REGULATION IMPACT STATEMENT

Responsible entities: Financial requirements

November 2011

About this Regulation Impact Statement

This Regulation Impact Statement addresses ASIC's proposals on changes to the financial resource requirements that apply to responsible entities of registered managed investment schemes.

What this Regulation Impact Statement is about

1 This Regulation Impact Statement (RIS) addresses ASIC's proposals on the financial resource requirements that apply to responsible entities of registered managed investment schemes.

2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

- ensuring businesses that act as responsible entities for registered managed investment schemes have adequate financial resources to conduct their business in compliance with the *Corporations Act 2001* (Corporations Act) and in a responsible manner; and
- administering the law effectively and with minimal procedural requirements.

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

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

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A Introduction

Background

Financial resource requirements for responsible entities

4 The licensing provisions of the *Financial Services Reform Act 2001* commenced on 11 March 2002. Under this regime, responsible entities of registered managed investment schemes must obtain an Australian financial services (AFS) licence that authorises them to operate registered managed investment schemes. AFS licensees are subject to the conduct obligations of Ch 7 of the *Corporations Act 2001* (Corporations Act), including obligations to:

(a) have available adequate financial resources to provide the financial services covered by their AFS licence and to carry out supervisory arrangements (see s912A(1)(d));

(b) do all things necessary to ensure that the financial services covered by their AFS licence are provided efficiently, honestly and fairly (see s912A(1)(a));

(c) have adequate risk management systems (see s912A(1)(h)); and

(d) comply with the conditions on their AFS licence (see s912A(1)(b)), including both the financial resource requirement conditions and the prescribed conditions under reg 7.6.04 of the Corporations Regulations 2001 (Corporations Regulations).

5 As part of our role as regulator of the financial services industry, we are responsible for administering the minimum financial resource requirements that an AFS licensee must meet. These requirements are set by way of s912A(1)(d) and clarified by way of licence conditions. The pro forma licence conditions are set out in Pro Forma 209 *Australian financial services licence conditions* (PF 209) and are further explained in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166).

6 RG 166 notes that the financial requirements on AFS licensees are designed to ensure that:

(a) they 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 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.

7 The current financial resource requirements consist of a number of elements, including that licensees:

(a) must be solvent and have more assets than liabilities;

(b) may elect one of five options to demonstrate they meet the cash needs requirement of PF 209, including preparing a cash flow for the next three months, providing an eligible undertaking or evidence of other support from an authorised deposit-taking institution (ADI), or its parent providing a cash flow forecast for the next three months (not all options require the preparation of a cash flow forecast by the responsible entity, and those that do only require projection over a three-month period);

(c) must have minimum net tangible assets (NTA) of $50,000; and

(d) when an external custodian is used, must have NTA of at least 0.5 of the value of scheme property (i.e. funds under management (FUM)) up to a maximum of $5 million or, when an external custodian is not used, have at least $5 million of NTA.

8 PF 209 and RG 166 apply to a diverse range of AFS licensees, including responsible entities, brokers, market and clearing participants, custodians, margin lenders and foreign exchange dealers. PF 209 and RG 166 set out different requirements for each of these groups of AFS licensees.

Industry characteristics

9 There are approximately 600 AFS licence holders that are authorised to act as responsible entities and that manage an aggregate of approximately 4500 registered schemes. The largest responsible entities have over $90 billion in assets under management (approximately $35 billion of which is managed by the responsible entity) and revenue exceeding $500 million. Approximately 130 responsible entities are considered small, having assets under management of less than $30 million, with some managing less than $2 million. Approximately 50 responsible entities are large, having assets under management of $5 billion or more, with the balance of responsible entities having assets under management between these ranges.

10 Some responsible entities operate in the retail sector, others operate in the wholesale sector and many operate in both. Assets under management in the retail sector by responsible entities are approximately $172.3 billion, with the balance of assets in the wholesale market of $144.5 billion, totalling $316.8 billion.[1] Responsible entities operate simple and complex business structures. Some are stand-alone entities and others form a part of a large

[1] Australian Bureau of Statistics (ABS), December 2010.

conglomerate group. The number of full-time employees of responsible entities is estimated to be 25,000.[2]

11 Responsible entities operate in a diverse range of markets, with registered schemes falling into eight main classes, including unlisted managed schemes,[3] listed managed funds (exchange-traded funds and listed investment trusts), Australian listed real estate investment trusts (A-REITS), unlisted property schemes, mortgage schemes, infrastructure schemes, agribusiness schemes, and timeshare and serviced strata schemes.[4]

Assessing the problem

Industry developments

12 Since the introduction of the minimum financial resource requirements in 2002, there have been a number of significant developments in relation to responsible entities, including:

(a) a substantial increase in the amount of assets managed by responsible entities in Australia,[5] driven primarily by compulsory superannuation contributions.[6] This is particularly relevant to the ongoing compliance costs and the law relevant to these schemes and the financial resources needed to meet those costs;

(b) significant growth in the number of registered schemes;[7]

(c) diversification in the size, complexity and nature of the types of schemes managed by responsible entities;[8] and

(d) a number of recent high-profile collapses of responsible entities[9] where arguably the quantum of financial resources has made it difficult for the scheme to be wound up in an orderly fashion.

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[2] Based on full-time equivalent (FTE) employees in licensed businesses at the time of the application for the AFS licence.

[3] The main categories of managed funds are cash, cash-enhanced, equities, specialist equities, bonds, yield, alternative and multi-sector. About 3600 fall into this category.

[4] There are approximately 62 A-REITS, 650 unlisted property schemes, 124 pooled mortgage schemes and 44 contributory mortgage schemes, 22 infrastructure funds listed on ASX, 420 agribusiness schemes and 40 timeshare and serviced strata schemes.

[5] The ABS estimates that the value of investment in public offer (retail) unit trusts has increased from $155 billion at December 2002 to $286 billion at December 2010. It should be noted that this excludes the value of many investment types required to be registered as managed investment schemes by the Corporations Act.

[6] The Australian funds management industry (including superannuation funds) is the fourth largest funds management industry in the world, with more than $1.23 trillion estimated in assets under management and one of the highest levels of managed funds per capita (Source: IBISWorld). This is expected to continue to grow, aided by planned increases to the superannuation guarantee threshold from its present level of 9%.

[7] In 2002, the number of registered schemes was 1806. At 31 December 2010, there were 4553 registered schemes.

[8] The size of FUM varies from approximately $1 million to $90 billion. The assets managed under schemes range from simple cash schemes to complex hedge funds, with interests in underlying assets as wide as multiple layers of other hedge funds, financial assets, real property, infrastructure and agribusiness schemes.

[9] Over the last four years, there have been approximately 35 responsible entities placed into external administration. Some high-profile examples include Allco Wholesale Investment Limited, City Pacific Ltd, Environinvest Ltd, Fincorp Financial Services Limited, Great Southern Managers Australia Limited, Octaviar Aqua Managers Limited, Record Funds Management Limited, Rubicon Asset Management Limited, Timbercorp Securities Limited and Westpoint Management Limited.

Adequacy of financial resource requirements

13 As a result of these developments, some of the current financial resource requirements introduced in 2002—which have not been updated in the intervening period—are out of date and no longer meet the appropriate minimum standards that responsible entities should meet in order to comply with their existing obligations under the Corporations Act. Consequently, almost 10 years after their introduction, we consider it an appropriate time to review the current financial resource requirements for AFS licensed responsible entities. The proposals in Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140) apply only to responsible entities.

14 In particular, the global financial crisis showed the inadequacy of these requirements. Before the global financial crisis, inflows of capital into schemes significantly outweighed outflows, fees earned by responsible entities were healthy and relatively stable, credit was readily available for responsible entities and their parent entities, and there were no external pressures to stress test the adequacy of the financial resource requirements. The global financial crisis demonstrated that when investor inflows into schemes dry up and outflows significantly increase, the fees earned by responsible entities can be severely affected and responsible entities can find themselves without enough cash very quickly.

15 When unanticipated events occur, such as the availability of credit disappearing, responsible entities with low capital bases have little capacity to absorb unforeseen events. Even if the responsible entity does have assets, if those assets are not capable of quickly being converted to cash, they are not useable by the responsible entity in urgent circumstances.

16 When an entity has a low capital base and fails, there are usually insufficient resources to effect a transition or wind up scheme assets. In particular, the current financial requirements have proven to be inadequate to enable an orderly transition or wind down in the event of a responsible entity failing and being placed into external administration. There were 35 such failures in the period 2007 to 2011, following the onset of the global financial crisis. In many of these cases, the responsible entities under current AFS licence requirements did not have sufficient capital or liquidity to meet the costs of administrators and other professional service providers required to wind down or transition assets. In turn, this contributed to a loss of investors' funds and a corresponding, but harder to measure, loss of investor confidence in the managed investment industry.

17 In addition, when an entity fails, scheme assets are often left unmanaged temporarily. A responsible entity has the most intimate knowledge of scheme assets and such knowledge may disappear with its collapse. It can take months for third parties, such as replacement responsible entities,

liquidators and administrators, to regain this knowledge. The process is costly and highly inefficient.

