



**ASIC**

Australian Securities & Investments Commission

## REPORT 352

# Response to submissions on CP 194 Financial requirements for custodial or depository service providers

June 2013

### **About this report**

This report highlights the key issues that arose out of the submissions received on Consultation Paper 194 *Financial requirements for custodial or depository service providers* (CP 194) 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.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

This report does not contain ASIC policy. Please see updated Regulatory Guide 166 *Licensing: Financial requirements* (RG 166).

# Contents

<b>A</b>	<b>Overview</b> .....	<b>4</b>
	Responses to consultation.....	5
<b>B</b>	<b>Proposed financial requirements for custodians</b> .....	<b>6</b>
	Increasing the NTA capital requirement .....	6
	Responsible entities and IDPS operators .....	7
<b>C</b>	<b>Proposed financial requirements for incidental providers</b> .....	<b>9</b>
	Defining 'incidental custodial or depository services' .....	9
	NTA requirement for incidental providers .....	10
<b>D</b>	<b>Cash flow and liquidity requirements</b> .....	<b>12</b>
	Requiring 12-month cash flow projections.....	12
	NTA liquidity requirement .....	13
<b>E</b>	<b>Proposed implementation and transition period</b> .....	<b>15</b>
	<b>Appendix: List of non-confidential respondents</b> .....	<b>16</b>

## A Overview

- 1 As part of our role as regulator of the financial services industry, ASIC is responsible for setting the minimum financial requirements that Australian financial service (AFS) licensees must meet.
- 2 The financial requirements for all AFS licensees are set out in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166). They apply to AFS licensees by way of conditions on their AFS licence, or by the application of modified provisions of the *Corporations Act 2001* (Corporations Act) under ASIC class orders (e.g. Class Order [CO 13/761] *Financial requirements for custodial or depository service providers*).
- 3 In RG 166, we state that the financial requirements for AFS licensees help to ensure that:
  - (a) AFS licensees have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act (including carrying out supervisory arrangements);
  - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and
  - (c) there are incentives for owners to comply with the Corporations Act through risk of financial loss.
- 4 We have been progressively reviewing the financial requirements that apply to AFS licensees in various industry sectors. After reviewing the financial requirements for the custodial or depository services sector, we determined that new requirements may be necessary to ensure that they remain appropriate and represent the most suitable mechanisms for achieving the objectives set out in paragraph 3.
- 5 In Consultation Paper 194 *Financial requirements for custodial or depository service providers* (CP 194), we set out our proposed financial requirements for custodial or depository service providers. CP 194 also set out our proposed requirements for responsible entities of registered managed investment schemes (schemes) and platform operators that hold scheme or other property and assets (referred to in this report as ‘asset holders’).
- 6 In particular, CP 194 set out our proposals on:
  - (a) the net tangible asset (NTA) requirement for custodians;
  - (b) the NTA requirement for asset holders of registered schemes;
  - (c) the NTA requirement for asset holders of investor directed portfolio services (IDPS);
  - (d) the definition of ‘incidental custodial or depository services’;

- (e) the NTA requirement for incidental providers;
- (f) the requirement for cash flow projections; and
- (g) the NTA liquidity requirement.

- 7 This report highlights the key issues that arose out of the submissions received on CP 194, and our responses to those issues.
- 8 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 194. We have limited this report to the key issues.
- 9 For a list of the non-confidential respondents to CP 194, see the appendix. Copies of these submissions are available on the ASIC website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp) under CP 194.
- 10 We have now released our final guidance on financial requirements for custodial or depository service providers and asset holders for registered schemes and IDPS: see Regulatory Guide 166 *Licensing: Financial requirements* and Class Orders [CO 13/761] *Financial requirements for custodial or depository service providers* and [CO 13/760] *Financial requirements for responsible entities and operators of investor directed portfolio services*.
- 11 We will assess whether there is a need for further guidance or regulation after observing how industry complies with the financial requirements for custodial or depository service providers, in light of our regulatory experience and any case law on these obligations.

