- 91 It should be noted that the test for consideration as an incidental provider is the proportion of financial service business revenue from custodial or depository services of the AFS licensee and its related bodies corporate. However, the NTA requirement is sized to 10% of average revenue, because it aims to reflect the total operating risk of the licensee but not its related bodies corporate.

D Proposed implementation period

Key points

Some businesses may either choose to restructure or recapitalise as a result of the revised requirements. A transition period may therefore be appropriate.

Commencement date and transition period

Proposal

D1 We propose:

- (a) that the reforms be effective for new providers as of 1 July 2013; and
- (b) for existing providers, responsible entities of managed investment schemes and IDPS operators, to implement a transition period of 12 months until 1 July 2014.

Your feedback

D1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this paper?

D1Q2 Do you require a transition period to ensure that adequate arrangements are in place to meet the requirements of the proposals? If so, is 12 months a sufficient period? If a longer transition period is required, please explain why.

Rationale

- 92 We think these proposals are important to ensure the strength and stability of the custodial or depository services industry, 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.
- 93 The earliest practical time for the implementation of the proposals for new providers would be 1 July 2013. We propose to provide a 12-month transition period for existing providers.

E Regulatory and financial impact

- 94 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) ensuring that providers 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.
- 95 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 a 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 a minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).
- 96 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.
- 97 To ensure that we are in a position to properly complete any required RIS, please give us as much information as you can about our proposals or any alternative approaches, including:
- (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits.

Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on 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 AFS 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
ASX 24	The exchange market formerly known as Sydney Futures Exchange (SFE), operated by Australian Securities Exchange Limited
Australian ADI	Australian authorised deposit-taking institution—has the meaning given in s9
average revenue	Average revenue means: <ol style="list-style-type: none"> (a) for a licensee in its first financial year of being authorised to provide a custodial or depository service—the licensee's forecast of its revenue from the date of that authorisation for the remainder of the first financial year pro-rated to a 12-month period; (b) for a licensee in its second financial year in which it is authorised to provide a custodial or depository service—the aggregate of the licensee's: <ol style="list-style-type: none"> (i) estimate of its actual revenue for the second financial year-to-date; and (ii) forecast of its revenue for the remainder of the second financial year; and (c) for a licensee in its third financial year in which it is authorised to provide a custodial or depository service—the average of: <ol style="list-style-type: none"> (i) the aggregate of the licensee's: <ol style="list-style-type: none"> (A) estimate of its actual revenue for the third financial year to-date; and (B) forecast of its revenue for the remainder of the third financial year; and (ii) the licensee's revenue for its second financial year in which it is authorised to provide a custodial or depository service; and

Term	Meaning in this document
	<p>(d) for all subsequent financial years—the average of:</p> <ul style="list-style-type: none"> (i) the aggregate of the licensee's: <ul style="list-style-type: none"> (A) estimate of its actual revenue for the current financial year-to-date; and (B) forecast of its revenue for the remainder of the current financial year; and (ii) the licensee's revenue for the last preceding financial year; and (iii) the licensee's responsible entity revenue for the second preceding financial year <p>Note: We expect providers to base their forecast on reasonable assumptions and to take into account the actual revenue over that financial year-to-date in making the forecast.</p>
cash or cash equivalents	<p>Cash or cash equivalents means:</p> <ul style="list-style-type: none"> (a) cash on hand, demand deposits and money deposited with an Australian ADI that is available for immediate withdrawal; (b) short-term, highly liquid investments that are readily convertible to known amounts of cash that are subject to an insignificant risk of changes in value; (c) the value of any eligible undertaking provided by an eligible provider; and (d) a commitment to provide cash from an eligible provider that can be drawn down within 5 business days and has a maturity of at least 6 months
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
Custodian	A provider of a custodial or depository service that is not an incidental provider
eligible custodian	<p>An eligible custodian is:</p> <ul style="list-style-type: none"> (a) an Australian ADI; or (b) a market or clearing participant; or (c) a subcustodian appointed by one of the above subject to limitations in relation to persons appointed by an ASX 24 participant who is not otherwise an eligible custodian
financial service	Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act
financial services business	<p>A business of providing financial services</p> <p>Note: This is a definition contained in s761A. The meaning of 'carry on a financial services business' is affected by s761C.</p>