18 Our detailed rationale for considering that particular financial resource requirements in existing licence conditions are no longer adequate to enable responsible entities to meet their obligations under the Corporations Act are provided below.

Weaknesses in the cash needs requirement

19 There are two key weaknesses in the current cash flow forecasts requirement. The first is that not all responsible entities are required to prepare cash flow forecasts (e.g. those choosing to meet the cash needs requirement using Options 3 to 5 in RG 166). Responsible entities that are not presently preparing cash flow forecasts may not be independently focusing sufficiently on their cash flow needs, may not be meeting general obligations to have adequate financial requirements and risk management systems, and may have a high dependency on third parties to fund any cash flow deficiencies. The examples outlined in this RIS regarding the financial resource management problems experienced by various responsible entities during the analysis period may not be applicable to responsible entities adopting Options 3 and 4 in RG 166. The reason for this is that such entities are either subsidiaries of prudentially regulated ADIs or they have a commitment from an ADI to meet their liabilities. However, ASIC considers that there will be benefits from ensuring that all entities develop a deeper understanding of the key drivers of their cash flow needs.

20 The second weakness in the current cash flow forecasts for the cash needs requirement is that the current three-month forecast period is too short. A three-month period is unlikely to provide directors or company officers with the opportunity to identify potential cash flow risks at a sufficiently early stage to allow them to take meaningful and corrective action (e.g. if a responsible entity is unable to renew finance or there is a significant reduction in revenue). This gives rise to a question whether the responsible entity has adequate risk management systems as required by law.

21 Thirdly, there may be some instances where there is a sub-optimal understanding or awareness of key variables affecting the entity’s cash flow statement. Entities that prepare and have the board consider the key variables of their cash flow statement can positively influence the overall stability of the market, through their own higher levels of stability.

22 It is important to note the 12-month cash flow forecast is standard industry practice for schemes and allows responsible entities to plan their financial resource requirements on an ongoing basis and to meet their obligations regarding having adequate resources.

Inadequacy of the NTA requirements

23 The minimum NTA requirement of $50,000 no longer provides a responsible entity of any size with adequate resources to meet the compliance requirements imposed on them by the Corporations Act. The current minimum of $50,000 would not cover the salary of one experienced compliance officer for half a year, let alone the cost of establishing and maintaining compliance systems to comply with the Corporations Act and meeting financial and auditing obligations.

24 On transition or wind down, $50,000 has proven significantly inadequate to meet the costs of administrators and other professional service providers required to wind down or effect a transition of assets.

25 With an increasing focus on global comparability, there is also a risk that confidence in our financial services system may be undermined because our minimum NTA requirement is significantly below the approximate minimum requirements of major global and regional financial centres, and does not offer comparable consumer protection. International regulators with higher minimum NTA requirements include the UK Financial Services Authority (A$175,000), the US Securities and Exchange Commission (A$100,000), the Monetary Authority of Singapore (A$780,000) and the Hong Kong Securities and Futures Commission (A$635,000).[10]

26 For example, if a responsible entity fails, a responsible entity with NTA of $780,000 at its disposal (e.g. in Singapore) will be much better placed to effect an orderly and responsible transition of scheme assets to a replacement responsible entity, or wind down the scheme, than a responsible entity with NTA of $50,000. The responsible entity will have more resources at its disposal to pay employees and the professional advisers required to effect the transition or winding up of the scheme.

27 When there are insufficient resources, the responsible entity is unable to fund the continued management of scheme assets in the best interests of members, and the value of scheme assets can significantly deteriorate (e.g. development assets or agricultural assets).

28 In relation to the calculation of the NTA requirement, there are business models for which FUM alone does not adequately assess the risk associated with operating those responsible entity businesses. For example, large, complex responsible entity businesses can earn significant amounts of revenue from sources not linked to FUM. Another example occurs in agribusiness schemes, which often have limited scheme property or FUM, but high levels of actual or accrued revenue. For example, Timbercorp Securities Limited and Great Southern Managers Australia Limited lacked

[10] Based on exchange rates as at 3 June 2010.

sufficient working capital to service the cost of ongoing operations over the life of the schemes. The operational risks within these businesses are not reflected in a FUM calculation. It would be preferable if the NTA requirement more appropriately reflected the actual operating risk flowing from all revenue streams associated with the responsible entity's obligations.

29 Further, in relation to the calculation of the NTA requirement, a responsible entity that enters into personal guarantees exposes itself to a liability associated with that guarantee. The NTA calculation does not appropriately reflect that potential liability.

30 The maximum NTA requirement of $5 million was introduced in 2002. The value of $5 million today is considerably less than in 2002. If $5 million were increased for inflation alone since 2002, the maximum NTA requirement could be justifiably increased to $7.5 million. However, the amount of FUM has almost doubled in the last decade.[11] The largest responsible entities currently have over $90 billion in FUM and $500 million in revenue. The figure of $5 million is less than 0.006% of existing FUM and 0.01% of revenue for such entities. The operating risk associated with growth of FUM does not stop above a certain threshold (i.e. $5 million). The NTA requirement should reflect all operating risk within a responsible entity business.

31 In relation to the composition of the NTA requirements, at present the most a responsible entity must hold in cash is 20% of cash outflows for the next three months. There is little further guidance on the composition of NTA (e.g. how much of the NTA should be in cash or other liquid assets). It is therefore possible for responsible entities to meet their NTA requirement in non-liquid assets.[12]

32 One of the purposes of the NTA requirement is to ensure funds are available to the responsible entity for use in situations that are not anticipated. It is logical that a portion of these funds should be in cash, at call or readily realisable to assist the responsible entity to manage unexpected events. The current 20% requirement, which equates to approximately 18 days of expected cash outflows in a 'business-as-usual' situation, is likely to be manifestly inadequate in the event of significant unexpected expenses and/or commitments. Incapacity to meet short-term unexpected expenses may unnecessarily expose a responsible entity to the risk of failure.

33 On collapse of the parent entity, there is a heightened risk of the responsible entity failing if it is reliant on an eligible undertaking provided by its parent entity to meet its NTA and liquidity requirements.

[11] See footnote 5.
[12] There is the requirement for responsible entities adopting Options 1 or 2 in RG 166 to meet the cash needs requirement to demonstrate that 20% of cash flow is to be held in cash.

Accuracy of data for analysis

34 In relation to reporting of NTA requirements, actual NTA, average value of scheme property, average gross revenue and cash or cash equivalents as at the end of each financial year, neither ASIC nor the managed investment industry has access to accurate data on an industry-wide basis to enable appropriate monitoring and reporting on, and representation of, the managed investment industry. The current use of FUM collected from rating agencies and net asset information from ASIC's 'Form FS70' for the purposes of data analysis is not consistent due to the treatment of a number of adjustments (including non-tangible assets).

ASIC's objectives

35 The proposal is aimed at ensuring businesses that act as responsible entities for registered managed investment schemes have adequate financial resources to conduct their business in compliance with the Corporations Act in a responsible manner.

36 In developing our proposals, we have been mindful of the fundamental purposes of the financial resource requirements for AFS licensees and focused on the most suitable mechanisms for achieving those purposes in the context of the managed investment industry. The proposals have been aligned with the existing principles outlined in RG 166. Specifically, the proposals seek to:

(a) ensure responsible entities have adequate financial resource requirements to meet operating costs (e.g. costs of ensuring compliance with the Corporations Act) throughout the life of their schemes;

(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.

37 The proposals do not seek to:

(a) prevent responsible entities from becoming insolvent due to poor business models or cash flow problems;

(b) prevent schemes from failing due to poor business models or cash flow problems; or

(c) provide compensation to scheme members who suffer a loss, for whatever reason.

38 As outlined in RG 166, in setting AFS licence conditions for financial resource requirements, we seek to set minimum standards that are framed as clearly and simply as possible so as to provide certainty. The proposals seek

to balance the requirement to ensure that responsible entities have sufficiently rigorous risk management frameworks and resources to support the responsible management of other people's money against a need to avoid an unreasonable burden in maintaining particular levels of assets, which create unjustifiable barriers to market entry.

B Options and impact analysis

Options

39 We consider the options to include:

Option 1: Clarify the financial resource requirements for responsible entities required by the law (preferred option).

Option 2: Maintain the existing financial resource requirements for responsible entities (status quo).

40 Under Option 1, the new financial resource requirements would, in summary, require a responsible entity to:

(a) maintain a 12-month cash flow forecast, aimed at increasing the early detection of cash flow issues in a ‘business-as-usual’ situation;

(b) change the method of calculating NTA, which would result in an increased minimum NTA requirement, removal of the existing $5 million cap on the NTA requirement and the introduction of a revenue component to the test for determining a responsible entity’s NTA requirement;

(c) assess the maximum liability under any personal guarantees provided by the responsible entity, and exclude from the NTA calculation that potential liability;

(d) exclude from the calculation of the NTA requirement any eligible undertakings provided by a listed parent entity;

(e) introduce an NTA liquidity requirement, which would require a responsible entity to hold at least 50% of its NTA requirement in cash or cash equivalents, and the balance of the NTA requirement in liquid assets; and

(f) report its NTA requirement, actual NTA, average value of scheme property, average gross revenue and cash or cash equivalents at the end of each financial year.

