REGULATION IMPACT STATEMENT

Financial requirements for custodial or depository service providers

June 2013

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals on changes to the financial resource requirements that apply to providers of custodial or depository services (providers) and responsible entities of registered managed investment schemes (registered schemes) or investor directed portfolio service (IDPS) operators that hold scheme or other property or assets (asset holders for registered schemes or IDPS).

What this Regulation Impact Statement is about

1 This RIS addresses ASIC's proposals on the financial requirements that apply to providers and asset holders for registered schemes or IDPS.

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

- maintaining, facilitating and improving the performance of the financial system and entities in it;
- promoting confident and informed participation by investors and consumers in the financial system; and
- administering the law effectively and with minimal procedural requirements.

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

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

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A Introduction

Background

Financial requirements for providers

4 The licensing provisions of the *Financial Services Reform Act 2001* commenced on 11 March 2002. Under this regime, providers must generally obtain an Australian financial services (AFS) licence that authorises them to provide custodial or depository services.

5 AFS licensees are subject to the conduct obligations of Ch 7 of the *Corporations Act 2001* (Corporations Act), including obligations to:

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

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

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

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

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

7 RG 166 states that the financial requirements for AFS licensees are designed to ensure that:

(a) they have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act;

(b) there is a financial buffer that decreases the risk of disorderly or non-compliant wind-up if the business fails; and

(c) there are incentives for owners to comply with the Corporations Act through risk of financial loss.

8 PF 209 and RG 166 apply to a diverse range of AFS licensees, including responsible entities, investor directed portfolio service (IDPS) operators, brokers, market and clearing participants, custodians, margin lenders and foreign exchange dealers. PF 209 and RG 166 set out different requirements for each of these groups of AFS licensees. The regulatory regime generally does not subject bodies regulated by the Australian Prudential Regulation Authority (APRA) to resource requirements under the Corporations Act (see s912A(1)(d)).[1] This recognises that APRA's prudential regulation addresses these issues. Custodians that are bodies regulated by APRA may include insurance companies and superannuation entities.

9 The current financial requirements in RG 166 vary in their application depending on the nature, scale and complexity of the financial services provided. All AFS licensees must meet the base level financial requirements, as well as the surplus liquid funds (SLF) and adjusted surplus liquid funds (ASLF) requirements (unless they are a body regulated by APRA or subject to foreign prudential regulation or are a market or clearing participant).

10 In addition, certain categories of AFS licensee must meet 'tailored' and/or additional financial requirements in RG 166 that reflect the particular financial products and services offered. This is because we consider that the nature and characteristics of the products and services offered by these licensees means that special conditions are necessary in order to meet the requirement to hold adequate financial resources. The categories of AFS licensee for which tailored or additional financial requirements apply are:

(a) market and clearing participants;

(b) responsible entities;

(c) IDPS operators;

(d) custodial or depository services;

(e) trustee companies providing traditional services;

(f) issuers of margin lending facilities;

(g) foreign exchange dealers; and

(h) retail OTC derivative issuers.

11 These categories of licensee must meet a combination of the standard financial requirements and the tailored and additional requirements. The tailored and additional requirements are set out in Appendices 1–8 of RG 166.

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[1] Licensees who are regulated by APRA, and are not required to comply with s912A(1)(d), are not required to comply with ASIC's financial requirements. However, as a condition of its AFS licence, such a licensee must remain at all times a body regulated by APRA and have its auditor confirm this to ASIC annually on a positive assurance basis, and at any other time that ASIC requests: see PF 209, condition 27.

12 Net tangible assets (NTA) is a measure of financial strength currently used in the financial requirements applicable to certain AFS licensees—for example, responsible entities, IDPS operators, custodians, issuers of margin lending facilities and trustee companies providing traditional services. NTA essentially includes all tangible assets less liabilities (excluding certain related party receivables and subordinated debt).

13 If a licensee offers more than one type of financial product and/or service, more than one set of financial requirements may apply. If this is the case, the licensee must meet all applicable requirements; however, there is no need to hold separate assets to meet each requirement and the licensee can count the same assets to meet multiple requirements.

Industry characteristics

14 The term 'custodial or depository service' is given specific statutory definition in the Corporations Act. The Corporations Act states that a person provides these services to another person if, under an arrangement between the provider and the client or between the provider and another person with whom the client has an arrangement, a financial product or a beneficial interest in a financial product is held by the provider in trust for, or on behalf of, the client or another person nominated by the client: see s766E.

15 ASIC authorises certain entities to provide custodial or depository services for financial products. Providers can be categorised into three main groups:

(a) custodians (see paragraphs 25–35);

(b) incidental providers) (see paragraphs 36–43); and

(c) asset holders for IDPS (see paragraphs 44–47).

An authorised custodial or depository service provider must demonstrate compliance with the financial requirements of its AFS licence.

16 The operation of a registered scheme or holding of assets of a registered scheme is specifically excluded from the definition of custodial or depository services. However, ASIC does impose financial requirements on asset holders for registered schemes (see paragraphs 48–53). As such, the proposals set out in this RIS apply to asset holders for registered schemes. Some of the proposals for providers have already been implemented for asset holders for registered schemes (see Regulation Impact Statement *Responsible entities: Financial requirements*).

17 A diverse range of businesses are involved in providing custodial or depository services or asset holding services. Approximately 668 AFS licensees currently provide custodial or depository services or are asset holders for registered schemes or IDPS. Of these, approximately 13 are custodians (this figure does not include custodians that are bodies regulated

by APRA),[2] 513 are incidental providers, and the remainder (142 licensees) are asset holders for registered schemes or IDPS.

18 Providers and asset holders for registered schemes or IDPS are key service providers in the financial services industry and play a significant role in the safekeeping of client assets. As at 31 December 2012, approximately $2.065 trillion of assets of Australian investors are held in custody.[3] This is expected to more than triple over the next 15 years to $6.4 trillion (in nominal terms),[4] in part due to the increase in superannuation guarantee contributions.[5]

19 We consider providers and asset holders for registered schemes or IDPS to be gatekeepers within the financial services industry, with responsibility in the product chain for the safekeeping of client assets.

20 In Australia, the main clients of custodial or depository services and asset holding services are:

(a) superannuation fund trustees (excluding trustees of self-managed superannuation funds);

(b) responsible entities of managed investments (including registered schemes);

(c) insurance companies;

(d) endowment funds and charities;

(e) broker–dealers; and

(f) federal and state governments.

21 The use of providers and asset holders for registered schemes and IDPS may be driven by a number of factors such as:

(a) for responsible entities, ASIC's financial requirements and the standards in Regulatory Guide 133 *Managed investments: Scheme property arrangements* (RG 133); or

(b) for registrable superannuation entities, the requirements of the *Superannuation Industry (Supervision) Act 1993* and APRA's requirements for the custody of superannuation entities.

22 In addition, clients may appoint a provider to undertake safekeeping of client assets even when not required to do so by the terms of their AFS licence. For

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[2] This figure does not include custodians that are bodies regulated by APRA, who are outside the scope of this RIS.

[3] Australian Custodial Services Association ('ACSA'), *Australian investor assets under custody*, ACSA website www.custodial.org.au/public_panel/industrystats_investor.php.

[4] Excluding other types of custodial arrangements, such as 'incidental custody' (see RG 166 and PF 209 for an explanation of 'incidental' services). Rice Warner Actuaries, *Investment custody in Australia,* report, March 2011. The Australian Government has announced changes that, if implemented, will increase the superannuation guarantee rate from 9% to 12% from 2013–14 to 2019–20.

[5] ACSA *Australian investor assets under custody*, ACSA website, www.custodial.org.au/public_panel/industrystats_investor.php; Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011.

example, a provider may be engaged because the client may not have the expertise to provide certain back-office or 'investment administration' functions, such as trade settlement, proxy voting, unit pricing and mandate monitoring. It may be more cost effective and efficient for the licensee to engage a provider in this manner.

Current requirements

23 Our guidance on what we consider to be the minimum financial requirements for registered schemes to meet their obligations under the Corporations Act was introduced in 1998. Our guidance on what we consider to be the minimum financial requirements for providers to meet their obligations under the Corporations Act was introduced in 2002.

