ASIC

Australian Securities & Investments Commission

REPORT 259

Response to submissions on CP 140 Responsible entities: Financial requirements

November 2011

About this report

This report highlights the key comments received in the submissions on Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140) and details our responses to those comments.

About ASIC regulatory documents

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

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

Regulatory guides: give guidance to regulated entities by:

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

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

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

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

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A Overview/Consultation process

1 In Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140), we set out our proposals on the financial requirements that should apply to Australian financial services (AFS) licensees that act as a responsible entity for registered managed investment schemes.

2 The present licensing provisions of the *Financial Services Reform Act 2001* commenced on 11 March 2002. Under this regime, responsible entities of registered managed investment schemes are required to obtain an AFS licence which 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, among other things, the obligation 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).

3 As a part of our role as regulator of the financial services industry, we are responsible for setting the minimum financial resource requirements that an AFS licensee must meet. These requirements are imposed 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).

4 As outlined in RG 166, in setting the financial requirements, we seek to set minimum standards that are framed as clearly and simply as possible so as to provide certainty. Balanced against the need for responsible entities to have sufficient resources to support the responsible management of other people's money is the need to avoid an unreasonable burden to maintain a level of assets and an unjustifiable barrier to market entry for providing different kinds of financial services.

5 The proposals in CP 140 were aimed at providing a structured approach to dealing with both expected and unexpected risks across a 12-month forecast period. We proposed to:

(a) restrict guarantees and indemnities to maximise the likelihood that a responsible entity will survive the insolvency of other entities, including a parent or related entity;

(b) require rolling 12-month cash flow projections to increase the visibility of cash flow issues in a 'business as usual' situation; and

(c) change both the amount and the liquidity provisions of the net tangible assets (NTA) requirements to ensure adequate resources are available to assist responsible entities to address unexpected situations over the full 12-month projection period.

6 This report highlights the key comments contained in the submissions received on CP 140, and during subsequent industry consultation, and our responses to those comments.

7 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 140. We have limited this report to the key issues.

8 For a list of the non-confidential respondents to CP 140, see page 16 of this report. Copies of the non-confidential submissions are on the ASIC website at www.asic.gov.au/cp under CP 140.

Responses to consultation

9 We received 48 responses to CP 140 from a wide variety of sources, including from responsible entities themselves, relevant industry bodies, accounting firms and law firms. We are grateful to respondents for taking the time to provide us with their comments.

10 The majority of respondents agreed with the need to revisit the financial resource requirements imposed on responsible entities. Many felt the financial resource requirements, introduced in 2002, were outdated and a review of the requirements was both necessary and appropriate. In addition, some respondents suggested focus should be given to the establishment of an insolvency regime for the managed investment scheme sector.

11 Some respondents suggested a more complex risk assessment framework should be developed to identify varying risk levels and capital requirements in relation to those risk levels.

12 Some respondents warned that we should be cautious not to impose overly onerous conditions on responsible entities, which would stifle the entry of new participants, lessen competition domestically and reduce the Australian investment management sector's competitiveness globally.

13 Comments on the proposals included the following:

(a) There was general disagreement with the proposal to restrict guarantees and indemnities due to the impracticalities associated with implementation.

(b) Respondents recognised the need and beneficial effects for the business of preparing 12-month cash flow forecasts but some sought clarification on the frequency and timing of the projections.

(c) The majority of respondents agreed with the need for an increase in the NTA capital requirements. However, there were varying opinions on the level of minimum capital required, the use of funds under management versus average gross revenue in the NTA calculations, and the imposition of a cap in the NTA requirement.

(d) We received mixed responses on the NTA liquidity requirements. Many provided no comments. Some felt the 50% liquidity requirement may be too onerous, while most agreed that a six-month realisation period for liquid assets was appropriate.

(e) Most respondents agreed with a transition period of between 12 months and 24 months.

(f) There was general consensus that implementing the proposals would increase compliance costs for responsible entities.

14 After assessing the responses, we conducted a further phase of consultation. We met with approximately 11 respondents with varied industry involvement and provided a summary of the major comments and our proposed responses to these comments. The feedback during the additional consultation phase appeared generally to be positive, although some re-emphasised their submission responses.