Term	Meaning in this document
IDPS	Investor directed portfolio service, as defined in Class Order [CO 02/294] <i>Investor directed portfolio services</i>
IDPS property	Property acquired or held through the IDPS other than property held by the client
incidental custodial or depository services	Defined at proposal C1
incidental provider	An AFS licensee that provides incidental custodial or depository services but does not include a licensee authorised to operate registered schemes as a responsible entity or a licensee to which s912AB as notionally applying under [CO 12/752] applies (being certain retail dealers in OTC derivatives)
liquid assets	Liquid assets means: <ul style="list-style-type: none"> (a) cash or cash equivalents other than paragraph (d) of the definition of 'cash or cash equivalents'; and (b) assets that the licensee can reasonably expect to realise for their market value within 6 months, that are free from encumbrances and, in the case of receivables, free from any right of set-off
NTA (net tangible assets)	An AFS licensee's adjusted assets less adjusted liabilities, as defined in RG 166
provider	An AFS licensee that provides custodial or depository services under the licence
retail client	A client as defined in s761G of the Corporations Act and Ch 7, Pt 7.1, Div 2 of the Corporations Regulations
RG 148 (for example)	An ASIC regulatory guide (in this example numbered 148)
s766E (for example)	A section of the Corporations Act (in this example numbered 766E), unless otherwise specified
SLF	Surplus liquid funds
wholesale client	A client as defined in s761G of the Corporations Act and Ch 7, Pt 7.1, Div 2 of the Corporations Regulations

List of proposals and questions

Proposal	Your feedback
<p>B1 We propose that a Custodian be required to hold NTA equal to the greater of:</p> <p>(a) \$10 million; or</p> <p>(b) 10% of average revenue.</p> <p>An-ASX listed parent would not be an eligible provider for the purpose of inclusion in calculating NTA (unless it is an eligible provider for another reason).</p> <p>For the purpose of calculating the NTA, the adjusted liabilities would include (as added to total liabilities) the maximum potential liability of any personal guarantee the Custodian has provided, with certain exceptions for stapling agreements.</p>	<p>B1Q1 What benefits do you consider will result from this proposal?</p> <p>B1Q2 What disadvantages do you consider will result from this proposal?</p> <p>B1Q3 Do you think a requirement to hold NTA equal to 10% of average revenue is unreasonable? If so, why?</p> <p>B1Q4 For AFS licensees with low or zero revenue, what would be the best alternative proxy measure for operating risk?</p> <p>B1Q5 Should there be a deemed minimum revenue from the holding of any kind of asset to prevent diversion of revenue to related bodies to minimise the NTA requirement? If not, why not? If so, what amount should this be? Would two basis points of the average value of the property held be appropriate?</p> <p>B1Q6 Are the remuneration practices in this industry such that an alternative proxy measure for operating risk should be considered, such as one based on the value of assets held?</p> <p>B1Q7 Should there be an additional requirement to hold NTA of a certain percentage of the value of the relevant property held under custodial or depository services or as an asset holder or master custodian of a registered scheme? If so, what should this amount be? Would two basis points of the value of the property held be appropriate?</p> <p>B1Q8 Would complying with this proposal require you to restructure your business in any way?</p> <p>B1Q9 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>B1Q10 Are there any practical problems with the implementation of this proposal?</p> <p>B1Q11 Will this proposal have any impact on competition?</p> <p>B1Q12 Are there any characteristics specific to providing custodial and depository services in emissions units that warrant us taking a different approach to financial requirements for AFS licensees that only provide this type of service?</p>