## Responses to consultation

- 12 We received 12 responses (including two confidential responses) on CP 194 from industry associations, banks, property investors, trustee companies, financial advisory firms, and legal practitioners. We are grateful to these respondents for taking the time to send us their comments.
- 13 Additionally, we met with two industry associations to discuss our proposed guidance.
- 14 Respondents were generally supportive of our program to review the financial requirements for this sector, although several respondents raised concerns about specific aspects of our proposals.
- 15 Sections B–E of this report set out in more detail the issues raised during consultation, and our responses to those issues.

## B Proposed financial requirements for custodians

### Key points

This section outlines the key issues raised in submissions on Section B of CP 194 and our responses to those issues.

It covers our proposed guidance on:

- increasing the NTA capital requirement for custodians; and
- extending the NTA requirement for custodians to responsible entities holding scheme property or assets and IDPS operators holding IDPS property or assets.

### Increasing the NTA capital requirement

- 16 In CP 194, we proposed that custodians be required to hold NTA equal to the greater of:
- (a) \$10 million; or
  - (b) 10% of average revenue.
- 17 Our proposal to increase the NTA requirement for custodians was supported by one industry association, which stated that the proposal would better align the financial requirements with operating risks faced by providers of custodial or depository services.
- 18 Other respondents noted that the increased NTA requirement would provide a more rigorous obligation than is currently imposed and would assist the orderly transition of clients' assets from an insolvent custodian to a solvent entity.
- 19 However, most respondents did not agree with the proposed increase in the NTA requirement for custodians. They said that the higher NTA amount would increase costs for businesses, which would ultimately be passed on to clients. They also submitted that the proposal would result in reduced competition in the marketplace for custodial or depository service providers.
- 20 A number of respondents were concerned about the meaning of the term 'average revenue'. They commented that the term is vague and may be difficult to calculate. As an alternative, some respondents suggested that a fixed amount would be preferable. Another option proposed by some respondents was an NTA requirement based on the value of assets held.
- 21 Two respondents submitted that there should be a cap on the maximum NTA for custodians. A figure of \$15 million was nominated as an appropriate maximum.

- 22 In CP 194, we also asked respondents if there were any characteristics specific to providing custodial or depository services in emissions units that would warrant us taking a different approach to financial requirements for AFS licensees that only provide this type of service.
- 23 This question received very few responses. One respondent submitted that a different approach was appropriate due to the lower risk of custodial failure for licensees holding emissions units compared to other types of property. Another respondent submitted that emissions units should be treated the same as other kinds of assets.

#### *ASIC's response*

We have adopted the NTA requirement proposed in CP 194. We believe that the previous requirement of \$5 million is no longer sufficient and that a higher minimum NTA is needed to ensure that custodians have adequate financial resources to meet their operating costs and obligations.

We have not set a cap on the NTA capital requirement. In our view, operational risks would continue to exist beyond a cap, and these risks would not be reflected if the NTA requirement was capped.

We appreciate the alternative proposals suggested by some respondents to the issue of 'average revenue' under the proposed requirement. Each alternative had merit. However, they would have involved departing from the existing framework of financial requirements in RG 166.

In our view, it is desirable to implement a consistent approach to calculating NTA for AFS licensees. Moreover, we think that there would be significant practical difficulties associated with complying with an asset-based NTA requirement, as suggested. A definition of 'average revenue' is provided in the updated RG 166.

We have applied the same approach to financial requirements for holding emissions units as for other financial products. Therefore, holders of emissions units must comply with the financial requirements for custodians, incidental providers or other asset holders (as relevant). We will assess whether there is a need for further guidance or regulation after observing how this market sector develops.

## Responsible entities and IDPS operators

- 24 In CP 194, we proposed that the NTA requirement for custodians should apply to asset holders for registered schemes and IDPSs.
- 25 Our proposed guidance on this issue generated many comments, including significant disagreement. Several respondents suggested that this proposal would result in an increase in responsible entities and IDPS operators appointing external custodians, to avoid the increased NTA requirement.

- 26 A couple of respondents submitted that differences in the nature of the custodial services performed by responsible entities or IDPS operators and custodians mean that equivalent financial requirements may not be suitable.
- 27 By contrast, one industry association commented that the major benefit of this proposal was that the equivalent financial requirements would provide similar protection to consumers, regardless of who held the assets.
- 28 Approximately one-quarter of respondents suggested that increased costs associated with complying with the proposed NTA requirement would restrict new enterprises and possibly lead to the termination of existing registered schemes. In contrast, one respondent suggested the proposal would create a level playing field for asset holders, improving competition.