24 The original NTA requirement for asset holders for registered schemes was determined following consultation within ASIC regarding the appropriate level of capital requirements for licensees providing these services. It was subsequently determined that it was appropriate to apply the same benchmark to custodians as was applied for asset holders for registered schemes.

Custodians

25 Some businesses are set up mainly to provide custodial or depository services, as opposed to businesses where these services are merely incidental: see paragraphs 36–43. We use the term 'custodian' to describe these operators. A custodian requires custodial or depository services authorisation on its AFS licence.

26 A custodian is responsible for the holding of property for another person who is the beneficial owner. A custodian is commonly charged with the responsibility of holding the legal title in certain trust property, but the management powers and responsibilities in respect of the trust property are given to, and undertaken by, another person.

27 While the custodial industry commonly refers to the role of custodian as a 'bare trustee', ultimately the nature of the relationship between the parties is determined by the substance of the obligations into which they have entered into, rather than the name.

28 Except in limited circumstances, such as a potential breach of law, the custodian is usually required to act on all authorised instructions of the client (e.g. a registrable superannuation entity or responsible entity) or its authorised agents (e.g. an investment manager or administrator).

29 It is the responsibility of the custodian to ensure that it acts only under authorised instructions. Generally, a person referred to as a custodian does not have any discretion as to how a client's assets are to be invested or administered—it can only deal with the assets on the instructions from the client and in accordance with those instructions.

30 Clients of custodians place substantial trust in the custodian to ensure the safekeeping of their assets. Substantial operating capacity is usually required for these custodians. An orderly winding up is particularly important for these businesses, in order to prevent client loss, because the custodian may hold assets of many different clients coming from different sources.

31 Currently a custodian must meet the base level financial requirements in RG 166 and the additional $5 million NTA requirement in RG 166.226. A custodian that holds client money or property must also meet the SLF requirement unless the value of the money and property for all clients is less than $100,000: see RG 166.71.

32 Custodians must also show that they have sufficient resources to meet anticipated cash flow expenses (cash needs requirements). They can do this by using one of five options set out in RG 166, which generally involve either preparing a cash flow forecast or obtaining a financial commitment from an authorised deposit-taking institution (ADI) or parent entity: see RG 166.38.

33 Custodians who choose to meet the cash needs requirement using Options 1 or 2 in RG 166 are required to prepare cash flow forecasts. The cash flow forecast must cover a period of at least three months. Custodians who choose to meet the cash needs requirement using Options 3 to 5 in RG 166 are not required to prepare cash flow forecasts.

34 Divisions 2 and 3 of Pt 7.8 of the Corporations Act (client money and property provisions) impose certain obligations on custodians in relation to client money and other property:

(a) Div 2 requires that, subject to certain exceptions, money paid to an AFS licensee, such as a custodian, must be held in an Australian ADI or other type of account prescribed by the Corporations Regulations (s981A(1) and 981B(1)). The money is taken to be held in trust by the custodian (s981H).

(b) Div 3 requires that an AFS licensee, such as a custodian, must ensure that property it receives (other than money) is only dealt with in accordance with:

  (i) the terms and conditions on which the property was given to the AFS licensee (s984B(1)(b)(i)); and

  (ii) any subsequent instructions given by the client to the AFS licensee (s984B(1)(b)(ii)).

35 In the case of scheme property of a registered scheme, the property must be held separately by the custodian, unless relying on:

(a) Class Order [CO 98/51] *Relief from duty to separate assets of a managed investment scheme*, which permits the use of omnibus accounts under certain conditions (see RG 133); or

(b) Class Order [CO 03/1111] *Prime brokerage services: relief from obligation to hold scheme property separately*, which permits money to be held by an ADI as custodian under a prime brokerage arrangements.

Incidental providers

36 RG 166.226(a) requires custodians to have at least $5 million NTA if they have custody of client assets 'other than incidentally' to financial services provided by them or their related body corporate.

37 Currently, we use the term 'incidental providers' to describe licensees who are authorised to provide custodial or depository services but are exempt from the $5 million NTA requirement, on the basis that these services are merely 'incidental' to other financial services they provide.

38 The concept of incidental custodial or depository services is not currently defined in RG 166, although it was applied following consultation by ASIC in 2002. There is significant uncertainty within industry about the meaning and application of this concept, especially among new applicants for custodial or depository services authorisation.

39 RG 166 sets out two examples of custodial functions that are performed incidentally:

(a) the more limited role undertaken by nominee services provided in conjunction with stockbroking; or

(b) the custodial functions that will be performed in wholesale trusts incidentally to the dealing involved in investment management.

40 These examples are intended as a guide only. Whether or not individual services fall within the incidental exclusion depends on the nature of the service provided and other relevant circumstances.

41 An incidental provider must comply with the base level financial requirements of its AFS licence: see RG 166.32. It must also meet the $50,000 SLF requirement for holding client assets if it holds client money or assets unless the value of the money and property for all clients is less than $100,000: see RG 166.71.

42 Incidental providers who choose to meet the cash needs requirement using Options 1 or 2 in RG 166 are required to prepare cash flow forecasts. The cash flow forecast must cover a period of at least three months. Incidental

providers who choose to meet the cash needs requirement using Options 3 to 5 in RG 166 are not required to prepare cash flow forecasts.

43 We consider that many licensees apply for authorisation as a provider on the basis that they are incidental providers, whether or not they provide, or intend to provide, these services because there are minimal financial requirements for incidental providers. As incidental providers, these licensees are required to comply with the financial requirements that apply to the other financial services they provide (see paragraph 13), but are not presently required to meet additional financial requirements as a result of their custodial or depository authorisation.

Asset holders for IDPS

44 An IDPS is a scheme for acquiring and holding investments that involves custody arrangements and consolidated reporting to investors.

45 Where the IDPS operator is responsible for holding IDPS property or assets on behalf of investors, the IDPS operator must currently hold $5 million NTA unless the IDPS property or assets are held by a person who meets our requirements for custodians or is an ADI or a market or clearing participant (or subcustodian appointed by either): see Table 9 in RG 166.

46 IDPS operators that hold client money or property must also meet the SLF requirement, unless the value of the money and property for all clients is less than $100,000: see RG 166.71.

47 IDPS operators who choose to meet the cash needs requirement using Options 1 or 2 in RG 166 are required to prepare cash flow forecasts. The cash flow forecast must cover a period of at least three months. IDPS operators who choose to meet the cash needs requirement using Options 3 to 5 in RG 166 are not required to prepare cash flow forecasts.

Asset holders for registered schemes

48 A responsible entity is a licensed entity or body that operates a registered scheme. The operation of a registered scheme or the holding of assets of a registered scheme does not constitute a custodial or depository service and therefore this authorisation is not required: see paragraph 16.

49 Through the operation of s601FC(2), a responsible entity is deemed to hold scheme property or assets on trust for members. Under s601FB(2), a responsible entity may appoint an agent to hold scheme property separately from other property. Broadly, due to the application of RG 166, if a responsible entity does not hold the greater of $5 million or 10% of average responsible entity revenue, it must appoint a provider to hold scheme property or assets, in order to comply with the terms of its AFS licence.

50 Where the responsible entity is responsible for holding scheme property or assets, the responsible entity must currently hold the greater of $5 million or 10% of average responsible entity revenue with no maximum, unless, for each registered scheme it operates, all the scheme property or assets of the scheme not held by members are:

(a) held by a person (appointed by the responsible entity) that holds at least $5 million NTA or is an ADI or a market or clearing participant (or subcustodian appointed by either); or

(b) special custody assets or Tier $500,000 class assets each of which are held by the responsible entity or a person appointed by the responsible entity (or subcustodian of that custodian).

51 A responsible entity that holds client money or property must also meet the SLF requirement unless the value of the money and property for all clients is less than $100,000.

52 Responsible entities are required to prepare a cash flow forecast that covers a period of at least 12 months and to have this approved by the board of directors at least quarterly: see RG 166.199.

53 A responsible entity that holds financial products under an unregistered managed investment scheme or acts as a provider in other ways not related to its responsible entity function will require custodial or depository service authorisation from ASIC.