41 ASIC considers each element of Option 1 is important and that the strength of this option lies in the combination of the elements. Option 1 has been designed to reduce the risk of disorderly failure of responsible entities by addressing the immediate anticipated funding requirements of a responsible entity over a 12-month horizon (the 12-month cash flow forecast). This would:

(a) provide a sufficient capital buffer to enable responsible entities to absorb unanticipated events, such as a reduction in revenue, an increase in expenses or an inability to procure replacement funding (the NTA requirement); and

(b) ensure that when a responsible entity does suffer unanticipated events, its NTA is in a sufficiently liquid form so that it can use its NTA to address the unanticipated events.

42 The requirement to exclude from the NTA calculation any potential liability under a personal guarantee and eligible undertakings from parent entities would ensure the NTA accurately reflects the assets of the responsible entity and that those assets will be available to the responsible entity even if its parent entity collapses.

43 While it is possible for some or all of these measures to be implemented separately, we do not consider that would suit the purpose. The combination of elements aims to address identified weaknesses in the current financial resource requirements. Failure to address only some of the elements would dilute the effect of the implemented measures and would not achieve ASIC's objective of ensuring responsible entities have adequate financial resources to meet operating costs throughout the life of the scheme and that there are sufficient resources to avoid disorderly or non-compliant wind-up in the case of responsible entity failure.

44 For example, if we increased the NTA requirement without introducing the cash flow and liquidity requirements, or introduced the NTA and cash flow requirements without introducing the liquidity requirement, responsible entities could still fail as a result of insufficient cash to meet immediate unforseen expenses, despite having more assets. Introduction of the NTA and liquidity requirements without the cash flow element would not cover the circumstance where the cash needs of the responsible entity over the 12 months exceed the NTA and liquidity requirements. The strength of Option 1 is in the combination of elements.

45 We have considered other options. For example, in CP 140, we proposed a prohibition on responsible entities providing some guarantees and indemnities to protect responsible entities from the consequences of such obligations. We have taken into account submissions from respondents that this element of the CP 140 proposals would be difficult to implement. We replaced the proposed restriction on guarantees and indemnities with the requirement for the responsible entity to estimate the maximum liability of any guarantee provided by the responsible entity, which is not limited to scheme assets, and to exclude this amount from the NTA calculation. This enables the NTA to better reflect the operational risk of the responsible entity, while maintaining flexibility for responsible entities to provide such guarantees, where appropriate.

46 For the NTA requirement, we proposed two options. One of these options provided for NTA to be calculated as 10% of gross revenue, with a

minimum of $500,000. In proceeding with Option 1, we have taken into account the submissions of respondents who preferred to retain the FUM component of the NTA calculation and who thought a minimum of $500,000 was too onerous for small responsible entities.

47 For the period of the cash flow projections, we sought to balance the objective of forecasts being over a sufficient period to enable responsible entities to fully appreciate their short-term funding risks with the difficulty of forecasting too far into the future. We have also considered current financial reporting requirements and practice within the industry. Taking into account all these factors, 12 months was considered the appropriate forecast period.

48 Other co-regulatory options, such as industry standards or codes, were not considered feasible alternatives for a number of reasons, including:

(a) there is no one industry body or combination of bodies that represents the wide variety of responsible entities—which vary by size, structure, asset type and location—that could draft, secure industry support for, implement and monitor compliance with a code or set of standards; and

(b) codes and standards are usually voluntary and are not enforceable, and therefore do not provide an appropriate incentive for responsible entities to self-regulate (they often result in the more compliant responsible entities complying with the codes or standards and the less compliant responsible entities not complying with them).

49 The co-regulatory approach would not address the problem or achieve our objectives and was not raised by any respondents as a feasible alternative to the CP 140 proposals, particularly in light of responsible entities already being subject to financial resource requirements as part of their AFS licence.

Impact analysis

Option 1: Clarify the financial resource requirements for responsible entities (preferred option)

50 Under this option, we would seek to modify provisions in the Corporations Act to provide greater detail about the financial resource requirements on AFS licensees with an authorisation to operate registered managed investment schemes in their capacity as a responsible entity. The clarified financial resource requirements would ensure that a responsible entity has adequate financial resources and liquidity to conduct its business in compliance with the Corporations Act and in the best interests of members.

In addition, we would update RG 166 to reflect the new financial resource requirements.[13]

12-month cash flow projections

51 The current cash needs requirement for all AFS licensees set out in RG 166.22(c) and existing licence conditions would be replaced. Under the current cash needs requirement set out in RG 166, there are five options for meeting the requirement. Only Options 1 and 2 require responsible entities to maintain cash flow forecasts. There is no such requirement for responsible entities that rely on Options 3 to 5 in RG 166.

52 We would revise the cash needs requirement for responsible entities in RG 166 to require all responsible entities to prepare cash flow forecasts and extend the minimum period over which a responsible entity needs to forecast its cash flow from three months to 12 months. The cash flow forecast would be required to be prepared on a basis similar to the existing Option 1 in RG 166, which requires a business-as-usual cash flow.

53 A responsible entity would be required to demonstrate, based on the cash flow forecast, that over the projection period it will have:

(a) access to sufficient resources to meet its liabilities; and

(b) sufficient resources to comply with the cash or cash equivalents component of its NTA requirement.

54 A responsible entity would be able to include as part of its cash balance the value of any eligible undertaking provided by an eligible provider.

55 Directors of a responsible entity would also be required to:

(a) pass a resolution at least quarterly approving the cash flow forecasts; and

(b) cause revised cash flow forecasts when there is a material change.

56 It is anticipated that the retention of audit requirements on an annual basis will further ensure that appropriate rigour is applied in preparing these cash flow forecasts.

NTA capital requirement

57 In accordance with Option 1 of our proposals in CP 140, the NTA requirement would be revised from a minimum of $50,000 and 0.5% of FUM to the greater of:

(a) $150,000;

[13] A copy of the draft updated RG 166 is attached as an appendix to Report 259 *Response to submissions on CP 140 Responsible entities: Financial requirements* (REP 259), which will be released simultaneously with this RIS.

(b) 0.5% of the average value of scheme property, being:

   (i) assets (including mortgages held by members of a mortgage scheme and managed as part of the scheme); plus

   (ii) any other scheme property not counted in calculating the value of assets,

   of the registered scheme(s) operated by the licensee (defined as average value of scheme property) capped at $5 million; or

(c) 10% of the average gross revenue of the responsible entity with no maximum.

58 The inclusion of a revenue test better reflects the operating risks faced by some responsible entities. Revenue is the primary cash inflow used by the majority of entities, including responsible entities, to meet their liabilities and satisfy other obligations imposed on them. Consequently, we believe that revenue is the better indicator of a responsible entity's overall operating risk.

59 This is further supported by Basel III, which uses revenue to determine a bank's capital requirements for operating risk relating to asset management businesses.

60 We are also aware that it is a common market practice for responsible entities to outsource some of their legal obligations through contractual agreements to third-party service providers. This means that a responsible entity may:

(a) earn revenue that is passed on in full to these service providers; and/or

(b) contract with these service providers so that they are paid directly from scheme property.

61 To ensure that responsible entities maintain NTA that covers all aspects of scheme operations, the definition of gross revenue includes payments out of scheme property that relate to fulfilling a responsible entity's obligations under the Corporations Act, even if some of those obligations are outsourced to other entities.

62 We have proposed the use of average gross revenue, covering the previous 24 months and a forecast for the next 12 months, rather than gross revenue from the previous 12 months, to smooth variances in capital requirements arising from fluctuating revenue from factors such as performance fees and one-off transaction fees.

Exclusion of personal guarantees from NTA requirement

63 To ensure that the NTA requirement appropriately reflects the risk associated with any personal guarantees, a responsible entity would be required to assess the value of, and exclude from the NTA calculation, the

potential liability under any personal guarantees provided by the responsible entity.

Exclusion of parent entity eligible undertakings from NTA requirement

64 The definition of eligible provider would be adjusted for responsible entities to exclude listed parent entities because the benefits of such undertakings are not likely to be available in the event that a listed parent itself experiences financial difficulties.

NTA liquidity requirement

65 A responsible entity would be required to hold a proportion of its NTA requirement as cash or cash equivalents and the remaining balance in liquid assets. The intention is to ensure that responsible entities have adequate cash reserves to address unexpected and immediate expenses.

66 It is proposed that a responsible entity be required to hold:

(a) the greater of $150,000 or at least 50% of its minimum NTA requirement as cash or cash equivalents, with ‘cash or cash equivalents’ being defined as assets that are:

(i) cash on hand, demand deposits and money deposited with an ADI that is available for immediate withdrawal;

(ii) short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value; and

(iii) the value of any eligible undertakings provided by an eligible provider; and

(b) the balance of its minimum NTA requirement as liquid assets, with a ‘liquid asset’ being defined as an asset that:

(i) can reasonably be expected to be realised for its market value within six months; and

(ii) is free from encumbrances and, in the case of receivables, free from any right of set-off.