#### *ASIC's response*

We have applied the NTA requirement for custodians to asset holders for responsible entities and IDPSs. We are not convinced that the custodial function performed by these asset holders is fundamentally different from that performed by custodians. In our view, it is appropriate to apply the same benchmark in each case.

We acknowledge comments about the likely impact of the revised requirement on compliance and operating costs. However, we consider that the changes are necessary to ensure that asset holders for responsible entities and IDPSs have the financial resources to meet their operating costs and obligations.

We note that assets used to meet the financial requirements for responsible entities or IDPS operators may also be used by these licensees to meet their financial requirements as asset holders.

Asset holders for responsible entities are currently required to calculate 10% of their average responsible entity revenue to determine their NTA requirement. Therefore, we consider that the average revenue component of the revised NTA requirement will not be overly burdensome for these licensees.



## C Proposed financial requirements for incidental providers

### Key points

This section outlines the key issues covered in submissions on Section C of CP 194 and our responses to those issues:

It covers our proposed guidance on:

- defining ‘incidental custodial or depository services’; and
- introducing an NTA requirement for incidental providers of custodial or depository services.

### Defining ‘incidental custodial or depository services’

- 29 In CP 194, we proposed that an AFS licensee provides ‘incidental custodial or depository services’ if:
- (a) the custodial or depository services are a need of the client because of, or in order to obtain, the provision of other financial services by the licensee or its related bodies corporate;
  - (b) the custodial or depository services do not form part of an IDPS; and
  - (c) the revenue of the licensee and its related bodies corporate reasonably attributable to the custodial or depository services (which at least includes the cost of providing those services) comprises less than 10% of the total revenue derived from the financial services business of the licensee and its related bodies corporate in the last financial year.
- 30 We stated that only businesses that provide custodial or depository services in accordance with this definition would be eligible for the reduced minimum NTA requirement.
- 31 Respondents overwhelmingly supported our proposal to clarify the meaning of incidental custodial or depository services. However, the wording of the proposed definition generated considerable disagreement.
- 32 The main issue raised by respondents was the breadth of the definition. Some respondents felt that, in its current form, the definition would capture the vast majority of fund managers and trustees and was too wide. Others felt that the definition might exclude providers who were traditionally exempt from the NTA requirement and was too narrow.
- 33 Most respondents anticipated that they would have difficulty identifying the proportion of revenue reasonably attributable to custodial or depository services in paragraph (c) of the proposed definition. They suggested that this is because fees for incidental custody services are usually bundled and

may be difficult to identify. As an alternative, some respondents suggested that we replace the 10% of total revenue test with an asset-based test.

- 34 A few respondents commented that, if revenue fluctuated, it would be possible for an operator to be classified as an incidental provider one year and not the next, creating problems for service providers whose financial requirements may change from year to year.
- 35 Several respondents queried the relevance of requiring disclosure of the provider's status as an incidental provider in a Financial Services Guide (FSG) or Statement of Advice (SOA). They submitted that incidental providers rarely cater to retail clients and, in the case of wholesale clients, FSGs and SOAs are not provided.

*ASIC's response*

We have adopted a definition of 'incidental provider' in place of the proposed definition of 'incidental custodial or depository services' in CP 194, but which substantially reflects the concepts in that definition.

In our view, this definition captures only those custodial or depository services that are truly incidental to the provision of other financial services by the licensee (rather than discrete offerings in their own right) and that represent a minor source of revenue for the licensee.

In response to feedback, we have provided additional guidance on identifying the revenue reasonably attributable to the custodial or depository services where the fee for these services is bundled or otherwise unidentifiable. To this end, we have also included definitions of 'custodial or depository services revenue' and 'financial services business revenue' in our updated guidance.

We have removed the requirement for incidental providers to disclose their status as such in an FSG or SOA. We appreciate that this is more consistent with the predominantly wholesale nature of incidental providers' client base.