Proposal	Your feedback
<p>B2 We propose that the NTA requirement for a Custodian, set out in proposal B1, also apply to:</p> <p>(a) a responsible entity holding scheme property or assets (other than special custody assets or Tier \$500,000 assets) unless it appoints an asset holder who it reasonably believes does meet the requirement or is an eligible custodian. If the asset holder is a provider, the responsible entity may assume, unless it is aware to the contrary, that the asset holder meets the custody financial requirements if it has an audit report lodged by the asset holder in Form FS71 Australian financial services licensee audit report for the last financial year in respect of compliance as a Custodian that has no qualification; and</p> <p>(b) an operator of an IDPS that is responsible for holding IDPS property unless it arranges for the IDPS property to be held by a Custodian or an eligible custodian.</p>	<p>B2Q1 What benefits do you consider will result from this proposal?</p> <p>B2Q2 What disadvantages do you consider will result from this proposal?</p> <p>B2Q3 Would complying with this proposal require you to restructure your business in any way?</p> <p>B2Q4 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>B2Q5 Are there any practical problems with the implementation of this proposal?</p> <p>B2Q6 Will this proposal have any impact on competition?</p>
<p>B3 We propose that a Custodian should be required to:</p> <p>(a) prepare a cash flow projection based on a reasonable estimate of its revenue and expenses over at least 12 months;</p> <p>(b) update the cash flow projection if:</p> <p>(i) the cash flows cease to cover the next 12 months;</p> <p>(ii) there is a material change; or</p> <p>(iii) the Custodian has reason to suspect that an updated projection would show it was not meeting its AFS licence conditions;</p> <p>(c) document its calculations and assumptions, and describe in writing why they are the appropriate assumptions;</p> <p>(d) have the cash flow projection approved at least quarterly by the directors of the provider as satisfying ASIC's requirements;</p> <p>(e) show, based on the cash flow projection, 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> <p>(f) demonstrate, based on the projection of its</p>	<p>B3Q1 Do you agree with this proposal? If not, why not?</p> <p>B3Q2 What additional costs will be incurred by your business as a result of this proposal? Will there be any cost savings?</p> <p>B3Q3 Are there any issues with limiting the options Custodians have to meet the cash needs requirement?</p> <p>B3Q4 Are there any practical problems with the implementation of this proposal? Please give details.</p>

Proposal	Your feedback
<p>cash flows, that it will hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or greater than the current amount it is required to hold in cash or cash equivalents; and</p> <p>(g) make the cash flow projection available to ASIC on request.</p> <p>This requirement would replace all five options currently available to meet the cash needs requirement: see Table 3 in RG 166.</p> <p>A tailored audit requirement would apply based on the cash flow projection requirement, on a corresponding basis to that now applying to responsible entities, as set out in [CO 11/1140].</p> <p>This requirement already applies to responsible entities. However, if a responsible entity is relying on a person that it appoints to hold scheme property or other assets to avoid having to meet the financial requirements that would apply if the responsible entity held that property or assets, then the responsible entity must have reasonable grounds to believe that the person meets this cash flow projection requirement. We would expect that this would include obtaining and retaining a copy of the required projections and audit reports reflecting the requirements that apply to Custodians.</p>	
<p>B4 We propose that:</p> <p>(a) at least 50% of the required NTA (as set out in proposal B2) should be held by a Custodian in cash or cash equivalents, with 100% being held in liquid assets (as defined in the 'Key terms'); and</p> <p>(b) a Custodian 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.</p> <p>If a responsible entity is relying on a person that it appoints to hold scheme property or other assets to avoid having to meet the financial requirements that would apply if the responsible held that property or assets, then the responsible entity must have reasonable grounds to believe that the person meets the requirements in proposal B4(a).</p>	<p>B4Q1 What benefits do you consider will result from this proposal?</p> <p>B4Q2 What disadvantages do you consider will result from this proposal?</p> <p>B4Q3 Would complying with this proposal require you to restructure your business in any way?</p> <p>B4Q4 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>B4Q5 Are there any practical problems with the implementation of this proposal?</p> <p>B4Q6 Will this proposal have any impact on competition?</p>