Summary of ASIC's response

In response to the comments raised, we have:

- replaced the proposed restriction on guarantees and indemnities with the requirement for responsible entities to exclude from NTA calculations and capital requirements the maximum liability under any guarantees not provided by the responsible entity except for guarantees that are limited to scheme assets or between stapled group members;
- provided clarification on the frequency and timing of cash flow forecasts;

- adopted the NTA capital requirements in Option 1 with a modification—that is, the greater of $150,000, 0.5% of the average value of scheme property (capped at $5 million), or 10% of the average responsible entity revenue (with no maximum);
- proceeded with proposal B(4) requiring responsible entities to hold all of their NTA capital requirement in liquid assets with 50% of the required NTA as cash or cash equivalents; and
- provided guidance that the new requirements will apply from 1 November 2012, with consideration to be given in exceptional circumstances to applications for relief.

Note: See the draft updated versions of RG 166 and PF 209, which form Appendices 1 and 2 to this report. The requirements or licence conditions in these draft documents will not apply until November 2012.

We acknowledge the comments about the likely increases in compliance and operating costs, but we consider the changes are appropriate and necessary to:

- ensure that a responsible entity has adequate financial resources to meet its operating costs throughout the life of its schemes;
- align the interests of responsible entities and scheme investors by ensuring that responsible entities have sufficient equity in the business to have a real incentive to ensure its success;
- ensure that Australia provides comparable investor protection with other leading financial centres and comparable regulatory regimes;
- limit the risk that a responsible entity will become insolvent because it has assumed liability for the debts of others, including members of its corporate group; and
- provide some level of assurance that, if the responsible entity does fail, there is money available for the orderly transition to a new responsible entity or to wind up the scheme.

B Our proposals

Key points

This section summarises the feedback we received in response to the proposals in CP 140 and the changes we have made to RG 166 as a result of our consultation.

Restricting guarantees and indemnities

15 To maximise the likelihood that responsible entities could survive the insolvency of a parent, related entity or other third party, in CP 140 we proposed to prohibit responsible entities from providing certain guarantees and indemnities.

16 The majority of respondents disagreed with this proposal. Many argued that the activities of responsible entities in relation to a scheme are already heavily regulated, including by the application of statutory and fiduciary duties (such as the duty to act in the best interests of members), conflict rules and Ch 2E of the Corporations Act (in relation to related party rules), which provide sufficient legal protection to members.

17 Many respondents noted that the nature of operations of a responsible entity requires the provision of certain guarantees and indemnities, with many being incidental to carrying out their business. Therefore, it would be difficult for responsible entities to operate schemes commercially without undue limitations—for example, for arrangements between stapled entities and for the benefit of subsidiaries.

18 Many noted that there are a significant number of guarantees and indemnities already in place, and that to renegotiate, unwind and restructure all of them would be expensive and in many instances unnecessary.

19 Respondents from agribusiness schemes noted that the structure and conduct of forestry projects are in accordance with the Product Ruling issued by the Australian Taxation Office (ATO). Changes to a scheme's operating structure, including variation of material contracts, may require referral back to the ATO to ensure the Product Ruling continues to apply.

20 No respondents provided specific numbers associated with additional costs, but many indicated that the proposal would result in significant increases in operating costs. The increases would be primarily driven by the need to:

(a) identify all arrangements and renegotiate arrangements;

(b) apply for a new AFS licence so that non-responsible-entity-related activities can be conducted by other entities within the corporate group; and

(c) restructure operations.

ASIC's response

In response to the comments received, we have replaced the proposed restriction on guarantees and indemnities with the requirement for responsible entities to exclude from NTA calculations and capital requirements the maximum liability under any guarantees not provided by the responsible entity except for guarantees limited to scheme assets or between stapled group members. We have done this on the basis that:

- the estimated cost of implementing the proposal to restrict guarantees and indemnities on an industry-wide basis would outweigh the benefits it may achieve;
- there is already significant protection under the Corporations Act (e.g. the requirement to act in the best interest of members and related party requirements);
- the restriction may impose undue limitations and be commercially imprudent; and
- exclusion of the maximum liability under proposed guarantees provided by the responsible entity in the NTA calculations avoids the NTA capital requirement being undermined when personal guarantees are called, without restricting a responsible entity's discretion to provide such guarantees.

Please see Class Order [CO 11/1140] *Financial requirements for responsible entities* for more detail.

Note: See also the draft updated versions of RG 166 and PF 209, which form Appendices 1 and 2 to this report. The requirements or licence conditions in these draft documents will not apply until November 2012.