## NTA requirement for incidental providers

- 36 In CP 194, we proposed to introduce a minimum NTA requirement for incidental providers. We proposed that incidental providers be required to hold NTA equal to the greater of:
- (a) \$150,000; or
  - (b) 10% of average revenue.
- 37 Some respondents supported our proposal. Other respondents favoured maintaining an NTA exemption for incidental providers. Responses were also divided on the issue of quantum, with some respondents submitting that the proposed requirement was inadequate, while most thought it was too high.

- 38 Almost all respondents to this issue thought that the NTA requirement would lead to fewer incidental providers, thereby reducing competition among the remaining service providers. By contrast, two respondents submitted that allowing incidental providers to meet a reduced NTA requirement gave them an unfair advantage over custodians who were required to meet the full NTA requirement.
- 39 A number of respondents submitted that the NTA requirement should not apply to incidental providers who have appointed a third party custodian to hold assets for them. They noted that a similar exemption is available to responsible entities. One respondent also suggested that the exclusion given to responsible entities for special custody assets and tier \$500,000 class assets should also apply to incidental providers.
- 40 One respondent suggested that the NTA requirement for incidental providers should be capped between \$1 million and \$2 million. They suggested that a cap of this amount would recognise the incidental nature of these service providers.

#### *ASIC's response*

We think that an exemption for incidental providers from the NTA requirement does not reflect the risks associated with providing a custodial or depository service. We think that a minimum NTA requirement is needed to ensure that incidental providers have adequate financial resources to meet the operating costs and obligations associated with providing such a service.

We believe that the benefits of this requirement outweigh the impact on incidental providers in this instance. In our view, a reduced NTA requirement for incidental providers appropriately recognises the differences in the nature and scale of the custodial or depository service providers.

Many incidental providers may also be authorised to provide other financial services. We note that assets used to meet financial requirements for other activities the licensee undertakes may also be used to meet their financial requirements as incidental providers.

We have not set a cap on the NTA capital requirement for incidental providers. In our view, operational risks would continue to exist beyond a cap, and these risks would not be reflected if the NTA requirement was capped. This is consistent with our approach to custodians and asset holders for registered schemes and IDPS.

We agree with respondents who submitted that incidental providers who have appointed a third party custodian to undertake physical custody of client assets on their behalf should be exempt from the NTA requirement. We have included this exemption in our updated guidance.

## D Cash flow and liquidity requirements

### Key points

This section outlines the key issues raised in submissions to CP 194 on requiring 12-month cash flow projections and the NTA liquidity requirement, and our responses to those issues.

### Requiring 12-month cash flow projections

- 41 In CP 194, we proposed to introduce a requirement for longer cash flow projections for providers of custodial or depository services. We proposed that providers should be required to prepare, and make available to ASIC on request, cash flow forecasts with anticipated revenue and expenses over at least 12 months, and that these should be approved by directors of the provider as satisfying our financial requirements.
- 42 More than half of respondents to this issue agreed with this proposal. Some respondents noted that it was consistent with the requirements that apply to responsible entities. Most respondents thought that the requirement should apply to both custodians and incidental providers.
- 43 A few respondents expressed a preference for continuing to apply Options 1–5 of the standard cash needs requirement in RG 166, stating that these options allowed for increased flexibility. One respondent submitted that the volatility of revenues for providers of custodial or depository services would reduce the utility of 12-month forecasts.
- 44 Most respondents indicated that their compliance and audit costs would increase if the proposal was implemented. It was not suggested that the additional costs would be significant. One respondent submitted that potential cost increases would be offset by gains arising from better business planning.
- 45 In paragraph 69 of CP 194, we stated that we expect responsible entities that rely on an asset holder to meet the financial requirements to include in their agreement with the asset holder or master custodian adequate provision for information to be given to the responsible entity on demand to demonstrate compliance with the financial and cash projection requirements.
- 46 Some respondents objected to this requirement on the basis that it would require existing custody agreements to be re-written, which they said was unduly burdensome.

