ASIC
Australian Securities & Investments Commission

REPORT 376

Response to submissions on CP 197 Holding scheme property and other assets

November 2013

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 197 *Holding scheme property and other assets* (CP 197) and outlines our responses 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 133 *Managed investments and custodial or depository services: Holding assets* (RG 133).

Contents

A Overview/Consultation process

1 In Consultation Paper 197 *Holding scheme property and other assets* (CP 197), we consulted on proposals to update our guidance for responsible entities of managed investment schemes that are registered with ASIC (registered schemes) on holding scheme property and other assets.

2 The proposals in CP 197 are also relevant for:

(a) licensed providers of custodial or depository services (licensed custody providers);

(b) operators of managed discretionary account (MDA) services that are responsible to clients for holding assets under an MDA service; and

(c) investor directed portfolio service (IDPS) operators that are responsible to clients for holding assets under an IDPS.

3 The substantive changes proposed in CP 197 have arisen from a number of related matters, including:

(a) the findings set out in Report 291 *Custodial and depository services in Australia* (REP 291);

(b) our recent surveillance work of existing major custodial providers;

(c) our recognition of the role of responsible entities, licensed custody providers, MDA operators and IDPS operators as important gatekeepers in the financial services industry; and

(d) the recommendations of the Parliamentary Joint Committee on Corporations and Financial Services (PJC) Inquiry into the collapse of Trio Capital on:

(i) the use of the term ‘custodian’; and

(ii) consideration by ASIC of the safeguards that a custodian could put in place to ensure it can identify and report suspicious transfers that do not trigger the anti-money laundering provisions.

4 A draft updated version of Regulatory Guide 133 *Managed investments and custodial or depository services: Holding scheme property and other assets* (RG 133) was attached to CP 197.

5 This report is not intended to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 197. We have limited this report to the key issues.

Responses to consultation

6 We received 10 responses to CP 197 from lawyers, industry bodies, custodians, banks and one compliance specialist. Of these, two submissions were confidential. We are grateful to respondents for taking the time to send us their comments.

7 This report highlights the key issues that arose out of the submissions received on CP 197, and our responses to those issues. Feedback received on CP 197 helped us to finalise our guidance, which is published in the final updated RG 133 (renamed *Managed investments and custodial or depository services: Holding assets*) and related class orders. Where relevant, this report explains where we have modified key aspects of our proposals in CP 197 in producing our final guidance.

8 For a list of the non-confidential respondents to CP 197, see the appendix of this report. Copies of the submissions are on our website at www.asic.gov.au/cp under CP 197.

B Holding scheme property and other assets

Key points

This section outlines the key issues covered in submissions received on CP 197 about the obligations of asset holders under RG 133 and related class orders, and our responses to those issues.

It covers:

- holding client assets;
- engaging another asset holder and client checks;
- agreement with a third-party asset holder;
- reporting suspicious matters;
- omnibus accounts; and
- land used in primary production schemes.

Holding client assets

9 In CP 197, we proposed to modify the *Corporations Act 2001* (Corporations Act) by class order so that from, 1 July 2014, an asset holder would be required to:

(a) hold the relevant assets on trust for its client and separately from its own assets or the assets of any other scheme or any other person, subject to the permitted use of omnibus accounts; and

(b) meet minimum standards for:

(i) organisational structure;

(ii) staff capabilities;

(iii) capacity and resources; and

(iv) checks on clients.

10 We proposed to give guidance on how Australian financial services (AFS) licensees can demonstrate compliance with their obligations, including processes for engaging another asset holder, conducting client checks and agreements with third-party asset holders.

11 Most respondents agreed with the proposed requirement that property be held on trust, but recommended that RG 133 should clarify that the trust may be a bare or directed trust, and that no active powers would be imposed on the custodian in relation to it.

12 A number of respondents noted that:

(a) the requirement to hold assets on trust is not a necessary or practical requirement of insolvency protection in all markets; and

(b) it would not be possible for a custodian to purport to hold cash on trust and also hold it on deposit as an authorised deposit-taking institution (ADI).