Assessing the problem

Industry developments

54 Our guidance on what we consider to be the minimum financial requirements for providers and asset holders for registered schemes to meet their obligations under the Corporations Act has not been updated since it was introduced: see paragraph 23. However, since then there have been a number of significant developments in relation to the custodial or depository and asset holding services industry, including:

(a) an exponential increase in the amount of assets under custody in Australia (see paragraph 55);

(b) significant diversification in the size, complexity and nature of the types of product offerings and hence assets held in custody (see paragraphs 56–57);

(c) substantial consolidation in the custody industry (see paragraphs 58–59); and

(d) significant growth in the number of businesses purporting to be incidental providers, including in circumstances where these services will constitute a significant offering of the business.

55 The substantial increase in the amount of assets under custody over the past two decades is closely correlated to the introduction of compulsory superannuation in the early 1990s. The growth and anticipated further growth of assets under custody is particularly relevant to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

56 The safekeeping of assets is a core custodial service. However, custody is also associated with a large number of additional products and services. Other services offered by custodians are provided independently of the core services and fall under the broad heading of 'investment administration'. Investment administration may include:

(a) mandate monitoring—monitoring, on behalf of the client, the investment managers' compliance with the investment mandate set by the client; and.

(b) fund accounting—preparing the financial accounts for the client managed investments or unit trusts, for which the custodian holds assets on behalf of the client. This also involves calculating net asset values and unit pricing.

Other investment administration services include calculating crediting rates, performance monitoring and reporting, tax reporting, and unit registry. There may be other services provided in addition to core services and investment administration, such as foreign exchange, risk measurement and monitoring and securities lending.[6]

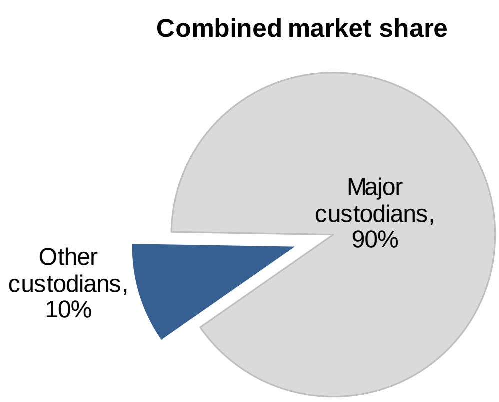
57 We expect that the nature and type of services that may be offered by custodians will continue to evolve and expand over time. For example, as consolidation in the superannuation industry continues, it is possible that certain investment administrative services and compliance monitoring are brought back in-house. This development is relevant to licensees' ongoing compliance costs and the financial requirements necessary to meet those costs.

58 In Australia, custody of a substantial majority of assets under custody is concentrated with a small number of custodians: see Table 1.

[6] Not all ancillary and investment administration services provided by custodians are performed under their AFS licence. However, it is normal practice for these services to be provided under a formal outsourcing arrangement with the clients, typically the custody agreement.

Table 1: Assets held in custody in Australia as at 31 December 2012

Major custodians	Assets in custody	Approx. market share
National Australia Bank Asset Servicing	$554.8 bn	27%
J P Morgan Treasury and Security Services	$375.6 bn	19%
BNP Paribas Securities Services	$296.4 bn	15%
Citi Global Transaction Services	$176.65 bn	9%
State Street Global Services	$171.49 bn	8%
Northern Trust Company	$126.41 bn	6%
HSBC Securities Services	$119.12 bn	6%
Other significant custodians	**Assets in custody**	
BNY Mellon	$83.31 bn	
Bond Street Custodians Ltd (part of Macquarie Bank)	$48.7 bn	
RBC Dexia Investor Services	$48.44 bn	
Asteron	$17.02 bn	
Ausmaq	$5.10 bn	
Netwealth	$3.48 bn	



59 The size of the major custodians and their combined market share is relevant to the size of their operational risk exposure.

60 Given these changes in the custodial or depository and asset holding services industry, we think that it is timely to review our regulatory guidance to ensure that our regulatory framework is adequate and promotes licensees who have sufficient financial resources to provide custody and asset holding services to their clients. We have also identified a number of other issues and risks that indicate it is timely for us to review the adequacy of the financial requirements: see paragraphs 61–68).

Regulatory review

61 As noted in paragraph 23, ASIC established the financial requirements for asset holders for registered schemes in 1998 and for custody providers in 2002. These requirements have not been updated or modified in the intervening period, despite the developments in the custodial or depository and asset holding services industry (outlined in paragraphs 54–60), and the risks and issues that consequently arise.

62 The Parliamentary Joint Committee (PJC) on Corporations and Financial Services (in its 'Inquiry into the collapse of Trio Capital') identified a clear expectation gap between what retail investors understand to be the role of a provider and what a provider is legally required to do. The PJC expressed strong support for ASIC's program to review provider businesses and identify issues requiring regulatory reform.[7]

63 In 2012, we released a Report 291 *Custodial and depository services in Australia* (REP 291), following a review of the industry that identified a number of key risks to the safety of client assets. In the report we recommended some matters of 'good practice' that providers may need to consider and noted that a separate review of the financial requirements for providers was underway.

64 More broadly, we are undertaking a review of custody standards other than financial requirements. As part of this, we have consulted with industry on revising RG 133.

65 Globally, there has been an increased regulatory focus on the safety of client assets and a number of international initiatives are being developed.[8]

66 A recent International Monetary Fund (IMF) review of Australia's implementation of the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulation concluded that Australia's safeguards for ensuring adequate segregation of client assets are not strong enough, as scheme assets may be held by a responsible entity itself or by its related entity.[9]

67 Consequently, more than 10 years after their introduction, we considered that it was an appropriate time to review the financial requirements for providers and asset holders for registered schemes or IDPS to assess whether a licensee who meets our requirements in RG 166 will comply with their obligations under the Corporations Act to have adequate resources to carry out their financial services business.

68 In November 2012, we released Consultation Paper 194 *Financial requirements for custodial or depository services providers* (CP 194). CP 194 set out ASIC's proposed financial requirements for providers and asset holders for registered schemes or IDPS. A detailed description of the consultation process is set out in Section C of this RIS.

[7] PJC, 'Inquiry into the collapse of Trio Capital', May 2012, p. 132.
[8] These international initiatives include the EU Alternative Investment Fund Managers Directive (AIFMD), the US *Dodd–Frank Wall Street Reform and Consumer Protection Act 2010* and various IOSCO principles (to the extent that a comparison can be made with the Australian market and regulatory framework).
[9] IMF, 'Australia: IOSCO Objectives and Principles of Securities Regulation—Detailed assessment of implementation', IMF Country Report No. 12/314, November 2012, p. 26.

Inadequacy of the NTA requirements

69 We acknowledge that there have been no instances of business failure directly attributable to inadequate financial requirements for providers or asset holders for responsible entities or IDPS. However, there have been a number of incidents involving this industry (such as the collapse of Opes Prime[10] and Trio/Astarra[11]) which have led to concerns regarding:

(a) the safety of investment assets that providers hold;

(b) the duty of care providers exercise; and

(c) whether providers have appropriate internal controls to ensure the safety of assets held for others.

These incidents have highlighted various points of systemic weakness in the regulation of providers and asset holders for registered schemes or IDPS. As such, we consider that a proactive approach to preventing a potential business failure in which inadequate financial resources was a contributing factor is justified in order to reduce the risk of client loss.

70 Inflationary pressures have decreased the utility of the existing financial requirements for ensuring that providers and asset holders have sufficient financial resources. Adjusted for inflation alone, the $5 million NTA figure originally introduced for custodians in 2002 is equivalent to $7.26 million in today’s dollars, and the $5 million introduced in 1998 for responsible entities is $7.56 million entities in today’s dollars.

71 Operating risk continues to exist above a $5 million threshold. The introduction of a 10% of average revenue requirement for responsible entities (including asset holders for registered schemes) recognises the non-linear nature of operating risk. The current ‘fixed’ NTA requirement for custodians and asset holders for IDPS does not reflect operating risk above the $5 million threshold.

72 The custodial industry in Australia is concentrated so that the failure of even one major custodian could have a negative impact on a large number of AFS licensees and their clients, as well as confidence in the sector overall.

