



**ASIC**

Australian Securities & Investments Commission

**REPORT 293**

# **Response to submissions on CP 156 Retail OTC derivative issuers: Financial requirements**

July 2012

## **About this report**

This report highlights the key issues that arose out of the submissions received on Consultation Paper 156 *Retail OTC derivative issuers: Financial requirements* (CP 156) and details our responses in relation to those issues.

### 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.

This report does not contain ASIC policy. Please see Regulatory Guide 239 *Retail OTC derivative issuers: Financial requirements* (RG 239).

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## A Overview/Consultation process

- 1 In Consultation Paper 156 *Retail OTC derivative issuers: Financial requirements* (CP 156), we consulted on proposed financial requirements for issuers of over-the-counter (OTC) derivatives to retail clients (retail OTC derivative issuers) under their Australian financial services (AFS) licences.
- 2 This report highlights the key issues that arose out of the submissions received to CP 156 and our responses to those issues. Our final guidance is contained in Regulatory Guide 239 *Retail OTC derivative issuers: Financial requirements* (RG 239).
- 3 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 156. We have limited this report to the key issues.
- 4 For a list of the non-confidential respondents to CP 156, see the appendix. Copies of the submissions are on the ASIC website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp) under CP 156.

### Our proposals

- 5 Under our proposals in CP 156, retail OTC derivative issuers would be required to meet the following financial requirements.

#### **Cash needs requirement (12-month cash flow forecasts)**

- 6 A retail OTC derivative issuer would be required to:
  - (a) prepare, on a quarterly basis, rolling cash flow forecasts with anticipated revenue and expenses over at least 12 months at an individual entity level in a ‘business-as-usual’ situation;
  - (b) make the cash flow forecasts available to ASIC upon request;
  - (c) have the cash flow forecasts approved by the directors of the issuer;
  - (d) document its calculations and assumptions, and describe in writing why they are the appropriate assumptions;
  - (e) update the projection of cash flows if it has reason to suspect that an updated projection would show it was not meeting its licence conditions; and
  - (f) show, based on the projection of cash flows, that it will have access as needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months, including any additional liabilities it might incur during that term.

## Net tangible assets (NTA) requirement

- 7 A retail OTC derivative issuer would be required to have at all times net tangible assets (NTA) of the greater of:
- (a) \$1,000,000; or
  - (b) 10% of its average revenue.
- 8 Of the required NTA, 50% would need to be held in cash or cash equivalents (excluding cash in client segregated or trust accounts) and 50% in liquid assets.
- 9 The issuer would be required to report its NTA position, together with workings, to ASIC as part of its profit and loss statement and balance sheet lodged with ASIC under s989B of the *Corporations Act 2001* (Corporations Act).

## Reporting requirements

- 10 If an issuer's NTA is 110% or less of the required NTA, the issuer would be required to report this to ASIC and continue reporting on a monthly basis until its NTA is above 110% of the required NTA.
- 11 If an issuer's NTA is less than 100% of the required NTA, the issuer would be required to replenish its NTA to above 100% within two months of the date the deficiency arose and, failing this, disclose the deficiency to its clients.
- 12 If an issuer's NTA is 75% or less of the required NTA, the issuer would not be permitted to enter into any transactions with clients that could give rise to any liabilities, contingent liabilities or financial obligations, until its governing body had certified in writing that, having conducted reasonable inquiries into its financial position, there was no reason to believe that it will fail to comply with its licence obligations.

Note 1: These requirements do not supersede, and are in addition to, issuers' obligations under the Corporations Act to notify ASIC of significant breaches (s912D) and to disclose to clients material changes and significant events (s1017B): see RG 239.

Note 2: We intend to implement revised reporting requirements that differ from those proposed in CP 156. The revised reporting triggers are explained in Section B of this report.

## Responses to consultation

- 13 We received two confidential responses and one non-confidential response from retail OTC derivative issuers and one response from the Australian Financial Markets Association. We are grateful to respondents for taking the time to send us their comments.
- 14 The main issues raised by respondents related to:
- the adequacy of the minimum amount of required NTA (\$1 million);

- the ability of retail OTC derivative issuers that are prudentially regulated overseas to apply for relief from the financial requirements;
- the effect on issuers that have a branch structure of calculating the required NTA based on the issuer's average revenue;
- concerns that excluding only money held in client segregated or trust accounts when calculating the required NTA may encourage issuers to transfer excess money out of these accounts; and
- concerns that requiring issuers to calculate cash flow forecasts on an individual entity level, rather than on a group basis, may disadvantage corporate groups.

- 15 In addition to our consultation on CP 156, in August 2011, we sent a questionnaire to retail OTC derivative issuers that would be affected by the proposed financial requirements. We invited these issuers to voluntarily complete the questionnaire, which asked for information about the financial impact on issuers of complying with the proposed requirements.
- 16 The questionnaire also sought issuers' comments on how they thought the proposed financial requirements would affect the retail OTC derivative sector generally. Where relevant, we have discussed these responses, in general terms, in Section B of this report.