Requiring rolling 12-month cash flow projections

21 Cash flow projections are an important tool in identifying potential risks to a business. In CP 140, we proposed the introduction of a requirement for longer cash flow projections for responsible entities. We proposed that responsible entities should be required to prepare, and make available to ASIC on request, rolling cash flow forecasts with anticipated revenue and expenses over at least 12 months, and that these should be approved by the directors of the responsible entity.

22 The majority of respondents agreed with the proposal. Many respondents supported a higher level of governance surrounding cash flow forecasts for the purpose of demonstrating that responsible entities can meet anticipated expenses. Most did not dispute the need for, or importance of, directors considering at least a 12-month timeframe for cash flow forecasting.

23 Some respondents sought clarification on how often the forecasts needed to be updated and the timing of the approval by the directors.

24 Some respondents noted that the quality of the cash flow forecasts would be limited to the robustness of the assumptions used.

25 Most respondents indicated that there would be a minor increase in costs due to changes to systems and processes, and increased administration costs associated with preparing and approving forecasts.

ASIC's response

In response to the comments received, we have clarified that a responsible entity is required to update its cash flow forecast when there is a material change, in addition to a 12-month timeframe forecast. Directors will need to review and approve any updated cash flow forecasts on at least a quarterly basis.

Note: See the draft updated versions of RG 166 and PF 209, which form Appendices 1 and 2 to this report. The requirements or licence conditions in these draft documents will not apply until November 2012.

We acknowledge that the quality of the cash flow forecasts will be limited to the robustness of the assumptions used. Responsible entities must document their calculations and assumptions used in the cash flow forecasts, and describe in writing why they are the appropriate assumptions. We believe that this, in combination with the quarterly review by directors and an annual review by auditors, will strengthen the robustness of the assumptions used.

We acknowledge the comments about the possible increase in compliance costs. However, we believe the benefits outweigh the increase in compliance costs in this instance.

Increasing the NTA capital requirements

26 AFS licensees that act as responsible entities should have adequate resources available:

(a) to meet their operating expenses;

(b) to be sufficiently motivated in ensuring the success of the business; and

(c) to assist with an orderly transition to a new responsible entity or winding-up of the scheme if the responsible entity fails.

In CP 140, we proposed to increase the NTA capital requirements of the responsible entity.

27 There was general acknowledgement from respondents that some changes to the existing financial resource requirements were both necessary and appropriate.

28 While the majority of respondents agreed with the need to increase the minimum NTA capital requirement, there were varying opinions on what the amount should be. Typically, the larger market participants favoured a

minimum NTA capital requirement between $0.5 million and $1 million, while smaller market participants favoured an amount closer to $150,000.

29 Several respondents suggested the possible inclusion of a cap on the proposed NTA capital requirement. Larger responsible entities, on average, have more sophisticated risk management and governance processes in place. As a result, they noted the non-linear and decelerating relationship between the funds under management and a responsible entity’s operational risks beyond a certain point. They argued that having a linear uncapped NTA capital requirement would not properly take into account this relationship.

30 Many respondents favoured maintaining the current use of funds under management, and there was strong resistance to the use of average gross revenue in the calculation of the NTA capital requirement. Primary concerns associated with the use of average gross revenue were:

(a) the inclusion of revenue that is passed on to third-party service providers;

(b) the lack of a clear definition for ‘average gross revenue’, providing the potential for certain entities to use ‘creative accounting’ in deriving the NTA capital requirements; and

(c) certain revenue (e.g. performance fees) being highly variable and therefore hard to forecast.

31 Some respondents also expressed concerns about the deeming provisions and proposed deeming rates. Because of the varying fee structures on different investment products, a deeming rate set at between 1% and 2% may lead to a significant increase in the NTA capital requirement for some responsible entities. This may not be commercially sustainable and would be especially relevant to responsible entities that specialise in products that are volume driven with a relatively low ratio of income to funds under management.

32 Some respondents were concerned about excluding parent entity eligible undertakings that may be included in the NTA calculation. This may limit a responsible entity’s ability to undertake other services, or reduce already limited guarantee lines.

33 Some respondents, notably from those entities that are also regulated by Australian Prudential Regulation Authority (APRA), were concerned that some of the proposals could lead to significantly different financial requirements being imposed on APRA-regulated and non-APRA-regulated entities, in addition to possible double counting of capital requirements.