- 47 In paragraph 70 of CP 194, we stated that we expect responsible entities will have a right to obtain cash flow projections and audit reports reflecting the audit reports that are required to be lodged with ASIC for custodians, and to require and keep those audit reports.
- 48 One industry group expressed strong concern about being required to disclose this information to their clients, which they said was commercially sensitive and confidential, and would place them at a market and competitive disadvantage.

#### *ASIC's response*

We acknowledge comments about possible increases in audit and compliance costs resulting from the requirement for longer cash flow projections. However, we do not believe these will be unduly burdensome.

We note that this requirement already applies to responsible entities. In our view, it is desirable to extend this requirement to custodians, incidental providers and asset holders for IDPSs.

After feedback on the potential burden of requiring custodians to disclose financial and audit information to a licensee who has appointed them to provide custodial or depository services (appointing licensee), we have amended our updated guidance.

Custodians are required to provide written assurance, if requested by an appointing licensee, stating that they meet the financial requirements for custodians. This assurance is necessary to assist the appointing licensee to form a reasonable belief that the third party meets the financial requirements for custodians.

## **NTA liquidity requirement**

- 49 In CP194, we proposed that at least 50% of the required NTA should be held by a custodian in cash or cash equivalents, with 100% being held in liquid assets, to assist them in meeting unexpected and immediate cash needs.
- 50 We stated that if a responsible entity is relying on a person that it appoints to hold scheme property or other assets to avoid having to meet the financial requirements that would apply if the responsible entity held that property or assets, it must have reasonable grounds to believe that the person meets the liquidity requirement.
- 51 Many respondents did not support the proposed liquidity requirement on the basis that it was onerous and represents an inefficient use of capital. It was submitted that this proposal may negatively impact on competition, although one respondent commented that the impact would be marginal.

- 52 A couple of respondents noted that this requirement was similar to existing liquidity requirements for other AFS licensees and would promote consistency across licence types.
- 53 Respondents generally agreed that custodians and incidental providers should be subject to the same liquidity requirement.
- 54 One respondent submitted that eligible undertakings in an unlimited amount provided by an Australian authorised deposit-taking institution (ADI) should be allowed in meeting the liquidity requirement.

*ASIC's response*

We have adopted the liquidity requirement proposed in CP 194. This requirement applies to custodians and incidental providers, as well as asset holders for registered schemes and IDPSs. This represents a change to the existing liquidity requirements for each of these providers.

In our view, it is desirable to implement a consistent approach to liquidity requirements for custodians, incidental providers and asset holders for registered schemes and IDPSs. We acknowledge that some licensees may need to restructure their asset holdings to meet this requirement.

We note that provision for eligible undertakings to constitute cash or cash equivalents for the purpose of meeting the NTA liquidity requirement was part of our original proposal, and is included in our updated guidance.

## E Proposed implementation and transition period

### Key points

In CP 194, we considered it appropriate for the proposed requirements to be implemented as soon as practicable.

The revised requirements commence from 1 July 2013 for new providers (i.e. AFS licensees that are licensed to provide a custodial or depository service from that date).

Existing providers (i.e. AFS licensees that were licensed to provide custodial or depository services on or before 30 June 2013) have until 1 July 2014 to comply with the revised requirements.

- 55 In CP 194, we proposed:
- (a) that the revised financial requirements be effective for new providers as of 1 July 2013; and
  - (b) for existing providers, responsible entities of managed investment schemes and IDPS operators, to implement a transition period of 12 months until 1 July 2014.
- 56 Some respondents indicated a preference for a 24-month transition period. However, most respondents were satisfied that a 12-month transition period after finalising our guidance would be sufficient to enable them to meet the revised requirements.

### *ASIC's response*

The revised financial requirements apply from 1 July 2013 for new providers, with a 12-month transition period for existing providers until 1 July 2014.

We think that this period allows existing providers enough time to restructure operations and raise funds, if necessary, to comply with the revised requirements.

## Appendix: List of non-confidential respondents

- 
- Allens/Goodman Group
  - Australian Custodial Services Association
  - Financial Services Council
  - Henry Davis York
  - McCullough Robertson Lawyers
  - McMahon Clarke
  - PMC Finservices Consulting Pty Ltd
  - Property Funds Association of Australia
  - Trustees Australia
  - Westpac Group
-