## B Proposed financial requirements for retail OTC derivative issuers

### Key points

In CP 156, we proposed to apply the following financial requirements to retail OTC derivative issuers:

- a cash needs requirement for rolling 12-month cash flow forecasts;
- an NTA requirement; and
- tailored reporting requirements.

Feedback on our proposals was generally positive, but some submissions argued that aspects of the requirements should be changed to accommodate particular business structures or models. Other submissions argued that aspects of the NTA requirement were inadequate.

### Cash needs requirement (12-month cash flow forecasts)

- 17 In CP 156, we proposed that the current cash needs requirement for all AFS licensees in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) be replaced by a requirement for retail OTC derivative issuers to maintain, at the individual entity level, rolling 12-month cash flow forecasts, created on a business-as-usual basis and updated monthly and approved by the issuer's directors. Using these forecasts, issuers would need to demonstrate that they can meet their financial obligations when they fall due.
- 18 The submissions were broadly supportive of this requirement. However, some submissions raised concerns about aspects of the proposals.

#### Entity level forecasting

- 19 Some submissions noted that the requirement to forecast cash flows on an individual entity basis limited the flexibility for corporate groups that include a retail OTC derivative issuer to undertake cash flow planning on a group-wide basis.

#### Approval of forecasts by directors

- 20 Some submissions suggested there was a need for greater guidance from ASIC on how cash flow forecasts should be approved by an issuer's directors. Respondents wanted to know how many directors would need to approve cash flow forecasts (e.g. the full board, a reduced number of directors, or a quorum

under the company's constitution). It was suggested that, for issuers with overseas directors, full board sign-off of cash flow forecasts would be difficult.

#### *ASIC's response*

We consider entity-level cash flow forecasting and, by extension, the requirement that retail OTC derivative issuers should demonstrate, on an individual entity basis, that they will be able to meet their obligations as and when they fall due is appropriate. We do not believe the objectives of the financial requirements would be met if issuers can rely on funds from a parent or associate to meet these requirements.

We do not think that ASIC should issue specific guidance on how cash flow forecasts should be approved by an issuer's directors. Rather, we would expect issuers to develop their own internal process of review, based on their existing compliance reporting frameworks, to ensure that directors approve cash flow forecasts as for other important business planning matters.

In RG 239, we also require issuers to demonstrate, based on cash flow forecasts, that they will have available adequate cash or cash equivalents to meet the NTA requirement: see paragraphs 21–27. This is to improve cash flow forecasting as a compliance tool for issuers.

## NTA requirement

- 21 In CP 156, we proposed that retail OTC derivative issuers should be required to have net tangible assets (NTA) of the greater of \$1,000,000 or 10% of the issuer's average revenue. We proposed that half of the required NTA should be held as cash or cash equivalents (excluding cash in client segregated or trust accounts) and the other half in liquid assets.

Note: For definitions of the terms used in calculating the required NTA, see Section C of RG 239.

- 22 The submissions were broadly supportive of the proposed NTA requirement. However, some submissions raised concerns about aspects of the proposals.

### **Adequacy of minimum required NTA**

- 23 Some submissions argued that the proposed minimum amount of \$1 million NTA was inadequate to ensure that retail OTC derivative issuers can operate their businesses in compliance with the Corporations Act.
- 24 However, responses to our follow-up questionnaire expressed differing views on this issue. While larger, more established issuers again suggested a higher minimum requirement (many argued that \$5 million was reasonable), some smaller issuers argued for a lower minimum requirement.



### Calculation of NTA for issuers that operate as a branch

- 25 There was some concern that calculating the required NTA based on the issuer's average revenue would disadvantage issuers that operate as a branch of an overseas company. This is because the issuer's average revenue, for the purposes of calculating the required NTA, would include revenue derived from overseas clients that are not clients of the branch. It was submitted that, for branch structures, the required NTA should be based on the branch's average revenue, rather than the issuer's.

### Exclusion of money held in client segregated or trust accounts

- 26 Concerns were raised that if only amounts held in client segregated or trust accounts were excluded in calculating the required NTA (including the proportion to be held as cash or cash equivalents), some issuers may transfer excess amounts of client money from these accounts into broker accounts held with hedging counterparties.
- 27 The excess cash balances held with counterparties could then be counted towards the cash portion of the required NTA, even though this money would ultimately be paid back to clients. This practice could cause detriment to clients, as client money not held in client segregated or trust accounts loses some of the protections afforded to it under the Corporations Act.

#### *ASIC's response*

In formulating the financial requirements, we seek to ensure that issuers have adequate resources to operate their businesses in compliance with the Corporations Act, while not unnecessarily increasing barriers to entry or reducing competition. We consider that the minimum required NTA strikes an appropriate balance.