34 Some respondents noted that existing schemes were offered to investors based on the existing minimum NTA capital requirement, and that increasing this mid-way through a fixed-life scheme may cause a responsible entity to be unable to comply with its AFS licence conditions and adversely affect its members’ interests.

35 Some respondents suggested alternative approaches to the calculation of the NTA capital requirements, including:

(a) increasing the NTA capital requirements, but on a sliding scale to properly reflect the decelerating relationship between the scale of a business and the risks; and

(b) adopting a qualitative model that factors in operating risk and the depth of experience of the management team.

ASIC's response

We have adopted the NTA capital requirements in Option 1—that is, the greater of $150,000, 0.5% of the average value of scheme property (capped at $5 million), or 10% of the average responsible entity revenue (with no maximum). We have amended this option (as shown) so that the NTA requirement is calculated using average responsible entity revenue rather than average gross revenue. Definitions of 'average RE (responsible entity) revenue' and 'average value of scheme property' are provided in the updated RG 166.

Note: See the draft updated versions of RG 166 and PF 209, which form Appendices 1 and 2 to this report. The requirements or licence conditions in these draft documents will not apply until November 2012.

We believe the current minimum requirement of $50,000 is no longer sufficient and a minimum of $150,000 is needed to ensure a responsible entity has adequate financial resources to meet its operating costs and obligations.

We have not adopted a cap on the NTA capital requirement. We acknowledge that:

- the relationship between the scale of a business and its operational risks is unlikely to be linear, but operational risks still exist beyond the cap, and this risk would not be reflected in capital requirements if a cap were imposed; and
- a cap may encourage a responsible entity to continue to use the entity for non-responsible-entity-related activities, introducing new risks that may affect a responsible entity's ongoing ability to meet its statutory obligations to scheme members.

We have included revenue in the calculation of the NTA capital requirement under Option 1. We believe revenue is a good indicator of a responsible entity's operating risks because:

- the primary resource for meeting a responsible entity's duties and obligations are the income generated from managing the scheme property, rather than the amount of scheme property under management; and
- any outsourcing through contractual agreements does not relieve a responsible entity from its obligations in the Corporations Act, which imposes ultimate responsibility for all aspects of managing investors' funds on the responsible entity, irrespective of whether certain of these functions have been outsourced. Accordingly, the NTA capital requirements reflect a responsible entity's legal obligations.

> We have replaced the deeming provision with the requirement for the NTA calculation to be the aggregate of actual revenue and any amount paid by the scheme (excluding actual responsible entity revenue) for the performance of the responsible entity's obligations.
>
> We have maintained our proposal to exclude the parent entity eligible undertakings from the NTA calculations. The purpose of the NTA capital requirement is to ensure the responsible entity has adequate resources available to it on a stand-alone basis to meet its obligations in both expected and unexpected situations.
>
> We appreciate the alternatives suggested by some respondents on the calculation of the NTA capital requirement. Each alternative presented had merit. However, most would require a significant deviation from the existing financial resource requirements framework and analysis of appropriate risk segregation and costing. Furthermore, the alternatives may require responsible entities to undertake significant system changes, which may be burdensome.
>
> ASIC and APRA have discussed the consultation responses, noting the preference for consistency between APRA and ASIC policies, and the issues around the duplication of resource requirements for responsible entities and registered superannuation entities. We continue to believe that ASIC's method of calculating the NTA capital requirements is the most appropriate approach for responsible entities.

Specifying the NTA liquidity requirements

36 A responsible entity should have adequate cash on hand to address unexpected and immediate cash requirements. In CP 140, we proposed that responsible entities should be required to hold all of their NTA capital requirement as liquid assets, with 50% of the required NTA as cash or cash equivalents (with a minimum of $150,000), to assist them in meeting unexpected and immediate cash requirements.

37 The majority of respondents were supportive of this proposal. Some others noted, to the extent the NTA capital requirement is capped, they would support the proposal. Few other respondents expressed concerns about the amount required to be held in cash and cash equivalents for the purpose of satisfying the NTA liquidity requirement.