67 A primary objective of the liquidity requirement is to ensure that a responsible entity’s NTA is in a form that can be called upon when required. There is currently little guidance as to the composition of a responsible entity’s NTA requirement and as such it could consist entirely of land and buildings, or other non-liquid assets, which would be of no use if a responsible entity needs to draw on these resources at short notice to fulfil its obligations to scheme members. This option requires that a portion of a responsible entity’s NTA be held as cash or cash equivalents to help it meet any immediate and unexpected expenses.

Reporting of financial data

68 We propose to require a responsible entity to report its NTA requirement, actual NTA, average value of scheme property, average gross revenue and cash or cash equivalents as at the end of each financial year.

$5 million NTA threshold

69 Under the existing regime, responsible entities of all schemes (except for those with tier $500,000 class assets or special custody assets) must have at least $5 million of NTA where they do not use an external custodian holding $5 million of NTA itself. We are not presently proposing to amend this threshold. However, responsible entities using an external custodian at present must hold 0.5% of FUM, up to $5 million. We propose to clarify that when a responsible entity's new NTA requirement is higher than $5 million, even if it is using external custodians, the responsible entity must hold the higher NTA requirement amount.

Benefits

70 Option 1 is designed to benefit investors, responsible entities, the managed investment sector and the Government by:

(a) ensuring compliance with the law;

(b) reducing the risk of disorderly failure of responsible entities; and

(c) enhancing confidence in the managed investment industry.

71 It seeks to ensure that responsible entities have adequate financial resources and liquidity management practices to support the management of other people's money responsibly, without being unreasonably burdensome or creating significant barriers to entry. Table 1 provides a summary of the key benefits of Option 1.

Table 1: Benefits of Option 1

Stakeholder	Benefit
Investors	Option 1 would provide better investor protection by ensuring: • a higher level of care and diligence from directors; • a better reflection of the operational risk of a responsible entity; • more resources are available to the investor on failure of a responsible entity; and • enhanced compliance with the Corporations Act.

Stakeholder	Benefit
Responsible entities	Option 1 would reduce the risk of responsible entity failure by ensuring a responsible entity: • is better placed to meet its liabilities through a more robust and accurate cash flow forecast; • has a greater capital buffer and liquidity to manage any unanticipated events; • has a greater level of compliance; and • has more resources available to it on failure.
Managed investment industry	Option 1 would enhance confidence in the industry by: • reducing the risk of responsible entity failure; and • enhancing compliance with the Corporations Act.
Government	Option 1 would reduce the risk of responsible entity failure by: • reducing the amount of government expenditure that is used to address the consequences of responsible entity failures; • ensuring more resources are available on failure of responsible entities; • preventing the loss of investor confidence caused by responsible entity failures; and • providing meaningful and accurate data on the industry for reporting and analytical purposes.

Benefits of 12-month cash flow projections

72 Requiring all responsible entities to prepare cash flow forecasts for 12 months, having directors update those cash flow forecasts quarterly and having those cash flow forecasts reviewed by auditors annually will enhance the stability of, and investor confidence in, responsible entities and the managed investment industry. It will also reduce the risk of disorderly failure of responsible entities. This is because:

(a) to meet the requirements and obligations under both the Auditing and Assurance Standards Board (AASB) and the Corporations Act, auditors must satisfy themselves that the responsible entity is capable of meeting its liabilities and other obligations over the next 12 months;

(b) cash flow forecasts signed off by directors are likely to have been prepared with care and diligence and be more accurate, providing management with a more effective decision-making tool (directors are obligated to perform their duties with care and diligence under the Corporations Act, and failing to do so may incur civil or criminal penalties);

(c) the majority of submissions made during our CP 140 consultation phase confirmed responsible entities are already preparing cash flow forecasts on a 12-month basis with director sign-off and review by auditors, with many noting that industry views 12 months as a more realistic and prudent timeframe in managing cash flow needs, which is supported by further submissions from auditors;

(d) for those responsible entities not already preparing 12-month cash flow forecasts, by requiring these responsible entities to prepare or extend their consideration and expectation over a period of 12 months, responsible entities will be much better placed to detect cash shortfalls earlier, providing greater time to address those risks;

(e) there should be fewer responsible entities failing due to an incapacity to meet unanticipated liabilities because a responsible entity will have more robust, accurate cash flow forecasting, resulting in it being more likely that it will have sufficient cash to meet its immediate liabilities—for example, an entity that is forecasting over a three-month period and that has a large refinancing due in six months may not sufficiently focus on the refinancing early enough to enable it to procure alternative finance, particularly in difficult market conditions. Any difficulty it may then find itself in may have been avoided if a 12-month forecast had been prepared because it would have brought to the attention of directors the need to refinance 12 months in advance, providing more time for sourcing of alternative finance or capital; and

(f) when responsible entity failure is unavoidable, the likelihood of failure should be identified by the responsible entity or the auditor earlier, providing an opportunity to smoothly effect a transition of scheme assets to another responsible entity to minimise disruption to investors.

Benefits of NTA capital requirement

73 We consider the new method of calculating the NTA capital requirement (see paragraph 57), removing the cap of $5 million and the exclusion from the NTA calculation of eligible undertakings from listed parent entities and the maximum liability of personal guarantees will benefit investors, responsible entities, the managed investment industry and Government by:

(a) improving investor confidence;

(b) enhancing compliance with the Corporations Act; and

(c) enhancing the alignment of the NTA requirement with operational risk.

74 This will better align the interests of responsible entities with their investors, and provide incentives to responsible entities through increased levels of capital at risk, reducing the risk of responsible entity failure and providing a larger pool of capital to fund the orderly transition of scheme assets or winding up of the scheme upon failure.

75 For investors, responsible entities, the managed investment industry and Government, there is likely to be more confidence in responsible entities leading to increased levels of local and international investment because:

(a) responsible entities will need to have access to greater levels of capital and liquidity in order to be licensed as a responsible entity;

(b) the minimum NTA requirement will provide similar investor protection to Australia's financial services centre peers;

(c) responsible entities will have reduced levels of failure;

(d) responsible entities will have more capital and liquid resources at their disposal to ensure that they and their service providers act in accordance with scheme constitutions, compliance plans and the Corporations Act;

(e) responsible entities will be less likely to fail as a result of having a greater capital buffer at their disposal to manage any unanticipated liabilities; and

(f) the loss of confidence in the managed investment sector that occurs when responsible entities fail and capital loss results for investors can be avoided.

76 For investors, the managed investment sector and Government, the NTA requirements will better reflect the operational risk of responsible entities because:

(a) as responsible entities grow bigger, they tend to become more complex and revenue more appropriately reflects the risk related to non-scheme revenue streams and more efficient product delivery;

(b) for responsible entities with typical FUM models that have less than approximately $5 billion in FUM (assuming approximately 1% revenue flow from FUM), the FUM component of the NTA requirement will continue to be the pertinent calculation;

(c) for responsible entities with high revenue and low FUM (e.g. agribusiness schemes), the revenue component of the NTA requirement results in greater and more appropriate levels of capital in the business than the FUM component of the NTA requirement;

(d) for responsible entities with risky business models that tend to earn higher returns to reflect the higher risk levels, the NTA requirement will better reflect their operating risk;

(e) removal of the maximum NTA requirement amount reflects that the operating risk of a responsible entity continues to grow with the growth of the responsible entity's revenue;

(f) under the 'Standardised Approach', revenue is acknowledged as the key measure of operating risk for asset management businesses within banks by Basel II;

(g) if the responsible entity outsources some of the performance of its legal obligations to third parties, the revenue upon which the NTA requirement will be calculated is the revenue attributable to the fulfilment of the responsible entity's obligations under the Corporations

Act, which aims to ensure that NTA reflects the full operational risk of the responsible entity; and

(h) the exclusion of parent eligible undertakings and personal guarantee liabilities from the NTA requirement will result in the NTA requirement better reflecting the actual resources available to, and the liabilities of, the responsible entity.

77 The new NTA requirement will provide an improved incentive for responsible entity success and better align the responsible entity's interests with those of investors because responsible entities will generally have more capital at risk, and therefore more to lose upon failure. This will motivate a responsible entity to successfully manage scheme assets and better align its interests with the interests of its investors.

78 A further benefit is that there will be more resources available upon failure because responsible entities will be required to hold a higher minimum NTA and there will be more capital available to fund an orderly transition of scheme assets or the winding up of schemes if needed. To the extent that the risk of responsible entity failure is reduced, investors will benefit by not incurring the costs of effecting a transition or winding up of a scheme which would have otherwise occurred upon failure. It is not possible to predict how many investors this may apply to or the amount of any savings by investors because savings will vary depending on the circumstances of each scheme and its responsible entity.

79 For the benefit of Government, a reduction in the number of responsible entity failures is likely to reduce the amount of government expenditure addressing the consequences that follow such failure. These costs include determining applications for relief, liaising with administrators, replacement responsible entities and investors, addressing investor complaints, and review and actioning misconduct.