73 The NTA exemption for incidental providers does not reflect the fact that there are risks involved in providing these services. The exemption increases the risk that an incidental provider will not have adequate resources to conduct its business in compliance with the Corporations Act, or to transfer assets to a solvent entity or for an orderly winding up if the business fails. For example, an incidental provider that holds $50,000 surplus liquid funds

[10] Opes Prime Group Limited was a major Australian securities lending and stock broking firm which suffered collapse in 2008.

[11] Trio Capital Limited, formerly known as Astarra Capital Limited, was a boutique funds management and superannuation firm that that collapsed in 2009.

but is not required to meet an NTA requirement as part of its custodial or depository services authorisation will be poorly placed to effect an orderly and responsible transition of assets or wind up. This is because $50,000 has proven significantly inadequate to meet the costs of administrators and other professional service providers in these circumstances.

74 For the above reasons, we consider that the current financial requirements for providers are not sufficiently robust to ensure that the goals of the financial requirements in RG 166 are met.

75 Moreover, there is an increased risk of disorderly or non-compliant wind-up in the event of business failure for these licensees if the financial requirements remain at current levels. For example, when a licensee has a low capital base and fails, there are usually insufficient resources to meet the costs of administrators and other professional service providers required to wind down or affect a transition of assets. This increases the risk of loss or deterioration of client assets. In addition, intimate knowledge of client assets may disappear with the collapse of the licensee. It can take months for third parties, such as replacement custodians, to regain this knowledge. This process is costly and highly inefficient.

Weaknesses in the cash flow projection and liquidity requirements

76 Asset holders for registered schemes are required to prepare 12-month cash flow forecasts. Other providers (i.e. those relying on Options 3 to 5 in RG 166) are not required to do this. This is a key weakness in the current requirements.

77 Providers that do not prepare cash flow forecasts may not be focusing sufficiently on their cash flow needs, may not be meeting general obligations to have adequate financial requirements and risk management systems, and may have a high dependency on third parties to fund any cash flow deficiencies.

78 For other providers, the existing provision for three-month cash flow forecasts (i.e. in Options 1 and 2 in RG 166) is too short. A three-month period is unlikely to provide directors or company officers with the opportunity to identify potential cash flow risks at a sufficiently early stage to allow them to take meaningful and corrective action. This brings into question whether the licensee has adequate risk management systems as required by law.

79 One of the purposes of the NTA requirement is to ensure funds are available to providers for use in unanticipated situations. Yet, there are few requirements in RG 166 regarding the composition of the NTA requirement. At present, the most a provider must hold in cash is 20% of cash outflows

for the next three months (for licensees who select Option 1 in RG 166 to meet the cash needs requirement). The situation is different for asset holders for registered schemes, which have tailored liquidity requirements under RG 166.207.

80 If assets are not capable of quickly being converted to cash, they are not useable by the licensee in urgent circumstances. Therefore, the current liquidity requirements for providers are likely to be manifestly inadequate in the event of significant unexpected expenses or commitments. Incapacity to meet short-term unexpected expenses may unnecessarily expose a provider to the risk of failure.

Accuracy of data for analysis

81 ASIC does not have access to accurate data on an industry-wide basis to determine how providers and asset holders for registered schemes or IDPS currently meet their financial requirements (some of which is not required to be reported to ASIC). For instance, we cannot determine whether a custodian is meeting the requirements as a result of an eligible undertaking or parent guarantee. This is because eligible undertakings and parent guarantees do not appear as assets on a licensee’s balance sheet.

82 Consequently, we are unable to gain a clear picture of how licensees meet the existing requirements. Indeed, using reported financial data as a basis for an impact analysis is likely to be misleading. For example, a custodian who relies on an eligible undertaking to meet the financial requirements may appear to be in breach of these requirements based on its balance sheet. As such, it is difficult to accurately assess the impact of the proposed requirements on providers and asset holders for registered schemes.

83 Compounding this difficulty, we did not receive any financial data or cost estimates from respondents in response to questions in CP 194 regarding the impact of the proposals on the regulated population, despite asking specific feedback questions about this.

ASIC’s objectives

84 These proposals are aimed at ensuring that businesses that act as providers or asset holders for registered schemes or IDPS have adequate financial resources to conduct their business in compliance with the Corporations Act and in a responsible manner. For these licensees, the nature of the services they provide and their gatekeeping role within the financial services industry means that tailored and/or additional conditions are necessary in order to meet the requirement to hold adequate financial resources: see paragraph 10.

85 The proposals outlined in this RIS are limited in their scope to considering the adequacy of the financial requirements for providers and asset holders for registered schemes or IDPS. As noted earlier, ASIC is currently undertaking a review of custody standards other than financial requirements: see paragraph 64.

86 In developing our proposals, we have been mindful of the fundamental purposes of the financial requirements for AFS licensees. We have focused on the most suitable mechanisms for achieving those purposes in the context of the custodial or depository services industry. The proposals have been aligned with the existing principles outlined in RG 166. Specifically, the proposals seek to:

(a) ensure providers and asset holders for registered schemes or IDPS have adequate financial requirements to meet their operating costs (e.g. costs of ensuring compliance with the Corporations Act);

(b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the licensee fails; and

(c) there are incentives for licensees to comply with the Corporations Act through risk of financial loss.

87 The proposals do not seek to:

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

(b) provide compensation to clients who suffer a loss, for whatever reason.

88 As outlined in RG 166, in setting AFS licence conditions for financial requirements, we seek to set minimum standards that are framed as clearly and simply as possible to provide certainty for providers and asset holders for registered schemes or IDPS. The proposals seek to balance the requirement to ensure that licensees have sufficiently rigorous risk management frameworks and resources to support the responsible holding of client assets against a need to avoid an unreasonable burden in maintaining particular levels of assets, which create unjustifiable barriers to market entry and profitability.

89 In addition, we have attempted to set out a sound basis or rationale for setting financial requirements at the proposed levels, in view of the operational risks and issues faced by these categories of AFS licensee.

B Options and impact analysis

90 Parties affected by the options in this section would include:

(a) custodians;

(b) incidental providers;

(c) asset holders for registered schemes;

(d) asset holders for IDPS;

(e) clients of paragraphs 90(a)–90(d), including the ultimate investors; and

(f) the Australian Government.

Issue 1: NTA for custodians

91 We consider the options to include:

Option 1: Increase the financial requirements for custodians (preferred option);

Option 2: Maintain the existing financial resource requirements for custodians of $5 million NTA (status quo).

Option 1

92 We recommend Option 1 under Issue 1 for custodians. Under this option, we would seek to modify provisions in the Corporations Act to increase the financial requirements for custodians. The new financial requirements would ensure that a custodian has adequate financial resources to conduct its business in compliance with the Corporations Act. In addition, we would update RG 166 to reflect the new financial requirements.

93 The financial requirements in Option 1 would, in summary, require a custodian to:

(a) hold minimum NTA the greater of $10 million or 10% of average revenue;

(b) maintain at least 50% of its NTA requirement in cash or cash equivalents, with the balance in liquid assets;

(c) report its NTA position, together with detailed workings, to ASIC; and

(d) maintain a 12-month cash flow forecast.

94 ASIC considers that each element of Option 1 is important and that the strength of this option lies in the combination of its elements.

95 Option 1 is designed to benefit custodians, their clients, the custodial or depository services industry and the Australian Government by:

(a) ensuring compliance with the law;

(b) enhancing the alignment of the NTA requirement with operating risk;

(c) reducing the risk of disorderly failure of custodians;

(d) ensuring a higher level of care and diligence from directors; and

(e) increasing confidence in the custodial or depository services industry.

96 Option 1 seeks to ensure that custodians have adequate financial resources and liquidity management practices to support the safekeeping of client assets, without being unreasonably burdensome or creating significant barriers to entry.

NTA requirement

97 The focus of the new NTA requirement is on operating risk, with average revenue used as a proxy for operating risk. The Basel II regulations define operating risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operating revenue is considered by Basel Committee on Banking Supervision as a reasonable proxy for operating risk.

98 Custodians operate in an environment with inherently high levels of operating risk. This is due to the large volume of daily transactions, the diversity of assets and the number of jurisdictions involved, the complexity of systems and products, and the high level of manual intervention required to perform many processes. AFS licensees operating in these markets may be exposed to a risk of financial loss due to operational failures.