13 In relation to the minimum standards, concerns were raised about the prescriptive nature of those standards, particularly for organisational structure and staff capabilities. Some respondents noted that small organisations may have difficulty complying with the minimum standards.

ASIC's response

In updated RG 133, we require that custodial property in Australia be held on trust, but note that:

- this will be a bare or directed trust in some circumstances; and
- in the case of cash, it is the account that constitutes the custodial property rather than the cash in the account.

We will continue to give relief under Class Order [CO 03/1110] *Prime brokerage services: Relief from obligation to hold client property on trust* and Class Order [03/1111] *Prime brokerage services: Relief from obligation to hold scheme property separately* as they relate to prime brokerage. These class orders will be dealt with under a separate consultation process.

We have clarified that the requirement to hold custodial property on trust does not apply to:

- overseas assets where there is no recognition of a trust in the relevant jurisdiction and it is reasonable for the property to be held in accordance with the local law; or
- overseas assets where it is not reasonable for the property to be held on trust under the local laws but the client documents that they are satisfied that the manner in which the assets are held provides reasonably effective protection in the case of the asset holder's insolvency and the basis for being satisfied.

We have effected the proposed minimum standards through class order, with some clarification where issues of concern were raised: see Section B of the updated RG 133.

The updated requirements apply from:

- 2 January 2015 for AFS licensees that are authorised to operate a registered scheme or provide a custodial or depository service or that hold or arrange for the holding of client assets before 2 January 2014; and
- 2 January 2014 for AFS licensees that are authorised to operate a registered scheme or provide a custodial or depository service or that hold or arrange for the holding of client assets on or after 2 January 2014.

See Table 1 in updated RG 133.

Engaging another asset holder and client checks

14 In CP 197, we proposed to state the following expectations as part of the obligations for AFS licensees that engage another asset holder:

(a) *Documented processes*: Responsible entities, licensed custody providers, MDA operators and IDPS operators should follow and document an appropriate process in selecting an appropriate asset holder or master custodian.

(b) *Pre-contract and ongoing inquiries*: Licensed custody providers should diligently consider what pre-contract inquiries and ongoing inquiries in relation to their clients are necessary, at reasonable intervals, to provide reasonable assurance that the asset holder's activities will not be facilitating unlawful activities.

15 Generally, respondents expressed concern about the purpose for which the inquiries would be conducted and the nature of certain inquiries, particularly credit checks.

16 Specific issues raised included:

(a) the custodian should not be required to act in a 'watchdog' role in relation to its clients because it is not in the best position to determine whether its clients are acting contrary to law or not;

(b) it would be difficult for custodians to make inquiries for clients who are based overseas;

(c) the proposed checks are too broad, and would require custodians to devote significant resources to client inquiries; and

(d) ongoing checks by custodians would be of little value, would be costly and would create a false sense of security for investors.

ASIC's response

The purpose of pre-contractual inquiries is to enable an AFS licensee to comply with its licence obligations to provide financial services efficiently, honestly and fairly, and reduce the risk of unexpected differences in capabilities or service requirements, which could lead to potentially avoidable operational risks and other issues.

In updated RG 133, we have not included a comprehensive list of examples of the types of inquiries that an asset holder should carry out, or prescribed the frequency of conducting subsequent inquiries. Rather, we have provided some examples that an asset holder may wish to consider: see Section B of updated RG 133.

The updated requirements apply from:

- 2 January 2015 for AFS licensees that are authorised to operate a registered scheme or provide a custodial or depository service

or that hold or arrange for the holding of client assets before 2 January 2014; and

- 2 January 2014 for AFS licensees that are authorised to operate a registered scheme or provide a custodial or depository service or that hold or arrange for the holding of client assets on or after 2 January 2014.

See Table 1 in updated RG 133.

Agreement with a third-party asset holder

17 In CP 197, we proposed to modify the existing requirements for agreements between a responsible entity, IDPS operator, MDA operator or a master custodian on the one hand and the master custodian or asset holder on the other hand as follows:

(a) Under the terms of the client agreement, the asset holder and any master custodian (as applicable) must indemnify the client against any loss or damage that arises from a failure to comply with the client agreement or to meet prevailing standards of good practice for holding assets in the places for which the assets are held.