Proposal	Your feedback
<p>C1 We propose to define the terms ‘incidental custodial or depository services’ as follows. An AFS licensee provides ‘incidental custodial or depository services’ if:</p> <ul style="list-style-type: none"> (a) the custodial or depository services are a need of the client because of, or in order to obtain, the provision of other financial services by the licensee or its related bodies corporate; (b) the custodial or depository services do not form part of an IDPS; and (c) the revenue of the licensee and its related bodies corporate reasonably attributable to the custodial or depository services (which at least includes the cost of providing those services) comprise less than 10% of the total revenue derived from the financial services business of the licensee and its related bodies corporate in the last financial year. <p>Only businesses that provide custodial or depository services in accordance with this definition would be eligible for the reduced minimum NTA requirement relative to Custodians.</p> <p>An incidental provider that does not have at least the NTA required of a Custodian would be required to disclose that it is a provider of ‘incidental custodial or depository services’ and as such is not required to and may not meet the financial requirements required by ASIC for custodians generally. This must be stated in each Financial Services Guide (FSG) relating to the custodial and depository service and any Statement of Advice (SOA) it gives which relates to financial products that involve the provision of the custodial or depository service, which is given to its retail clients (if these documents are required to be given).</p> <p>An incidental provider that does not meet the financial requirements applying to a Custodian would be required to lodge with ASIC a statement in the audit report provided on the licensee’s accounts (FS 71) for each financial year in which the incidental provider was authorised to provide custodial and depository services stating that, having reviewed the financial statements of each related body corporate of the licensee, the auditor has no reason to believe that the incidental provider did not meet part (c) of the definition of incidental custodial and depository services (audit opinion requirement) for the relevant financial year.</p>	<p>C1Q1 Do you agree with this proposal? If not, why not?</p> <p>C1Q2 Do you think limiting the definition of incidental custodial or depository services in this way is reasonable in light of the proposed implications? If not, why not?</p> <p>C1Q3 Are there any difficulties with identifying the proportion of revenue reasonably attributable to custodial or depository services? In such cases, what other method could be used to value the custodial or depository service?</p> <p>C1Q4 What additional processes would you need to implement to meet the proposed audit opinion requirement?</p> <p>C1Q5 Are there other practical problems with the implementation of this proposal? Please give details.</p> <p>C1Q6 What impact will this proposal have on your business?</p> <p>C1Q7 Is there a better way to evaluate the significance of custodial or depository services provided by an AFS licensee?</p>

Proposal	Your feedback
<p>C2 We propose that incidental providers be required to hold NTA (calculated as for Custodians) equal to the greater of:</p> <p>(a) \$150,000; or</p> <p>(b) 10% of average revenue.</p>	<p>C2Q1 What benefits do you consider will result from this proposal?</p> <p>C2Q2 What disadvantages do you consider will result from this proposal?</p> <p>C2Q3 Do you think a requirement to hold NTA equal to 10% of average revenue is unreasonable? If so, why?</p> <p>C2Q4 For AFS licensees with low or zero revenue, what would be the best alternative proxy measure for operating risk?</p> <p>C2Q5 Would complying with this proposal require you to restructure your business?</p> <p>C2Q6 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>C2Q7 Are there any practical problems with the implementation of this proposal?</p> <p>C2Q8 Will this proposal have any impact on competition?</p> <p>C2Q9 Are there any characteristics specific to providing custodial and depository services in emissions units that warrant us taking a different approach to financial requirements for AFS licensees that only provide this type of service?</p>
<p>C3 We propose that incidental providers be required to comply with the same requirements for cash flow projections and the audit report relating to the projections as apply to Custodians.</p>	<p>C3Q1 Do you agree with this proposal? If not, why not?</p> <p>C3Q2 What additional costs will be incurred by your business as a result of these proposals? Will there be any cost savings?</p> <p>C3Q3 Are there any issues with limiting the options providers have to meet the cash needs requirement?</p> <p>C3Q4 Are there any practical problems with the implementation of this proposal? Please give details.</p>

Proposal	Your feedback
<p>C4 We propose that:</p> <p>(a) at least 50% of the required NTA (as set out in proposal C2) should be held in cash or cash equivalents, with 100% being held in liquid assets (as defined in the 'Key terms'); and</p> <p>(b) an incidental provider affected by this proposal should report its NTA position, together with detailed workings, to ASIC as part of its annual submission of Form FS70.</p>	<p>C4Q1 What benefits do you consider will result from this proposal?</p> <p>C4Q2 What disadvantages do you consider will result from this proposal?</p> <p>C4Q3 Would complying with this proposal require you to restructure your business in any way?</p> <p>C4Q4 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>C4Q5 Are there any practical problems with the implementation of this proposal?</p> <p>C4Q6 Will this proposal have any impact on competition?</p>
<p>D1 We propose:</p> <p>(a) that the reforms be effective for new providers as of 1 July 2013; and</p> <p>(b) for existing providers, responsible entities of managed investment schemes and IDPS operators, to implement a transition period of 12 months until 1 July 2014.</p>	<p>D1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this paper?</p> <p>D1Q2 Do you require a transition period to ensure that adequate arrangements are in place to meet the requirements of the proposals? If so, is 12 months a sufficient period? If a longer transition period is required, please explain why.</p>