For issuers that operate as a branch, we believe it is appropriate for these issuers to use their total revenue in calculating the required NTA. This is because Australian retail clients could be affected by operational risk and other events involving the corporate entity, not merely the risk within the branch.

We have changed the definition of 'cash or cash equivalents' in RG 239 to exclude any cash or cash equivalents that are owed or payable to clients. This is to address concerns about issuers holding excess client money in accounts with hedging counterparties, rather than in client segregated or trust accounts.

## Reporting requirements

- 28 In CP 156, we proposed that if an issuer's NTA is:
- (a) 110% or less of the required NTA, it must report to ASIC on a monthly basis;
  - (b) less than 100% of the required NTA, it must replenish its NTA to above 100% within two months of the date the deficiency arose and, failing this, disclose the deficiency to its clients; and
  - (c) 75% or less of the required NTA, it must not enter into any transactions with clients that could give rise to any liabilities, contingent liabilities or financial obligations, until its governing body has certified in writing that, having conducted reasonable inquiries into its financial position, there is no reason to believe that it may fail to meet its licence obligations (certification requirement).

Note: These requirements do not supersede, and are in addition to, issuers' obligations under the Corporations Act to notify ASIC of significant breaches (s912D) and to disclose to clients material changes and significant events (s1017B): see RG 239.

- 29 Feedback on the reporting requirements was generally favourable. However, some submissions argued that some trigger points should be higher and some should be lower. In particular, feedback included the suggestions that:
- (a) issuers should be required to report to ASIC if their NTA falls below 125% of the required NTA, rather than 110%;
  - (b) issuers should be able to fall below 50% of the required NTA, rather than 75%, before being required to meet the certification requirement; and
  - (c) reporting to ASIC should not be required unless an issuer's NTA has fallen below 100% of the required NTA.

### *ASIC's response*

In setting the reporting requirements, we seek to balance:

- the regulatory cost to issuers;
- the need to provide an early warning mechanism for breaches of the NTA requirement; and
- the usefulness of reporting (i.e. so that issuers need not report to ASIC unless there is a genuine emerging concern).

To this end, we believe that 110% or less of the required NTA is an appropriate trigger point for reporting to ASIC. This is because, if an issuer's NTA falls below this level, it is quite possible that the issuer will ultimately breach the NTA requirement. As such, it is a suitable early warning mechanism. Reporting to ASIC at a higher level, such as 125%, may not have this benefit. We have also clarified that the issuer must continue reporting its NTA position to ASIC until its NTA is greater than 110% of the required NTA.

After further consideration of the current and proposed reporting requirements, we have amended the other trigger points as follows:

- If an issuer has less than 100% of the required NTA, it must:
  - replenish its NTA to above 100% within two months of the date the deficiency arose and, failing this, disclose the deficiency to its clients; and
  - not enter into any transactions with any persons to whom it provides financial services that could give rise to any further liabilities, contingent liabilities or other financial obligations, until its board of directors or other governing body has certified in writing that, having conducted reasonable inquiries into its financial position, there is no reason to believe that it may fail to meet its other licence obligations (see RG 239.34 for the full wording of this requirement).
- If an issuer has 75% or less of the required NTA, it must not under any circumstances enter into any transactions with any persons to whom it provides financial services that could give rise to any further liabilities, contingent liabilities or other financial obligations.

Note: See RG 239 and Class Order [CO 12/752] *Financial requirements for retail OTC derivative issuers*.

In our view, the viability of an issuer's business should be addressed at the most senior levels as soon as it breaches the NTA requirement. We also consider that it is an unacceptable risk for issuers to continue to take on liabilities if they have 75% or less of the required NTA.

## C Timing for implementation

### Key points

Feedback was generally supportive of the proposed timing for implementation.

However, some feedback suggested that the timeframe was too short, or that a staged implementation was unnecessary.

- 30 Respondents to CP 156 generally supported the timing for implementation. However, some respondents argued that:
- (a) the timeframe was too long, as the changes should be implemented as soon as practicable; and
  - (b) a staged implementation was not required.

### *ASIC's response*

The timing for implementation, including the staged implementation, is designed to give issuers time to take any steps needed to meet the financial requirements, such as restructuring their business or raising capital.

We consider that issuers who can currently meet the requirements without needing to take any additional steps should not receive an undue competitive advantage over issuers who require a reasonable timeframe in which to comply.

Given the time needed to finalise our guidance and complete the Australian Government's regulatory impact analysis requirements, we have changed the start date of the transition period to 31 January 2013 to give industry enough time to adjust.

## Appendix: List of non-confidential respondents

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- London Capital Group Pty Ltd trading as Capital CFDs
  - Australian Financial Markets Association
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