(b) If it is not possible for a responsible entity, IDPS operator or MDA operator that is responsible to clients for holding assets, or a master custodian, to obtain an indemnity on reasonable commercial terms for particular assets located outside Australia, as an AFS licensee it must:

(i) take all reasonable steps to negotiate the most favourable liability provisions for the client; and

(ii) consider what additional protections it should reasonably have in place to manage the associated risks (e.g. requiring more frequent checks).

18 We also proposed that the indemnity should be required under an agreement between a licensed custody provider and retail client for the provision of a custodial or depository service.

19 Most respondents did not agree with our proposal on the basis that the requirement is not consistent with current market practice. Under general law, custodians and their affiliates are only liable for their own acts and omissions and not those of their sub-custodians. While there is a general obligation for the custodian to monitor sub-custodians, after this responsibility is discharged, the custodian is not liable for acts or omissions of sub-custodians. Current custody agreements reflect this.

20 Responses also noted that:

(a) fundamentally, the proposed indemnity is not a form of indemnity that custodians are likely to accept;

(b) the client is protected under general law for negligence or breach of contract by the custodian;

(c) the indemnity would not reduce the total amount of risk in the system, but merely predetermine how overall risk is shared between the custodian and the responsible entity;

(d) the indemnity provisions may expand the custodian's liability to indirect damage, which could mean that the custodian may not be covered by insurance for this loss;

(e) the provisions may make the custodian liable for the actions of third parties, which it has no control over; and

(f) our proposal is more prescriptive compared to the policy of the Australian Prudential Regulation Authority (APRA) in Superannuation Prudential Standard 231 *Outsourcing* (SPS 231). For example, SPS 231 does not prescribe the specific nature and breadth of terms of the indemnity (other than in relation to sub-custodians). Rather, APRA imposes a principles-based requirement, unlike our proposal.

21 A number of respondents also suggested that there should be grandfathering provisions for existing agreements if ASIC proceeded with this proposal.

ASIC's response

In updated RG 133, we require the responsible entity, licensed custody provider, MDA operator or IDPS operator to include reasonable liability provisions in their agreement with the asset holder.

This should not include provisions that exclude the asset holder's liability for direct losses that would apply for the failure to take reasonable care under general law. If appropriate, it should also include reasonable indemnity provisions in relation to losses caused to the client by the asset holder's acts and omissions that relate to the agreement: see Section C of updated RG 133.

The updated requirements apply from:

- 1 November 2015 for AFS licensees that are authorised to operate a registered scheme or provide a custodial or depository service or that hold or arrange for the holding of client assets before 2 January 2014; and
- 2 January 2014 for AFS licensees that are authorised to operate a registered scheme or provide a custodial or depository service or that hold or arrange for the holding of client assets on or after 2 January 2014.

See Table 1 in updated RG 133.

Reporting suspicious matters

22 In CP 197, we proposed to modify the Corporations Act by class order to require responsible entities, licensed custody providers, MDA operators and IDPS operators to ensure that the agreement with any custodian they engage in connection with holding client assets obliges the asset holder to have adequate arrangements to ensure that it will report to ASIC within 10 business days if it suspects that the client may be in breach of s912D or, where relevant, s601FC(1)(l) of the Corporations Act.

23 All respondents disagreed with our proposal based on their view that it was not for the custodian to monitor suspicious activity of its client because the custodian would not have all information relevant to the activity. Furthermore, doing so may breach its contractual obligations to its client.

ASIC's response

We have imposed this requirement only on responsible entities because the holding of property of a registered scheme is not considered to be a custodial or depository service under s766E(3) of the Corporations Act, which has implications for certain breach reporting by custodians as well as reporting to the Australian Transaction Reports and Analysis Centre (AUSTRAC) under the applicable anti-money laundering legislation: see Section C of updated RG 133.

A suspicion may arise in the normal course of business and there is currently no requirement for custodians to conduct additional inquiries for the purpose of meeting their obligations.

We consider that custodians that hold scheme property may have information that could give rise to a suspicion. However, we consider that the requirement will address areas that are not covered by the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act).