80 For example, in the last three years, we have received approximately 2520 complaints at an estimated cost of $450,000 in relation to three failed responsible entities.[14] In relation to the 35 responsible entities that have gone into external administration over the last four years, an ASIC stakeholder team has estimated three full-time employees per year at $100,000 per employee on average has been required to address issues concerning responsible entities in administration. Another ASIC team has estimated its costs associated with addressing responsible entity failure in the examples listed in Table 2. These costs could be applied to other supervisory responsibilities if responsible entity failure is minimised.

[14] Australian Property Custodian Holdings Limited, Timbercorp Securities Limited and Great Southern Managers Australia Limited.

Table 2: ASIC's costs of addressing responsible entity failure

Name of entity	ASIC's internal staff costs	ASIC's external consultant costs
Environinvest	$96,560	$104,378
Great Southern	$1,244,380	$143,545
Timbercorp	$14,660	$116,000
LKM Capital Limited[15]	$223,480	$61,013

81 In attempting to identify the benefits from reduced responsible entity failure and reduced disorderly transition, there is significant uncertainty as to the ability to reliably calculate this on a whole-of-industry basis. While specific examples of failure can be identified from previous experience, ASIC cannot identify how much other firms would learn from others' experience (contributing to improved financial stability) and how much of the improved stability would be attributable to the strengthened interpretation of the Corporations Act requirements. Also, following the global financial crisis there has been a change in demand for the products of responsible entities (including the nature of the issuing entity). This will influence future performance of responsible entities. Further, market conditions in the future will be variable, contributing to variations in the number and severity of responsible entity failure. For these reasons, ASIC considers that any estimate it could produce would be subject to significant variability and would be of little value in the decision-making process.

Benefits of NTA liquidity requirement

82 We consider the new liquidity requirement to hold 50% of the NTA requirement in cash or cash equivalents, and the balance in liquid assets, will benefit investors, responsible entities and the managed investment industry because they will have greater levels of liquid assets to enable them to manage unanticipated circumstances. They should also have more liquidity in the event of failure to effect a transition of scheme assets or wind up a scheme.

83 For example, an entity choosing any of Options 3 to 5 in RG 166 to meet the current cash needs requirement, and which holds $5 million NTA, is not required to hold any of this money in cash. Under our proposal, the entity would be required to hold $2.5 million NTA in cash or cash equivalents.

84 The NTA liquidity requirement would enable a responsible entity to:

[15] LKM operated a debenture scheme managing approximately $63 million of investor funds invested principally in property development. It was placed into receivership on 1 August 2008 by the scheme's trustee (Sandhurst Trustees Limited).

(a) have cash at its disposal to address immediate unanticipated and unforseen events, such as significant drops in revenue or increases in expenses;

(b) have access to liquid assets to address short-term to medium-term issues (e.g. a financier not being prepared to extend existing credit);

(c) have a greater opportunity to develop and implement strategies to address unanticipated short-term liquidity issues that might otherwise result in the quick demise of a responsible entity, even if the responsible entity would be profitable over the short-term to medium-term; and

(d) upon failure, have more cash and liquid assets to enable an orderly transition of scheme assets or winding up of a scheme.

Benefits of reporting financial data

85 We consider that the requirement for responsible entities to report their NTA requirement, actual NTA, average value of scheme property, average gross revenue and cash or cash equivalents to ASIC annually will assist ASIC and the managed investment industry by providing meaningful and accurate data on that industry for reporting and analytical purposes, and the representation of the industry. At present, there is no one source of FUM data available to ASIC or the industry. Rating agencies monitor part of the FUM market, but complete data is not available.

86 We currently use a combination of FUM collected from rating agencies and net asset information from the 'Form F70' that AFS licensees must lodge (indicating assets minus liabilities) as a proxy for FUM, but this information inconsistently includes and excludes a number of adjustments (e.g. non-tangible assets) in the calculations. We are therefore unable to accurately analyse and report on the industry, and the industry is not able to accurately reflect the size of its market in comparison to the wider economy when making representations on behalf of itself to investors and the Government. Another example is that responsible entities do not currently provide NTA calculations, which makes it difficult for ASIC to assess the compliance level with the NTA requirements.

Normal ongoing licence condition operation

87 Responsible entities would remain subject to the rest of their AFS licence conditions. This includes a requirement to notify ASIC of a breach of RG 166 as soon as practicable. This allows ASIC to be aware of risks to entity failure to ensure that sufficient capital will remain available for an orderly transition in the case of negative unexpected cash-flow events.

Summary of benefits of Option 1

88 The benefits of Option 1 are that responsible entities will:

(a) be better placed to manage their cash flow requirements;

(b) be more protected from the capital drain of personal guarantees by exclusion of the maximum liability of such guarantees from the NTA requirement calculation;

(c) have higher levels of capital, cash holdings and liquid assets to enable them to address unexpected operating risks;

(d) have a greater motivation for success, and be better aligned with the interests of investors; and

(e) be better placed to fund an orderly transition or wind-up upon failure.

Costs

89 Responsible entities and investors may incur costs as a consequence of responsible entities complying with the new financial resource requirements.

90 In CP 140, we asked industry to provide us with estimates on how the proposals would impact on responsible entities in terms of compliance and administrative costs. Many respondents indicated that there would be additional compliance costs in terms of restructuring their business. However, most did not quantify the amount or provide a cost estimate that was capable of being extrapolated across the sector.

91 Table 3 provides a summary of the key costs of Option 1, while Table 4 provides an estimate of possible additional costs in dollars under Option 1.

Table 3: Costs of Option 1

Stakeholder	Costs of Option 1
Investors	Responsible entities may pass on any additional costs of the new financial resource requirements to investors.
Responsible entities	There may be an increase in compliance, administrative and capital costs associated with: • the increased opportunity cost of holding additional capital and holding liquid assets; • cash flow forecasts and auditing; • raising new capital; • restructuring and/or wind-up; • additional directors' meetings; and • collating and providing Form FS70 information.
Managed investment scheme industry	There may be a reduction in the level of competition because: • some responsible entities may choose to exit the industry; and • start-up responsible entities may find it more difficult to meet the new requirements.
Government	There may be a minor additional cost in considering any relief applications.

Table 4: An estimate of possible additional costs in dollars under Option 1

	Size of the responsible entity	
	Medium to large responsible entities (FUM > $30m)	**Small responsible entities (FUM < $30m)**
Estimated number of entities	385	130
Cost of implementing cash flow preparation: see paragraph 92	No impact	$8000 per entity (if not already preparing it)
Cost of extending cash flow forecasts from 3 to 12 months: see paragraphs 93–94	No impact	$1500 per entity
Cost of additional directors' meeting to review cash flow forecasts: see paragraph 95	No impact	$1875 per entity
Cost of auditing cash flow forecasts: see paragraph 96	$2000 per AFS licence	$2000 per AFS licence
Additional capital: see paragraphs 97–99	$100m	$9m
Cost of capital per every additional $1m: see paragraph 97	$79,800	$79,800
Cost of sourcing additional capital: see paragraphs 100–104	$5250 per entity	$18,000 per entity
Cost of restructuring: see paragraphs 105–113	$67,000–$162,000 per entity	$67,000–$162,000 per entity
Cost of the liquidity requirement: see paragraph 114	$11,100–$18,500	$11,100–$18,500
Cost of learning the new requirements: see paragraph 115	$15,500 per entity	$15,500 per entity

Note: Estimates are on the basis of the assumptions in each of the relevant paragraphs. Responsible entities will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by responsible entities in response to the proposals.

Cost of implementing cash flow preparation

92 Responsible entities not currently preparing cash flow forecasts will incur minor costs associated with preparing and auditing cash flow forecasts in addition to their other financial reporting requirements. This will involve responsible entities analysing and projecting their revenues, expenses and cash needs for the next 12 months. Based on submissions from auditing firms, there will be few entities that are not already preparing a cash flow forecast, but for such entities, an estimate of $2000 implementation costs (including review by management) and an annual $6000 cost of preparing the forecast has been estimated to ASIC.

Costs of extending cash flow projections to 12 months

93 Responsible entities using Option 1 or 2 of the current cash needs requirement in RG 166 will incur inconsequential costs associated with extending their cash flow forecasts from three months to 12 months. This will involve responsible entities extending their current analysis and projection of revenues, expenses and cash needs over the longer period. This will apply to the majority of responsible entities.

94 Based on submissions from auditing firms, most medium to large responsible entities (i.e. with FUM above $30 million) are already preparing 12-month cash flow projections as part of their financial reporting. There should therefore be no additional costs for these responsible entities or their directors. Most small responsible entities (less than $30 million) would have adopted Option 1 or 2 in RG 166 to meet their cash needs requirements. We estimate approximately 130 small responsible entities may have to spend up to an additional week extending their forecasts from three months to 12 months at a cost of $1500 per entity (assuming an analyst salary of $75,000 per year).