99 A financial buffer linked to average revenue is likely to be more appropriate for custodians than one based on a minimum NTA. As a result of consolidation in this sector, custodians are getting bigger and the industry has become increasingly concentrated. Setting the required level of NTA at 10% of average revenue will help to ensure that the level of financial resources each custodian holds corresponds to the size of its business, and therefore to the size of its operating risk exposure. This requirement is consistent with the average revenue requirement in RG 166 for responsible entities.

100 The minimum $10 million NTA requirement will provide a buffer against the potential for a disorderly winding up in the event that a custodian fails due to unexpected financial losses. In the event that a custodian does fail, the increased financial buffer will facilitate the transfer of assets from the custodian, reducing the risk of a disorderly or non-compliant winding-up.

101 Some AFS licensees (including most custodians) are structured to record very low or zero revenue. Typically, this occurs because the revenue of the licensee is received by its parent entity. At present, these licensees must nonetheless meet the fixed NTA requirement for custodians (i.e. $5 million NTA). The proposed requirement to hold NTA of 10% of average revenue would not affect these providers. Therefore, imposing a minimum NTA of $10 million will ensure that these custodians still hold sufficient financial resources to provide the financial services covered by their licence.

102 We have considered other options. For example, some respondents to CP 194 proposed a cap on the maximum NTA requirement, although this was not raised in the majority of submissions. We did not pursue this proposal on the basis that operating risk continues to exist above any cap or fixed amount and the NTA requirement should reflect this risk. Further, we note that RG 166 does not currently impose a cap on the maximum NTA requirement for responsible entities and IDPS operators who undertake self-custody.

103 In addition, we considered introducing a lower minimum NTA requirement for custodians. However, for a variety of reasons (including the period of time since the requirements were introduced, inflationary pressures, industry consolidation, the exponential growth of funds under management and the increasing complexity of product offerings and distribution management channels), we decided that a minimum NTA of $10 million NTA was the most appropriate option.

104 Although it is difficult to assess the impact of Option 1 based on reported financial data, we think that existing custodians will meet the proposed requirements through restructuring (i.e. by moving capital within a group or by way of merger) and/or eligible undertakings or parent guarantees (as is currently the case). Therefore, there will be no impact on competition among existing custodians as a result of the new requirements. A number of custodians are bodies regulated by APRA. These custodians will not be affected by ASIC’s new financial requirements: see paragraph 8.

105 Prospective custodians may find it more difficult to meet the new requirements. To the extent that the new requirements represent a barrier to entry for prospective custodians, we think that there is a net benefit to the community associated with restricting poorly capitalised entities from providing custodial or depository services: see paragraph 217.

106 As a result of the new requirement for custodians to report their NTA position, to ASIC, we will have access to detailed and accurate data to assist us to monitor this industry. Custodians do not currently provide NTA calculations, which makes it difficult for ASIC to assess compliance with the NTA requirements.

Cash flow and liquidity requirements

107 Under Option 1, the current cash needs requirement for AFS licensees in Section B of RG 166 would be replaced for custodians. Under the current cash needs requirements, there are five options available to custodians for meeting this requirement. Only Options 1 and 2 require custodians to maintain cash flow forecasts. There is no such requirement for custodians that rely on Options 3 to 5 in RG 166.

108 Under this option, we would introduce a cash needs requirement for all custodians, requiring them to prepare cash flow forecasts and extend the minimum period over which a custodian needs to forecast its cash flow from three months to 12 months. The cash flow forecast would be required to be prepared on a basis similar to the existing Option 1 in RG 166, which requires business-as-usual cash flow.

109 A benefit of requiring 12-month cash flow forecasts is that the risk of failure of a custodian due to incapacity to meet unanticipated liabilities would be reduced because the licensee will have more robust, accurate cash flow forecasting, resulting in it being more likely to have sufficient cash to meet its liabilities. In the event that failure is inevitable, the likelihood of failure should be identified earlier by the custodian or auditor, providing an opportunity to smoothly effect a transition of assets to another custodian to minimise disruption to clients.

110 Custodians would be required to hold a proportion of their NTA requirement in cash or cash equivalents and the remaining balance in liquid assets. The primary objective of the liquidity requirement is to ensure that a custodian's NTA is in a form that can be called on when required. There is currently little guidance as to the composition of a custodian's NTA requirement and as such it could consist entirely of non-liquid assets. Non-liquid assets would be of little use if the custodian needed to draw on these resources at short notice. The new liquidity requirements will assist custodians to meet any immediate and unexpected expenses.

111 The cash flow and liquidity requirements have been designed to reduce the risk of disorderly failure of custodians by addressing the anticipated funding requirements of a custodian over a 12-month period. In addition, they will ensure that a custodian's NTA is in a sufficiently liquid form to be used to address any unanticipated events. To the extent that the risk of failure is reduced, the safekeeping of client assets is enhanced to the benefit of clients generally.

112 The cash flow and liquidity requirements are consistent with the existing requirement for cash flow forecasts in RG 166 for responsible entities.

Costs

113 In CP 194, we asked industry to provide us with specific information on the impact of our proposals on business costs. Many respondents indicated that additional costs would be necessary to meet the new requirements. However, they did not quantify the amount or provide a cost estimate to substantiate this assertion.

114 We consider that custodians and their clients may incur costs as a consequence of custodians complying with the new financial requirements. There may be minor costs associated with calculating average revenue, sourcing NTA (through eligible undertakings or parent guarantees), preparing 12-month cash forecasts and additional reporting requirements. Custodians may also incur opportunity costs associated with holding their NTA requirement as cash or liquid assets.

115 Custodians that prefer to restructure (e.g. by moving capital within a group or by way of merger) rather than to meet the new NTA requirement will incur the cost of restructuring their business. The cost will depend on the complexity of the restructuring.

116 Clients of custodians may incur minor increases in fees if custodians pass any additional costs of the new financial requirements on to them.

117 We think that the costs to custodians and their clients will be minor. Table 2 provides an estimate of the possible additional costs in dollars for custodians under Option 1. These costs may be subject to significant variation depending on the licensee's individual circumstances.

118 ASIC has not created a whole-of-industry costs estimate due to the difficulty of extrapolating these costs on an industry-wide basis and predicting the nature of the competitive response to the new financial requirements. These factors mean that any estimate of whole-of-industry costs is likely to be unreliable or subject to significant variation, and therefore would not contribute meaningfully to the decision making process.

Table 2: An estimate of possible additional costs per entity for custodians under Option 1

Estimated number of licensees	13
Cost of implementing cash flow preparation: see paragraph 119	$8000 (if not already implemented)
Cost of extending cash flow forecasts from three to 12 months: see paragraph 120	$1500 (if not already implemented)
Cost of additional directors' meeting to review cash flow forecasts: see paragraph 121	$1875 (if not already implemented)
Cost of auditing cash flow forecasts: see paragraph 122	$2000

Additional capital (on average): see paragraph 123	$4 m
Cost of capital per every additional $1m	$79,800
Cost of sourcing additional capital: see paragraphs 124–126	$5250–$18,000
Cost of the liquidity requirement: see paragraphs 127–128	$5400–$9000
Cost of learning the new requirements: see paragraph 129	$15,500

Note: Estimates have been prepared on the basis of the assumptions in each of the relevant paragraphs. Individual custodians will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by individual licensees in response to the proposals.

Cost of implementing cash flow preparation

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

Costs of extending cash flow projections to 12 months

120 Custodians using Option 1 or 2 of the current cash needs requirement in RG 166 will incur inconsequential costs associated with extending their cash flow forecasts from three months to 12 months. This will involve custodians extending their current analysis and projection of revenues, expenses and cash needs over the longer period. We estimate that custodians may have to spend up to an additional week extending their forecasts from three months to 12 months at a cost of $1500 per entity (assuming an analyst salary of $75,000 per year).

Cost of additional directors' meetings to review cash flow forecasts

121 We estimate up to an extra half an hour may be required on average to review the extended forecast per meeting. If we assume three independent directors per custodian, each paid $20,000 per annum to meet quarterly, with each meeting being held for four hours, this could result in an additional cost of $1875 per year, assuming all directors for those custodians seek to increase their fees to review the extended cash flow.