Further, we consider that there are deterrent and transparency benefits in requiring responsible entities to include such a provision in their custody agreements.

Custodians are also encouraged to report matters to ASIC that may not fall within this new obligation, or the obligations under the AML/CTF Act, in reliance on the whistleblower provisions in the Corporations Act: see Information Sheet 52 *Protection for whistleblowers* (INFO 52).

The updated requirement to include this provision in custody agreements applies from:

- 2 January 2015 for responsible entities that are authorised to operate a registered scheme before 2 January 2014; and
- 2 January 2014 for responsible entities that are authorised to operate a registered scheme on or after 2 January 2014.

Relief from obligation to separate assets

24 In CP 197, we proposed that we would continue, with some amendments, our relief under Class Order [CO 98/51] *Relief from duty to separate assets of a managed investment scheme*, which permits the limited use of omnibus accounts.

25 We proposed the following additional requirements to the relief:

(a) the responsible entity or IDPS operator (or where the assets are not scheme property or other assets or IDPS property—the custodial or depository service provider) certifies at least annually that, in its opinion, the use of omnibus accounts does not expose the client to unreasonable risk and is in the best interests of its clients;

(b) written records of that opinion and the reasons are kept for six years after it has ceased to be the current document that enables use of the omnibus account;

(c) the custodian maintains records at all times showing the entitlements of clients in the account, conducts appropriate reconciliations and ensures that the account is always sufficient to meet the entitlements the responsible entity and any other person has in relation to that account; and

(d) where clients of the custodian may be retail investors, as in the case of an IDPS or MDA operator, the potential use of omnibus accounts is notified in the custodian's Financial Services Guide (FSG) and agreed to in writing by the retail client.

26 Respondents were generally supportive of the proposal provided that the frequency of reconciliations was not prescribed, although a concern was raised about the requirement that 'the account is always sufficient to meet the entitlement the responsible entity and any other person has in relation to that account'.

ASIC's response

We will continue to allow the use of omnibus accounts, as in [CO 98/51], with the additional requirements proposed in CP 197, except that written records must be kept for seven years: see Class Order [CO 13/1409] *Holding assets: Standards for responsible entities,* Class Order [CO 13/1410] *Holding assets: Standards for providers of custodial and depository services*, and Section F of updated RG 133.

We consider that, because asset holders, rather than clients, can determine the risk arising from other clients whose assets are included in an omnibus account, the asset holder and not the client should bear the cost of meeting any deficiency. We will require that the account must not fail to be sufficient after the end of the second business day to meet the entitlements of the client in relation to that account—if necessary, through the asset holder supplementing the account with its own assets.

The conditions under [CO 13/1409] and [CO 13/1410] apply from the date on which the class orders are made. However,

> responsible entities may choose to rely on [CO 98/51] until 1 January 2015, with the new requirements applying from 2 January 2015.

Land used in primary production schemes

27 In CP 197, we proposed to modify the Corporations Act by class order so that certain additional requirements would apply to responsible entities for interests in registered schemes involving primary production that include rights for use of land offered on or after 31 December 2013.

28 Under our proposed modifications:

(a) the responsible entity must ensure that registered interests in the land are held by members, on trust for members, or by an entity that is controlled by members for the duration of the scheme; and

(b) where the registered interest is a lease:

(i) the constitution of the registered scheme must give the responsible entity the power to require members to make payments to meet the obligations under the terms of any lease;

(ii) the responsible entity must retain any amounts paid by members in relation to the lease as scheme property until the money is used to meet lease payments; and

(iii) the terms of the lease must not be less favourable to the scheme than those that would apply on an arm's length basis and must exclude any action by the lessor or a head lessor in connection with the lease that would adversely affect the interests of members, other than where members or the responsible entity for the scheme are in default of their obligations under the lease and the head lessor has a right to take action because the breach has not been remedied within a reasonable time.

29 One respondent agreed with our proposals and suggested that the current standard AFS licence condition could be expanded to capture not just rights to use, but also rights to possession, rights to harvest or rights to a share of the benefits of an agricultural project, based on its submission that the definition of 'rights to use' is too narrow.