Cost of additional directors' meetings to review cash flow forecasts

95 A sample study of 30 active small responsible entities shows that 80% of responsible entity directors meet at least quarterly and are already considering cash flow at those meetings. We estimate up to an extra half an hour may be required on average to review the extended forecast per meeting. If we assume three independent directors per responsible entity, each paid $20,000 per annum to meet quarterly, with each meeting being held for four hours, this could result in an additional cost of $1875 per year for approximately 26 responsible entities (being 20% of 130), assuming all directors for those responsible entities seek to increase their fees to review the extended cash flow.

Cost of auditing cash flow forecasts

96 Responsible entities may incur minor increases in auditing costs as a consequence of extending the cash flow period from three months to 12 months, or having an auditor annually review a new cash flow forecast. The extension of, or new audit, requirement will involve auditing the responsible entity's projections of its revenues, expenses and cash needs for the next 12 months and will most efficiently be undertaken at the same time as fulfilment of the existing requirements for responsible entities to audit their financial statements. Based on submissions by auditing firms, we estimate the additional auditing costs to be approximately $2000 per AFS licensee.

Cost of additional capital to meet NTA requirement

97 For the new method of calculating the NTA requirement, being the greater of $150,000 (Test 1), 0.5% of FUM (Test 2) or 10% of gross revenue (Test 3), removing the cap of $5 million and the exclusion from the NTA calculation of eligible undertakings from listed parent entities and the value of personal guarantees, some responsible entities will incur the cost of providing additional capital to meet the increased NTA requirement. Our estimate of the impact of the new requirement is represented in Table 5.

Table 5: Estimated impact of changes on responsible entity population

	Responsible entities that meet tests	Responsible entities requiring increased NTA
Minimum NTA determined by Test 1 ($150,000 minimum)	88 (17%)	86 (17%)
Minimum NTA determined by Test 2 (0.05% of FUM)	133 (26%)	38 (7%)
Minimum NTA determined by Test 3 (10% of gross revenue)	125 (24%)	17 (3%)
Pass all tests	**346 (67%)**	
Fail tests and require additional capital		**141 (27.4%)**
Responsible entities with no registered schemes that would require increased NTA		**28 (5.4%)**
Require more capital		**169 (33%)**

98 Based on a dataset of 515 responsible entities,[16] we estimate 169 responsible entities may require additional capital to meet the new requirements. Of these, 28 entities are not currently operating registered schemes and there is a high probability that they will relinquish their licence in preference to meeting the higher NTA requirement. Of the remaining 141 responsible entities, we are unable to predict how many of this group will be unable or unwilling to source the required additional capital. We estimate 86 (17%) will require an average increase of $97,386 NTA to meet the minimum $150,000 NTA requirement, while 38 (7%) are estimated to require an average increase of $1,351,372 to meet the existing FUM test, and 17 (3%) are estimated to require an average increase of $2,826,291 to meet the new revenue test.

[16] Our database currently includes 598 entities that are licensed to act as responsible entities. This data set excludes 83 responsible entities that have been deregistered, struck off, are in external administration, are regulated by the Australian Prudential Regulation Authority (APRA) or for which ASIC has not received financial data since FY 2008.

99 We estimate that approximately $109 million in additional capital will be required to be sourced by responsible entities to meet the new financial resource requirements. We are unable to estimate the extent of personal guarantees provided by responsible entities.

Cost of sourcing additional capital

100 We do not expect any medium to large entities will need to source additional capital externally; thus the administrative costs associated with sourcing additional capital are expected to be minimal. It may involve possible reallocation of internal funding, which is likely to be carried out by the relevant funding personnel in addition to directors' approvals. The directors may need to meet and give consideration to the additional capital required.

101 As an example of the possible administrative costs associated with sourcing additional capital, there will be a total cost of $5250 per entity if the relocation of internal funding requires:

(a) one week's time of an analyst (assuming a salary of $75,000 per annum) at a cost of $1500 per entity; and

(b) one hour's time of directors at a cost of $3750 (as previously estimated).

102 For smaller responsible entities, which may need to source additional capital externally, the process may involve marketing by the chief executive officer to prospective investors, due diligence preparation and a directors' meeting to consider proposals. As an example, internal administrative costs would be $18,000 if:

(a) a chief executive officer paid $200,000 per annum spent two weeks marketing, at a cost of $7500;

(b) an employee (assuming analyst salary of $75,000 per annum) spent two weeks preparing due diligence, at a cost of $3000; and

(c) three independent directors spent two hours considering the proposal, at a cost of $7500.

103 These costs will vary depending on the complexity of the responsible entity, the availability of equity in the market and the viability of the responsible entity or its schemes.

104 The impact on the rate of return on equity for responsible entities will vary significantly. As an example, if the total existing capital base of a responsible entity was $100 million and $5 million was allocated to satisfying the current NTA requirements and the required rate of return was

7.5%p.a,[17] the effective rate of return for the usable capital after NTA consideration is estimated to be 7.89%. If, under the proposals, the entity will be required to increase its NTA from $5 million to $6 million, this would increase the required rate of return after NTA to 7.98%.

Cost of restructuring

105 Responsible entities that prefer to restructure (e.g. by moving capital within a group or by way of merger) than to meet the new NTA requirement will incur the cost of restructuring their business. The cost will depend on the complexity of the restructuring. Based on submissions by auditing firms, we estimate the auditing costs of restructuring per entity choosing to restructure by separating non-scheme and fund management activities from the responsible entity to include:

(a) $2000 to establish a new company;

(b) $20,000 if a new AFS licence is required;

(c) $30,000 for an audit of the new company and AFS licence; and

(d) $10,000 for tax return and other statutory obligations.

106 It is difficult to estimate the internal administrative costs for those responsible entities that choose to restructure without responsible entities providing this information, but we estimate these costs could range from $5000 to $100,000 per entity.

107 Responsible entities that are unable or unwilling to meet the new NTA requirement will need to find a replacement responsible entity, wind up their schemes or seek ASIC relief from the new NTA requirement. The cost of these options will depend on the circumstances. It is not possible for ASIC to anticipate which responsible entities will be unable to attract new capital or restructure to meet the new minimum NTA requirement, although responsible entities in the agribusiness sector may struggle to attract additional capital or restructure. When the new NTA requirement is unreasonably burdensome having regard to the circumstances of a particular responsible entity, ASIC may consider granting temporary relief.

108 Start-up responsible entities may find it more difficult to meet the higher minimum NTA requirement, which could reduce the number of new entrants into the industry and future competition.

109 Small responsible entities may find it more difficult to restructure than larger entities. We have therefore reviewed the 141 responsible entities which do not meet the new NTA requirement test and created a subset of 105 small

[17] We used the S&P ASX 200 Financials (Sector) as proxy for the required rate of return on equity in regard to responsible entities (i.e. the closest proxy available in the public domain; the period from 2008–09 was excluded due to the global financial crisis). The index returned approximately 7.5% during the period 2001–07.

responsible entities whose net assets are less than $150,000. Of these 105 small entities required to increase their NTA requirement, 86 will need to do so to meet the new minimum of $150,000, 16 will need to increase to meet the FUM test and three will need to meet the new revenue test. Of these small entities, 13 have strong parent/holding companies and it is anticipated that they will be easily recapitalised. The 92 (18%) remaining small responsible entities, which may have more difficulty changing their capital structure, have approximately 500 employees.

110 Large responsible entities with more than approximately $5 billion in FUM (assuming an average fee of 1% of FUM) and revenue over $50 million are likely to be required to meet a higher required NTA than the current maximum of $5 million. We estimate approximately 31 responsible entities, being 6% of the population, will have an NTA requirement above the current maximum of $5 million. Of these, 25 already hold net assets in excess of the new requirements. Only 6 (1%) will be required to secure an average increase of approximately $6,685,000 NTA, with a total additional NTA requirement for these entities estimated at $40 million.

111 Responsible entities may incur minor costs associated with calculating average gross revenue and average value of scheme property. Responsible entities will be required to provide a forward estimate of these for the next 12 months and the average gross revenue will include an estimate of fees flowing from scheme assets for performance of the responsible entity's duties which are not already included in the revenue of the responsible entity for various reasons, including that some or all of the responsible entity's duties are outsourced to third parties.

112 Responsible entities with high levels of revenue and low levels of FUM (e.g. agribusiness responsible entities) may incur the cost of a higher NTA requirement. For example, some agribusiness schemes do not have assets or own the land upon which trees are grown, but rather provide investors with contractual rights to revenue earned from the trees on the land. These schemes can have low FUM (and therefore a low NTA requirement at present) but high revenue. The current NTA requirement is not reflecting the operational risk associated with responsible entities running these schemes.

113 Responsible entities may incur additional costs associated with sourcing NTA from sources other than listed parent eligible undertakings or having to exclude the value of personal guarantees from their NTA calculation.

Cost of the liquidity requirement

114 Responsible entities may incur the opportunity cost of holding their NTA requirement as cash and liquid assets.[18] Entities adopting Option 1 or 2 of the current cash needs requirement in RG 166 must hold 20% of the NTA in cash, while entities adopting Option 3, 4 or 5 do not need to hold any portion of the NTA in cash. Table 6 estimates the opportunity cost of holding additional cash to meet the proposed 50% NTA requirement in cash.