38 Some respondents felt the requirement to hold 50% of NTA in cash or cash equivalents may be onerous. Reasons given included:

(a) this amount may not have any direct link to a responsible entity's actual cash and/or unanticipated cash needs for the forward six months. It would be more appropriate to link it to costs and/or cash flows rather than net assets;

(b) this amount may not reflect a responsible entity's track record of financial responsibility, nor the risk associated with the products or markets it deals in (i.e. the requirement may be appropriate for higher-risk responsible entities, such as newly established responsible entities or those with limited experience and/or operating in riskier financial markets or products); and

(c) it is an inefficient use of capital.

39 Some respondents suggested that eligible undertakings used to meet the NTA capital requirement should be included as cash and cash equivalents for the purpose of satisfying the NTA liquidity requirement.

40 The majority of respondents agreed that the six-month realisation period for the remaining 50% of assets was appropriate. Some respondents suggested that a 12-month period was preferable because this would be consistent with the concept of 'current' in accounting standards.

ASIC's response

In response to the comments received, we have adopted our proposal on the amount required to be held in cash and cash equivalents for the purpose of satisfying the NTA liquidity requirement. We have also adopted the suggestion to include eligible undertakings used to meet the NTA capital requirement as cash and cash equivalents. In updated RG 166 and [CO 11/1140], we provide the definition of 'cash and cash equivalents', and 'liquid assets'.

In response to the comments that the requirement to hold 50% of NTA in cash or cash equivalents may be onerous, and that it may be an inappropriate reflection of a responsible entity's risk or may not have any direct link with the entity's cash needs, we note that the NTA liquidity requirement is designed to address unanticipated risk. Linking the NTA liquidity requirement to cash flow would not achieve the objective of ensuring that capital is accessible when unanticipated events occur.

We continue to believe that the use of six months as the realisation period for the remaining assets is appropriate because any realisation period set at more than six months would not adequately address the unexpected cash needs of a responsible entity.

Note: See the draft updated versions of RG 166 and PF 209, which form Appendices 1 and 2 to this report. The requirements or licence conditions in these draft documents will not apply until November 2012.

C Proposed implementation and transition period

Key points

In CP 140, we considered it appropriate for the proposed reforms to be implemented as soon as practicable. Some businesses may require restructuring or recapitalisation to meet the revised requirements. We have decided that the new requirements will commence on 1 November 2012, with relief for extension to be considered in exceptional circumstances.

41 In CP 140, we proposed to:

(a) make the proposals effective for new responsible entities from 1 July 2011; and

(b) implement a transition period for existing responsible entities.

42 A transition period of either 12 months until 1 July 2012 or 24 months until 1 July 2013 was proposed.

43 Some respondents, primarily responsible entities, indicated a 24-month transition period was preferred and necessary. Most professional service firms did not express a preference between a 12-month and 24-month transition period.

ASIC's response

In response to the comments received, and in view of our decision not to adopt the proposed restriction on guarantees and indemnities, we have decided that the new requirements will apply from 1 November 2012. This period allows responsible entities sufficient time to restructure operations and raise funds to comply with the revised financial resource requirements, if necessary.

Relief for extension beyond 1 November 2012 may be granted under exceptional circumstances.

List of non-confidential respondents

- Accor Vacation Club
- Allens Arthur Robinson
- Alliance RE Ltd
- Australian Ethical Investment Limited
- Australian Plantation Products and Paper Industry Council
- AXA Asia Pacific Holdings Limited
- Baker and McKenzie
- Barringtons House
- Blaxland Vineyards Limited
- Bunnings Property Management Limited
- Commonwealth Bank
- Financial Services Council
- First Capital Markets Pty Ltd
- Freehills
- Harwood Andrews Pty Ltd on behalf of Banksia Mortgages Ltd
- Hughes, Harold
- Kelly, Alexander (Jamie)
- KPMG
- Launch Advisory
- Lennie, Owen S, Consultant to Timbercorp Growers Group
- McCullough Robertson
- McMahon Clarke Legal on behalf of ADPIA
- National Australia Bank Limited
- National Information Centre on Retirement Investments Inc
- One Vue Limited
- Property Council of Australia
- Transurban
- Trustee Corporations Association of Australia

List of appendices

The following appendices to this report may be downloaded and printed separately:

- Appendix 1 to REP 259: *Draft RG 166 Financial requirements, including requirements for REs that will apply from Nov 2012*
- Appendix 2 to REP 259: *Draft PF 209 AFS licence conditions that will apply from Nov 2012*.

For more information, including the related media release, go to www.asic.gov.au.

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