Cost of auditing cash flow forecasts

122 Custodians may incur minor increases in auditing costs as a consequence of extending the cash flow period from three months to 12 months, or having an auditor annually review a new cash flow forecast. The extension of or

new audit requirement will involve auditing the custodian's projections of its revenues, expenses and cash needs for the next 12 months and will most efficiently be undertaken at the same time as fulfilment of the existing requirements for custodians to audit their financial statements. Based on submissions by auditing firms, we estimate the additional auditing costs to be approximately $2000 per entity.

Cost of additional capital to meet NTA requirement

123 Some custodians will incur the cost of providing additional capital to meet the increased NTA requirement. Based on a dataset of 13 custodians, we estimate that eight may require additional capital to meet the new requirements. We estimate that these eight custodians will require an average increase of $6.36 million NTA to meet the minimum $10 million NTA requirement.

Cost of sourcing additional capital

124 The administrative costs associated with sourcing additional capital are expected to be minimal. For some custodians, this may involve possible reallocation of internal funding, which is likely to be carried out by the relevant funding personnel in addition to directors' approvals. The directors may need to meet and give consideration to the additional capital required.

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

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

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

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

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

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

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

Cost of the liquidity requirement

127 Custodians may incur the opportunity cost of holding their NTA requirement as cash and liquid assets. The possible cost of holding additional capital in liquid assets, rather than non-liquid assets, to meet the liquidity requirement will vary depending on the anticipated return from investment in other liquid and non-liquid assets. For example, if a custodian could earn 12% on a $100,000 non-liquid investment, and only 9% on cash, there would be a $4000 per year cost of meeting the liquidity requirement.

128 Table 3 estimates the opportunity cost of holding additional cash to meet the proposed 50% NTA requirement in cash. Custodians adopting Option 1 or 2 of the current cash needs requirement in RG 166 must hold 20% of the NTA in cash, while entities adopting Option 3, 4 or 5 do not need to hold any portion of the NTA in cash.

Table 3: Estimated opportunity cost for every additional $1 million capital

	Entities using the options in RG 166	
	Option 1 or 2	**Options 3, 4 or 5**
RBA cash rate (10-year average)[12]	5.0%	5.0%
S&P ASX 300 (10-year average)[13]	6.8%	6.8%
Current cash holding (%)	20.0%	0.0%
Proposed cash holding	50.0%	50.0%
For any additional $1 m capital, the estimated opportunity cost under the new requirement	$5,400	$9000

Cost of learning new requirements

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

[12] RBA 10-year average cash rate 2003–2013.

[13] The 10-year average of the annualised performance of the S&P ASX 300 was used in this instance. However, it should be noted that the opportunity cost will vary greatly depending on the type of investments in which the entity chooses to invest. This is a rough and generalised estimate of the opportunity cost under the proposed NTA cash requirement.

Cost of reporting

130 As part of the Form FS70 reporting requirements, responsible entities may incur inconsequential costs in collating and providing information for reporting to ASIC the:

(a) NTA requirement;

(b) actual NTA;

(c) average value of scheme property;

(d) average gross revenue; and

(e) cash or cash equivalents,.

131 Based on submissions from auditing firms, any additional costs in providing this information are included in the estimate of auditing costs of $2000 for reviewing or extending the cash flow forecast: see Table 2.

Summary of analysis

132 On balance, ASIC considers that the benefits associated with strengthening the financial requirements for custodians outweigh any additional costs to custodians and their clients associated with the Option 1.

Option 2

133 Under this option, we would maintain the existing financial requirements imposed on custodians in RG 166. This would mean:

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

(b) the NTA requirement would remain at $5 million; and

(c) only custodians meeting their cash needs requirement by electing Option 1 in RG 166 would be subject to a liquidity requirement.

Costs

134 If the current financial requirements are maintained, custodians will avoid any additional costs or restructuring associated with the new financial requirements.

135 Under this option, prospective custodians may find it easier to enter the industry as inflationary pressures continue to devalue the relative worth of the existing financial requirements.

136 We do not consider that there are any other benefits associated with maintaining the status quo.

137 We anticipate that there may be a negative impact on custodians, their clients, the custodial or depository services industry and Australian Government if the existing financial requirements were maintained.

138 Investor confidence in the custodial or depository services industry may decrease as a result of custodians:

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

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

139 Custodians with insufficient capital to fund the orderly transfer of client assets to a solvent entity on failure may result in breaches of the Corporations Act.

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

Summary of analysis

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

Issue 2: NTA for asset holders for registered schemes or IDPS

142 We consider the options to include:

Option 1: Align the financial requirements for asset holders for registered schemes or IDPS with the financial requirements for custodians (preferred option); and

Option 2: Maintain the existing financial resource requirements for asset holders for registered schemes or IDPS (status quo).

Option 1

143 We recommend Option 1 under Issue 2 for asset holders for registered schemes or IDPS. Under this option, we would seek to modify provisions in the Corporations Act to increase the financial requirements for asset holders (in line changes to the financial requirements for custodians). The new financial requirements would ensure that asset holders have adequate financial resources to conduct their business in compliance with the Corporations Act. In addition, we would update RG 166 to reflect the new financial requirements.

144 Option 1 would align the financial requirements for asset holders for registered schemes or IDPS with the (proposed) financial requirements for custodians. In summary, this would require asset holders to:

(a) hold minimum NTA the greater of $10 million or 10% of average revenue;

(b) maintain at least 50% of its NTA requirement in cash or cash equivalents, with the balance in liquid assets;

(c) report their NTA position, together with detailed workings, to ASIC; and

(d) maintain a 12-month cash flow forecast.

145 Some of the proposed financial requirements for custodians have already been implemented for asset holders of registered schemes. To the extent that any proposals have already been implemented for these licensees, they would remain the same after the implementation of this option.

NTA requirement

146 Under the existing regime, asset holders for responsible entities are required to hold NTA of the greater of $5 million or 10% of average responsible entity revenue. Asset holders for IDPS are required to hold NTA of $5 million. If Option 1 were implemented, asset holders for registered schemes or IDPS would be required to hold minimum NTA the greater of $10 million or 10% of average revenue.

147 RG 166 provides that the same of financial requirements should be applied to custodians as is applied for asset holders for registered schemes or IPDS. We think that is it important that there is consistent approach to capital requirements for licensees who are responsible for holding client assets, whether they are custodians, responsible entities or IDPS operators.

148 The reasons for increasing the minimum NTA requirement for custodians to the greater of $10 million or 10% of average revenue are discussed at paragraphs 97–106, and are also relevant to asset holders for registered schemes or IDPS. In summary, they include:

(a) ensuring that the level of financial resources held by a licensee corresponds to the size of its business;

(b) aligning the financial requirements with licensees' operating risk exposure;

(c) providing a buffer against the potential for a disorderly winding up; and

(d) securing accurate reporting about licensees' NTA position.

149 In addition, increasing the minimum NTA requirement to $10 million will help ASIC comply with the IOSCO Principles on the Regulation of Collective Investments. The recent IMF review of Australia's

implementation of the IOSCO Principles concluded that Australia's safeguards for ensuring adequate segregation of client assets are not strong enough where scheme assets are held by an responsible entity itself or by its related entity. By imposing a high minimum NTA in these circumstances, we reduce the risk that self-custody is not regarded as appropriate to ensure the protection of client assets.

150 Some respondents to CP 194 submitted that differences in the nature of the custodial services provided by asset holders for registered schemes or IDPS meant that a lower minimum NTA to that imposed on custodians may be appropriate. We did not pursue this option. In our view it is appropriate to apply the same benchmark for financial requirements to these asset holders to achieve competitive neutrality. Moreover, opportunities for regulatory arbitrage may arise if the financial requirements are not applied consistently to custodians and other asset holders.

151 Although it is difficult to assess the impact of our proposals based on reported financial data, we think that most existing asset holders for registered schemes or IDPS will meet the proposed requirements through restructuring and/or eligible undertakings or parent guarantees (as is currently the case). It is possible that some asset holders may choose to exit the industry and that prospective asset holders may find it more difficult to meet the new requirements. Overall, however, we think that the impact on competition for this industry segment will be minor. To the extent that competition impacts do occur, we think that there is a net benefit to the community associated with restricting poorly capitalised entities from providing asset holding services: see paragraph 217.