Table 6: Estimated opportunity cost for every additional $1 million capital

Option in RG 166	RBA cash rate (10-year average)[19]	S&P ASX 300 (10-year average)[20]	Current cash holding (%)	Proposed cash holding	For any additional $1m capital, the estimated opportunity cost under the new requirement
Entities using Option 1 or 2	5.1%	8.8%	20%	50%	$11,100
Entities using Option 3 to 5	5.1%	8.8%	0%	50%	$18,500

Cost of learning new requirements

115 An audit firm has estimated an opportunity cost of $14,000 and a cost of $1500 per responsible entity when applying the requirements for the first time. However, it should be noted that training on AFS licensing requirements is run annually nationally in any event. As with any revisions, the new requirements will be incorporated into all existing training requirements.

Cost of reporting

116 For reporting the NTA requirement, actual NTA, average value of scheme property, average gross revenue and cash or cash equivalents to ASIC as part of the Form FS70 reporting requirements, responsible entities may incur inconsequential costs in collating and providing this information. Based on submissions from auditing firms, any additional costs in providing this

[18] The possible cost of holding additional capital in liquid assets, rather than non-liquid assets, to meet the liquidity requirement will varying depending on the anticipated return from investment in other liquid and non-liquid assets. For example, if a responsible entity could earn 12% on a $100,000 non-liquid investment, and only 9% on cash, there would be a $4000 per year cost of meeting the new liquidity requirement.
[19] RBA 10-year average cash rate 2001–11.
[20] The 10-year average of the annualised performance of S&P ASX 300 was used in this instance. However, it should be noted the opportunity cost will vary greatly depending on the type of investments in which each responsible entity chose to invest. This is a rough and generalised estimate of the opportunity cost under the proposed NTA cash requirement.

information are included in the estimate of auditing costs of $2000 for reviewing or extending the cash flow forecast: see Table 4.

Costs to investors

117 Investors may incur minor increases in fees if responsible entities pass any additional costs of the new financial resource requirements on to investors.

Costs to government

118 Government may incur minor additional costs in considering any relief applications in relation to the new financial requirements. We estimate the potential cost to be 10 to 25 applications at 10 hours per application.

Costs to industry

119 One of our objectives is to ensure that responsible entities have adequate resources to meet the requirements under the Corporations Act. The impact of these measures in combination may result in some consolidation of the industry as smaller operators move out of the sector. The benefits of reducing the number of responsible entities include:

(a) the likelihood that only well-capitalised responsible entities will remain in the market, which will enhance the stability of the managed investment sector;

(b) remaining responsible entities are likely to be large and better resourced, leading to operating efficiencies; and

(c) the number of small adventurous responsible entities with inadequate resources and business models is likely to be reduced.

120 In costing the impacts on industry, ASIC has not created a whole-of-industry cost due to the difficulty in accurately identifying the nature of the competitive response to the new regulations (e.g. a firm requiring more capital may cease operation, merge or source additional capital—all of which involve different levels of costs). This means that any point estimate of whole-of-industry costs would be subject to significant variation and would not be reliable enough upon which to make a decision in comparison to the benefits (noting that the whole-of-industry benefits are also subject to significant variation).

Summary of analysis

121 ASIC considers on balance that the enhancement of investor and financial consumer confidence in the managed investment industry flowing from responsible entities being more stable as a consequence of being required to prepare longer and more accurate 12-month cash flow forecasts outweighs any additional costs to responsible entities and investors associated with preparation of the cash flow forecasts.

122 The benefits to investors, responsible entities, the managed investment industry and Government that arise from the new method of calculating the NTA requirement (see paragraph 57), removing the cap of $5 million, as well as the exclusion from the NTA calculation of eligible undertakings from listed parent entities and the value of personal guarantees, include:

(a) enhancing responsible entity compliance with the Corporations Act;

(b) better aligning the interests of responsible entities with their investors;

(c) enhancing the alignment of the NTA requirement with operational risk;

(d) improving incentives for responsible entities to want to succeed;

(e) reducing the risk of responsible entity failure; and

(f) providing a larger pool of capital to fund the orderly transition of scheme assets or winding up of the scheme upon failure.

123 These benefits outweigh any additional costs to responsible entities and investors incurred in complying with these requirements and the disadvantage of the potential loss of a small number of undercapitalised and less stable responsible entities.

124 The new liquidity requirement to hold 50% of the NTA requirement in cash or cash equivalents and the balance in liquid assets will ensure responsible entities will be more liquid and capable of managing unanticipated circumstances. This benefit will outweigh the additional costs of being required to hold the NTA requirement in cash or liquid assets.

125 Finally, the improvement to ASIC and the managed investment industry's capacity to accurately report and analyse data on the managed investment industry outweighs the additional cost to responsible entities of providing the additional data.

Option 2: Maintain the existing financial resource requirements for responsible entities (status quo)

126 Under this option, we would maintain the existing financial resource requirements imposed on responsible entities in RG 166. This would mean:

(a) only responsible entities meeting their cash needs requirements by electing Option 1 or 2 in RG 166 would be required to prepare cash flow forecasts;

(b) the minimum NTA requirement would remain at $50,000;

(c) responsible entities would be required to hold NTA of 0.5% of scheme property, with a maximum of $5 million;

(d) the NTA calculation would include eligible undertakings from parent entities and not exclude the maximum liability of personal guarantees; and

(e) there would be no NTA liquidity requirement.

Benefits

127 The benefit of maintaining the current financial resource requirements is that responsible entities and investors will avoid any additional costs or restructuring associated with the new financial resource requirements.

Costs

128 We estimate a number of potential costs to be incurred by responsible entities, investors, the managed investment industry and Government in relation to maintaining the existing financial resource requirements. There may be a continued lack of investor confidence in the managed investment industry flowing from responsible entities:

(a) not having sufficient liquid assets to enable anticipated and unexpected events to be addressed;

(b) having insufficient capital at risk to have the appropriate incentives to succeed;

(c) being at risk of failure on parent entity collapse or the calling of a guarantee, and

(d) having NTA requirements significantly below regional financial service centre peers.

129 For example, agribusiness schemes continue to have difficulties in attracting new investments due to the loss of investor confidence following several high-profile responsible entity collapses.

130 Responsible entities with insufficient capital to fund the orderly transition of scheme assets or winding up of the scheme upon failure can result in reduced levels of compliance with the Corporations Act.

131 Investor losses may flow from inadequate management of schemes in circumstances where there are insufficient resources to fund the ongoing management of scheme assets or transition of those assets to a new responsible entity.

132 Responsible entities with low FUM and high revenue may not have adequate levels of NTA. For example, Great Southern Managers Australia Limited had revenue ranging from $150 million to $400 million in the five years before its collapse in 2008. However, its FUM was negligible, requiring it to hold the minimum of $50,000 NTA only.

133 Unavailability of accurate data on the value of scheme assets managed by responsible entities makes it difficult for effective supervision of the market and for the managed investment industry to accurately substantiate its size and influence. For example, responsible entities do not presently provide

NTA calculations, which makes it difficult for ASIC to assess compliance levels with the NTA requirements.

134 Another potential cost is the loss of confidence in the Government by local and international investors for failure to address the problems identified with the existing financial resource requirements.

135 Finally, the increased cost to Government in addressing the consequences of responsible entity failure, including sourcing replacement responsible entities, court proceedings, licensing action and addressing investor complaints, are another potential cost.

Summary of analysis

136 ASIC considers the benefits are outweighed by the cost of this option.

C Consultation

137 In September 2010, we published CP 140, which set out our proposals on clarifications to the financial resource requirements to apply to responsible entities of registered managed investment schemes. We invited submissions on the proposed financial resource requirements for responsible entities. CP 140 also provided background and rationale to these proposals.

138 We provided presentations to Financial Services Council (FSC) members at an event scheduled by the FSC. The FSC represents the retail and wholesale funds management, superannuation and life insurance industries and Financial Advisory Networks. The FSC has over 135 members who are responsible for investing over $1 trillion on behalf of more than 10 million Australians.

139 We have set out below a brief summary of our responses to the feedback received in submissions to CP 140. For further detail, see Report 259 *Response to submissions on CP 140 Responsible entities: Financial requirements* (REP 259).

140 The consultation period ended on 15 November 2010. We received 48 submissions from a wide variety of sources, including responsible entities, relevant industry bodies, and law and auditing firms. Of the 48 submissions, 28 were non-confidential. We understand that some of the responses were provided by professional service firms or industry bodies and were informed by the views of more than just the respondents themselves.

141 Most respondents recognised the need for a review of the financial resource requirements imposed on responsible entities. However, some submissions also raised concerns about the impact the proposals would have on their business and the industry in general. The following are examples of some of the views expressed in the written submissions.