30 Another respondent thought that ASIC should address these issues through disclosure under the 'if not, why not' principle, rather than mandating how businesses should be operated or prohibiting certain types of business models.

ASIC's response

We have modified the Corporations Act by class order so that additional requirements apply to responsible entities for interests in registered schemes that are offered to retail clients on or after 2 January 2014, where these schemes involve primary production including rights for the use of land: see Class Order [CO 13/1406] *Land holding for primary production schemes* and Section E of updated RG 133.

We have clarified that the rights of members to use land include rights that are sufficient to enable all relevant uses of the land that are relevant to the registered scheme, including access, cultivation, maintenance, and harvesting of output.

We are of the view that there are compelling reasons to protect members' interests in land used in primary production schemes, which cannot be adequately addressed through 'if not, why not' disclosure. Because the risk arises outside the operation of the scheme, it is inappropriate for retail clients to be subject to this risk. On the basis of our experience, we are not satisfied that disclosure will prevent investors from being exposed to the risk of loss of their interest in this situation.

The requirements in [CO 13/1406] apply from 1 July 2014 to all responsible entities of the relevant registered schemes.

C Issues for consideration

Key points

In addition to our proposals in CP 197, we invited feedback on extending the list of 'special custody assets' to include additional types of assets, such as certain derivatives.

We also consulted on the use of the term 'custodian' in disclosure documents.

Special custody assets

31 In CP 197, we considered whether to extend the list of 'special custody assets' that a responsible entity may hold without meeting the relevant net tangible assets (NTA) requirement in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166). Options included the following:

(a) *Option 1:* Not extending the definition of special custody assets or Tier $500,000 class assets to include any additional types of assets.

Note: For the definition of 'special custody assets' and 'Tier $500,000 class assets', see RG 166.

(b) *Option 2:* Extending the list of special custody assets to include additional assets as listed in Table 2 of CP 197 on the conditions described (or on other appropriate conditions).

32 All respondents agreed that the assets should be added to the definition of 'special custody assets'. Respondents explained that assets such as derivatives cannot commercially be held in custody because the custodian would need to become a party to the contract, which changes the relationship from custodial to trading, with the associated risks.

33 Some respondents also recommended extending the list of 'special custody assets' to encompass:

(a) general insurance products;

(b) inter-funding schemes, on the condition that the investee funds are registered schemes which are operated by the same or a related party responsible entity of the investor fund/scheme. It was argued that the costs of engaging an external asset holder to hold such interests were unnecessary.

ASIC's response

For responsible entities and IDPS operators, we have extended the list of 'special custody assets' to include the following assets, but on certain conditions, so that the risk of not using a custodian to hold such assets is managed by requiring the responsible entity or IDPS operator to comply with requirements that will ensure protection is achieved:

- derivatives with liability attached and associated margin accounts;
- private equity investments;
- certain deposit-taking facilities; and
- certain associated contracts.

We were not convinced by the submissions on general insurance products and inter-funding schemes within related entities. However, we have provided that, where we have recognised a special custody asset, incidental contractual rights that cannot practically be transferred independently of the asset would also be included as special custody assets: see updated RG 166.

Use of the term 'custodian'

34 In CP 197, we proposed that product issuers and licensed custody providers should clearly describe the role of an asset holder in any Product Disclosure Statement (PDS), FSG or other material available to retail clients to:

(a) ensure that retail clients are unlikely to be misled; and

(b) minimise the possibility of giving retail clients unwarranted reassurance because of the custodian's appointment.

35 All respondents strongly supported the proposal, several of whom asked us to prescribe the wording that should be included in disclosure material.

ASIC's response

We expect the role of the asset holder to be adequately described by responsible entities in PDSs, FSGs and other material available to retail clients. However, we have not prescribed the exact wording that should be included.

Appendix: List of respondents

- Australian Custodial Services Association
- Compliance and Risk Services Pty Ltd
- Financial Services Council Ltd
- Henry Davis York Lawyers
- HSBC
- McCullough Robertson Lawyers
- Primary Securities Ltd
- Property Council of Australia