152 To the extent that elements of the proposed financial requirements for custodians have already been implemented for asset holders for registered schemes, there will be no further impact for these licensees.

153 As a result of the new requirements, providers may be better resourced and better prepared for unexpected operating risks.

Cash flow and liquidity requirements

154 The reasons for introducing new cash flow and liquidity requirements for custodians were discussed at paragraphs 107–112, and are also relevant to asset holders for registered schemes or IDPS.

155 The liquidity requirement is consistent with existing requirements for responsible entities, although it will alter the way the requirement applies to asset holders for registered schemes. The liquidity requirement for all responsible entities is based on the amount of NTA they would be required to hold if they did not undertake self-custody. Under this option, the liquidity requirement for these asset holders for registered schemes will be based on the amount of NTA they are required to hold, including as a result of being

an asset holder. This may mean that they are required to keep a higher proportion of their NTA as liquid assets.

Costs

156 In CP 194, we asked industry to provide us with information on the impact of our proposals on business costs. Many respondents indicated that there would be additional administrative and compliance costs, associated with meeting the additional requirements. However, most did not quantify the amount or provide a cost estimate.

157 We think that asset holders for registered schemes or IDPS and their clients may incur costs as a consequence of asset holders complying with the new financial requirements. The nature of these costs was outlined in paragraphs 113–118 in relation to custodians, and is also relevant here.

158 To the extent that elements of the proposed financial requirements for custodians have already been implemented for asset holders for registered schemes, there will be no further costs for these licensees.

159 We think that the costs to asset holders for registered schemes or IDPS and their clients will be minor. Table 4 provides an estimate of the possible additional costs in dollars for asset holders under Option 1. These costs may be subject to significant variation depending on the licensee's individual circumstances.

160 ASIC has not created a whole-of-industry costs estimate due to the difficulty of extrapolating these costs on an industry-wide basis and predicting the nature of the competitive response to the new financial requirements. These factors mean that any estimate of whole-of-industry costs is likely to be unreliable or subject to significant variation, and therefore would not contribute meaningfully to the decision making process.

Table 4: An estimate of possible additional costs per entity for asset holders for registered schemes or IDPS under Option 1

	Medium to large asset holder (Revenue >$10m)	Small asset holder (Revenue <$10 million)
Estimated number of licensees	40	102
Cost of implementing cash flow preparation	No impact	$8000 (if not already implemented)
Cost of extending cash flow forecasts from three to 12 months	No impact	$1500 (if not already implemented)
Cost of additional directors' meeting to review cash flow forecasts	No impact	$1875 (if not already implemented)

	Medium to large asset holder (Revenue >$10m)	Small asset holder (Revenue <$10 million)
Cost of auditing cash flow forecasts	$2000 per AFS licence (if not already implemented)	$2000 (if not already implemented)
Additional capital (on average)	$1.7m	$6.36m
Cost of capital per every additional $1 m	$79,800	$79,800
Cost of sourcing additional capital	$5250*	$18,000
Cost of the liquidity requirement	$5400–$9000 (if not already implemented)	$5400–$9000 (if not already implemented)
Cost of learning the new requirements	$15,500 per entity (if not already implemented)	$15,500 per entity (if not already implemented)

Note: The basis on which these estimates were prepared is discussed in paragraphs 119–130. Individual asset holders for registered schemes or IDPS will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by individual licensees in response to the proposals.

* This figure is an estimate of the administrative costs associated with sourcing additional capital internally. We do not expect any medium to large entities will need to source additional capital externally.

Summary of analysis

161 On balance, ASIC considers that the benefits associated with strengthening the financial requirements for asset holders for registered schemes or IDPS outweigh any additional costs to these licensees and their clients associated with Option 1.

Option 2

162 Under this option, we would maintain the existing financial requirements for asset holders for registered schemes or IDPS.

163 For asset holders for registered schemes, this would mean:

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

(b) the NTA requirement would remain the greater of $5 million or 10% of their average revenue; and

(c) asset holders would be required to hold cash or cash equivalents valued at $150,000 or 50% of the NTA the licensee would be required to hold if it did not undertake self-custody, whichever is greater.

164 For asset holders for IDPS, this would mean:

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

(b) the NTA requirement would remain at $5 million; and

(c) only asset holders meeting their cash needs requirement by electing Option 1 in RG 166 would be subject to a liquidity requirement.

Costs

165 By maintaining the current financial requirements, asset holders for registered schemes or IDPS will avoid any additional costs or restructuring associated with the new financial requirements.

166 Under this option, prospective asset holders may find it easier to enter the industry as inflationary pressures continue to devalue the relative worth of the existing financial requirements.

167 We do not consider that there are any other benefits associated with maintaining the status quo.

168 Potentially negative impacts associated with maintaining the existing financial requirements for custodians were discussed in paragraphs 134–140, and are also relevant for asset holders for registered schemes or IDPS.

169 In addition, if the current financial requirements remain unchanged, asset holders for registered schemes may be at a competitive disadvantage compared to other providers. This is because some changes to the financial requirements for asset holders for registered schemes have already been introduced: see paragraphs 71 and 76. Consequently, asset holders for registered schemes are required to meet a higher standard of financial requirements than other providers.

170 Similar issues may occur if the financial requirements for asset holders for registered schemes or IDPS were maintained and the financial requirements for custodians were increased in line with our recommendations. Opportunities for regulatory arbitrage would arise in these circumstances, which may result in the flow of client assets from better capitalised and more stable entities to entities of less financial substance.

Summary of analysis

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

Issue 3: NTA for incidental providers

172 We consider the options to include:

Option 1: Amend the financial requirements for incidental providers (preferred option);

173 **Option 2:** Maintain the existing financial requirements for incidental providers (status quo).

Option 1

174 We recommend Option 1 under Issue 3 for incidental providers. Under this option, we would seek to modify the provisions of the Corporations Act to introduce new financial requirements for incidental providers. The new requirements would ensure than incidental providers have adequate financial resources to conduct their business in compliance with the Corporations Act. In addition, we would update RG 166 to reflect the new requirements.

175 The financial requirements in Option 1 would, in summary, require an incidental provider to:

(a) maintain a 12-month cash flow forecast;

(b) hold minimum NTA the greater of $150,000 or 10% of average revenue;

(c) maintain at least 50% of its NTA requirement in cash or cash equivalents, with the balance in liquid assets; and

(d) report its NTA position, together with detailed workings, to ASIC.

176 Under this option, 'incidental provider' is defined to mean an AFS licensee who is authorised to provide a custodial or depository services:

(a) that does not provide any custodial or depository service other than services which:

  (i) are a need of the person to whom the services are provided because of, or in order to obtain, the provision of other financial services by the licensee or its related bodies corporate; and

  (ii) do not form part of an IDPS; and

(b) whose custodial or depository services revenue is less than 10% of its financial services revenue.

177 Only businesses that provide custodial or depository services in accordance with this definition would be eligible for the reduced minimum NTA requirement for incidental providers.

178 An incidental provider that does not meet the financial requirements for custodians (see paragraph 93) would be required to lodge with ASIC a statement in their audit report that, having review the financial statements of each related body corporate of the licensee, the auditor has no reason to believe that the licensee did not meet the requirement in paragraph 176(b) of the definition of 'incidental provider' (audit opinion requirement).

179 Incidental providers who appoint a third-party custodian to hold client assets on their behalf may be eligible for an exemption from the NTA requirement in certain circumstances.

NTA requirement

180 The introduction of a minimum NTA requirement for incidental providers recognises that there is a degree of operating risk associated with providing any custodial or depository service. It is important that these AFS licensees have the necessary experience, systems and controls in place to support their authorisation to provide these services, irrespective of the nature of other services for which they may be authorised, even if this financial service is provided only incidentally.

181 Nonetheless, we recognise that in certain circumstances it would be unreasonably costly for incidental providers to meet the full financial requirements for custodians. Accordingly, we have decided to introduce a significantly reduced minimum NTA for incidental providers.