Restriction of guarantees and indemnities

142 The majority of respondents disagreed with the proposal to restrict guarantees and indemnities, and we have determined it appropriate to remove this requirement from the final proposals. The primary comments expressed were that:

(a) the proposal would prevent responsible entities from operating schemes commercially without undue limitations;

(b) the proposal would be excessively burdensome for responsible entities to unwind and renegotiate existing arrangements;

(c) in some cases, providing guarantees and indemnities may be in the best interests of members, so not providing them may be a breach of s601FC of the Corporations Act; and

(d) the proposal may create significant challenges for responsible entities that are part of corporate groups.

143 We replaced the proposed restriction on guarantees and indemnities with the requirement for the responsible entity to estimate the maximum liability of any guarantee provided by the responsible entity, which is not limited to scheme assets, and to exclude this amount from the NTA calculation. This enables the NTA to better reflect the operational risk of the responsible entity, while maintaining flexibility for responsible entities to provide such guarantees, where appropriate.

Increased period for cash flow projections

144 There was general support for increasing the period of cash flow projections to 12 months. However, a number of respondents suggested that holding monthly board meetings merely to update the forecasts was not operationally efficient, and requested clarification on how often they must be updated and the timing of the approval by directors. We have made amendments such that rolling 12-month forecasts are to be updated and approved quarterly.

Increasing the minimum NTA capital requirement

145 Most respondents agreed with our proposal to increase the minimum NTA capital requirement. Some respondents expressed concerns about the impact the proposal would have on their costs and that the minimum requirement of $150,000 was too high. However, some suggested the minimum was significantly too low and that they would prefer a minimum up to $1 million.

146 Many of the respondents suggested that the proposed changes would lead to consolidation in the industry and a loss of competition, and may discourage new responsible entities from entering the market. These concerns were largely acknowledged in CP 140, with ASIC noting that this would result in better capitalised and more stable responsible entities, which are likely to become more remote from non-scheme related activities.

Use of gross revenue in the NTA requirement

147 Many respondents felt that the use of gross revenue did not accurately reflect the risk a responsible entity faces, and that the current FUM model is well understood and is less susceptible to ‘creative accounting’ and fluctuation than revenue. Given the feedback received, we propose to retain elements of the existing FUM framework, albeit with the addition of a secondary test that uses average gross revenue, where this would produce a higher NTA requirement than using the existing FUM calculation, and would more appropriately reflect the operational risk of the responsible entity.

NTA liquidity requirement

148 There was a mixed response to the proposed NTA liquidity requirement. Approximately one-third of respondents supported, one-third opposed and one-third did not comment on the proposal. Most support was received from smaller responsible entities and most opposition was from larger responsible entities. A number of respondents suggested that holding 50% of required NTA in cash or cash equivalents was onerous. It was suggested that:

(a) this amount should be linked to a responsible entity's actual cash and/or unanticipated cash needs over the forward six months; and

(b) it may not reflect a responsible entity's level of risk and may be an inefficient use of capital.

149 We have considered these responses, but believe that the NTA liquidity requirement is designed to address unanticipated risk and, as such, linking the amount required to cash flow or costs would not achieve our objective.

Transition period

150 A number of respondents suggested that a transition period of 24 months would be appropriate for implementation of the proposals, given the time required to unwind guarantees and indemnities. However, with our decision not to proceed with the prohibitions on guarantees and indemnities, we are of the view that 12 months is a fair and reasonable timeframe, with relief for extension possible in exceptional circumstances.

Further consultation

151 We subsequently directly consulted on a confidential basis with 11 respondents regarding the submissions received and our proposed responses. These respondents were a mix of responsible entities and representative bodies or respondents who had discussed the proposals with a number of clients. For example, we met with a number of internal committees of the FSC, which has 135 members. We met with legal and auditing firms, whose submissions noted that they had discussed the proposals with a number of their clients in preparing their submissions.

152 We generally received a positive response to the amended proposals detailed in Option 1 above—in particular, the removal of the proposed prohibition on guarantees and indemnities.

153 We also obtained feedback from advisory firms on the drafting of the proposed new financial requirements and some of the cost implications regarding the proposals.

D Conclusion and recommended option

154 There is significant uncertainty surrounding the quantitative whole-of-industry costs and benefits. However, ASIC recommends Option 1 because, on the qualitative evidence available, it addresses the identified problems and achieves ASICS's objectives.

155 We consider Option 1 achieves our objectives because this option will:

(a) ensure that responsible entities have more financial resources and are better able to meet their operating costs (e.g. the costs of ensuring compliance with the Corporations Act) throughout the life of their schemes through more robust cash flow forecasting, greater levels of capital and liquidity, and capital levels better reflecting the operational risk of a responsible entity;

(b) align the interests of responsible entities and scheme investors by imposing increased minimum NTA and higher capital requirements so that responsible entities are entities of substance with sufficient capital at risk to provide responsible entities with a real incentive to successfully manage scheme assets;

(c) ensure Australia provides comparable investor protection to other leading financial services centres and comparable regulatory regimes by increasing the minimum NTA requirement and better aligning the NTA requirement with operational risk to enhance investor confidence in Australia's reputation as an attractive financial services centre;

(d) provide increased levels of assurance that, if a responsible entity does fail, there will be more money available for the orderly transition to a new responsible entity or for winding up schemes; and

(e) secure accurate and efficient reporting of NTA requirements, actual NTA, average values of scheme property, average gross revenues and cash or cash equivalents to assist ASIC and the managed investment industry have access to meaningful and accurate data on the industry for reporting and analytical purposes and the representation of the industry.

156 We conclude that the benefits of Option 1 on balance outweigh its costs as follows:

(a) the likely enhancement of investor confidence in the managed investment industry flowing from responsible entities being more stable as a consequence of being required to prepare longer and more accurate 12-month cash flow forecasts outweighs any additional costs to responsible entities and investors associated with preparation of the cash flow forecasts;

(b) the benefits to investors, responsible entities, the managed investment industry and Government from enhancing responsible entity compliance with the Corporations Act, better aligning the interests of responsible entities with their investors, enhancing the alignment of the NTA requirement with operational risk, providing better incentives for responsible entities to want to succeed, reducing the risk of responsible entity failure and providing a larger pool of capital to fund the orderly transition of scheme assets or winding up of the scheme upon failure, that arises in relation to the new method of calculating the NTA requirement, being the greater of $150,000, 0.5% of FUM or 10% of gross revenue, removing the cap of $5 million, and the exclusion from the NTA calculation of eligible undertakings from listed parent entities and the value of personal guarantees, outweigh any additional costs to responsible entities and investors incurred in complying with these requirements;

(c) the benefit to investors, responsible entities and the managed investment industry of responsible entities being more liquid and capable of managing unanticipated circumstances, which will result from the new liquidity requirement to hold 50% of the NTA requirement in cash or cash equivalents, and the balance in liquid assets, outweighs the additional costs to responsible entities of being required to hold the NTA requirement in cash or liquid assets; and

(d) the improvement to ASIC and the managed investment industry's capacity to accurately report and analyse data on the managed investment industry and represent the industry outweighs the additional cost to responsible entities of providing the additional data.

157 On this basis, ASIC recommends Option 1.

E Implementation and review

Implementation

158 ASIC proposes to use its modification power to modify the law to implement the new requirements on all responsible entities. We did not formally consult on this proposed methodology for implementation, but did informally discuss the issue with some respondents. No objections were raised during those discussions.

159 We typically use our modification power to grant relief, but we have used our modification power to impose new requirements in relation to short selling and credit legislation. Exercise of our modification power is an efficient mechanism to effect the proposed changes. The use of the modification powers means that the changes will be effected through a class order. The class order is a disallowable instrument and is reviewable by the Senate. This means that the Senate could disallow the proposal if it objected to it. Implementation will occur by early November 2011, with the new requirements commencing 1 November 2012.

160 The other implementation method considered by ASIC was varying the individual AFS licence conditions of each responsible entity. However, this method is inefficient because each responsible entity could request a hearing in relation to the varying of their licence conditions, which could be a significant drain on ASIC's resources if all 600 licensees that are authorised to act as responsible entities sought a hearing.

161 We will, on a case-by-case basis, but only when a responsible entity can demonstrate extenuating circumstances, provide responsible entities with a further transition period of 12 months to 1 November 2013. When the new NTA requirement is unreasonably burdensome having regard to the circumstances of a particular responsible entity, we may also consider granting temporary relief from some or all of the new financial resource requirements.

162 We will provide guidance and a summary of these proposals in a draft updated RG 166. This draft RG 166 is expected to be published in early November 2011. Furthermore, we will also publish a draft updated PF 209 at the same time. These draft versions of RG 166 and PF 209 will be published as Appendices 1 and 2 to REP 259. This will enable all existing responsible entities to understand the financial resource requirements that will apply to them from 1 November 2012. It will also enable prospective responsible entities to fully assess what financial resource requirements will apply to them from 1 November 2012.

Review

163 We will continue to monitor compliance by responsible entities with their financial resource requirements through breach reporting by the responsible entity and by the auditor and when conducting individual surveillances. We propose to monitor and review the effectiveness of the proposed new financial resource requirements within three years of their application and may subsequently make alternative proposals to enhance the effectiveness of the changes as required.