182 Several respondents to CP 194 submitted that there should be an exemption from the NTA requirement for incidental providers who appoint a third-party custodian to hold assets for them. A similar exemption currently applies to responsible entities. In response to this feedback, we have created this exemption from the NTA requirement for incidental providers, provided they reasonably believe the third-party custodian meets the requirements for custodians or is an eligible custodian. Based on commentary in submissions to CP 194, we think that a large number of incidental providers would appoint a custodian to hold assets for them as a result of this exemption.

183 We have considered other options. For example, some respondents to CP 194 proposed a cap on the maximum NTA requirement for incidental providers, although this was not raised in the majority of submissions. One benefit of imposing a cap on the maximum NTA requirement is that it recognises the differences between the nature and scale of custodial or depository services offered by incidental providers and those offered by custodians. However, we did not pursue this proposal on the basis that operating risk continues to exist above any cap or fixed amount and the NTA requirement should reflect this risk.

184 We anticipate that some existing licensees may not be able to meet the financial requirements for incidental providers under Option 1, and may cease providing these services to their clients. However, we do not consider the potential loss of a small number of undercapitalised and less stable incidental providers from this industry to be disadvantageous.

185 Prospective incidental providers may find it more difficult to meet the new requirements. To the extent that the new requirements represent a barrier to entry for prospective incidental providers, we think that there is a net benefit

to the community associated with restricting poorly capitalised entities from providing custodial or depository services: see paragraph 217.

186 For incidental providers who are caught by the requirement to hold NTA of 10% of average revenue (approximately 171 licensees or 33% of incidental providers), we anticipate that most will appoint a third-party custodian to hold client assets on their behalf to avoid this requirement: see paragraph 182. Another option available to incidental providers would be to restructure their custodial or depository activities into a separate entity (quarantining that revenue from their other business revenue) to avoid the average revenue requirement.

187 For clients, the benefits of Option 1 for incidental providers will include:

(a) increased incentives for licensees to ensure the safekeeping of client assets;

(b) the restriction of licensees with inadequate capital or liquidity reserves from providing custodial or depository services;

(c) remaining providers will have more capital and liquid resources at their disposal to ensure their compliance with the Corporations Act;

(d) the financial requirements will better reflect licensees' operating risk; and

(e) greater confidence in the security of their assets and the custodial or depository services industry.

Cash flow and liquidity requirements

188 The cash flow and liquidity requirements in Option 1 for incidental providers are consistent with those recommended for custodians and asset holders for registered schemes or IDPS. The reasons for introducing new cash flow and liquidity requirements for custodians were discussed at paragraphs 107–112, and are also relevant to incidental providers.

Costs

189 In CP 194, we asked industry to provide us with information on the impact of our proposals on business costs. Many respondents indicated that there would be additional administrative, compliance and audit costs, associated with meeting the additional requirements. However, most did not quantify the amount or provide a cost estimate.

190 We think that incidental providers and their clients may incur costs as a consequence of incidental providers complying with the new financial requirements. The nature of these costs was outlined in paragraphs 113–118 in relation to custodians, and is also relevant here. In addition, there may be additional costs for incidental providers associated with appointing a third party custodian to hold assets on their behalf, although this will also involve

some savings for the incidental provider in no longer having to hold the assets themselves. The additional cost will depend on the nature of the incidental provider, the type of assets held and whether the third party custodian is a related entity. There may also be additional costs associated with meeting the audit opinion requirement. We think that the costs to incidental providers and their clients will be minor. Table 5 provides an estimate of the possible additional costs in dollars for incidental providers under Option 1. These costs may be subject to significant variation depending on the licensee’s individual circumstances.

191 ASIC has not created a whole-of-industry costs estimate due to the difficulty of extrapolating these costs on an industry-wide basis and predicting the nature of the competitive response to the new financial requirements. These factors mean that any estimate of whole-of-industry costs is likely to be unreliable or subject to significant variation, and therefore would not contribute meaningfully to the decision making process.

Table 5: An estimate of possible additional costs per entity for incidental providers under Option 1

	Medium to large asset holder (Revenue >$10m)	Small asset holder (Revenue <$10 million)
Number of licensees	79	434
Cost of implementing cash flow preparation	No impact	$8000
Cost of extending cash flow forecasts from three to 12 months	No impact	$1500
Cost of additional directors’ meeting to review cash flow forecasts	No impact	$1875
Cost of auditing cash flow forecasts	$2500	$2500
Additional capital (on average)	$30,000	$170,000
Cost of capital per every additional $1 m	$79,800	$79,800
Cost of sourcing additional capital	$5250*	$18,000
Cost of the liquidity requirement	$5400–$9000	$5400–$9000
Cost of learning the new requirements	$15,500	$15,500

Note: The basis on which these estimates were prepared is discussed in paragraphs 119–130. Individual incidental providers will not necessarily incur all estimated costs. Costs incurred will depend on the choices made by individual licensees in response to the proposals.

* This figure is an estimate of the administrative costs associated with sourcing additional capital internally. We do not expect any medium to large entities will need to source additional capital externally.

Summary of analysis

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

Option 2

193 Under this option, we would maintain the current approach to financial requirements for incidental providers. This would mean:

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

(b) incidental providers would be exempt from the NTA requirement for custodians; and

(c) only incidental meeting their cash needs requirement by electing Option 1 in RG 166 would be subject to a liquidity requirement.

194 A benefit of maintaining the current financial requirements for incidental providers is that incidental providers will avoid any additional costs or restructuring associated with the new financial requirements.

195 Barriers to entry for incidental providers are already low and would be expected to remain unchanged if the status quo were maintained: see paragraph 43.

196 We do not consider that there are any other benefits associated with maintaining the status quo.

197 We consider that it is inappropriate to retain the NTA exemption for incidental providers. Currently, there is no requirement to maintain any level of NTA in order to provide incidental custodial or depository services. This does not reflect the risks associated with providing any custodial or depository service.

198 Potentially negative impacts associated with maintaining the existing financial requirements for custodians were discussed in paragraphs 134–140, and are also relevant for incidental providers.

199 In addition, under Option 2 there is a significant risk that there would not be sufficient capital available to fund an orderly transition of client assets to a solvent entity in the event of the failure of an incidental provider. With potentially few capital resources, the incidental provider would be unable to meet the costs of administrators and other professional service providers necessary to wind down or effect a transition of assets to a solvent entity.

Summary of analysis

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

C Consultation

201 CP 194 set out ASIC's proposed financial requirements for providers and asset holders for registered schemes or IDPS. CP 194 also provided background and rationale to these proposals. We invited submissions on the proposed financial requirements in CP 194.

202 The consultation period for CP 194 ended on 14 January 2013. We provided extensions to the deadline for submissions of up to three weeks on request. We received 12 submissions on CP 194, including from industry associations, industry participants and their advisers. Of the 12 submissions, 10 were non-confidential. The responses provided by industry associations were informed by the views of more than just the associations themselves.

203 We met also with representatives of the Financial Services Council (FSC) and the Australian Custodial Services Organisation (ACSA) to discuss the proposals in CP 194. The FSC represents the retail and wholesale funds management, superannuation and life insurance industries and financial advisory networks. The FSC has over 130 members who are responsible for investing over $1.8 trillion on behalf of more than 11 million Australians. ACSA is the peak industry body representing members of Australia's custodial and administrative industry. Collectively, the members of ACSA hold securities and investments in excess of $1.8 trillion in custody and under administration.

204 We have set out below a brief summary of our responses to the feedback received in submissions to CP 194. For further detail, see Report 352 *Response to submissions on CP 194 Financial requirements for custodial or depository service providers* (REP 352).

205 Most respondents recognised the need for a review of the financial requirements for providers and asset holders for registered schemes or IDPS. However, several submissions expressed concern about the potential impact of the proposals on their business and the industry in general. The following are examples of some of the views expressed in written submissions.

NTA for custodians and asset holders for registered schemes or IDPS

206 Most respondents did not agree with the proposed increase in the NTA requirement for custodians and asset holders for registered schemes or IDPS. They said that the increased 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 providers.

207 We have adopted the NTA requirements proposed in CP 194. We consider that the current 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.

208 We have decided to apply the NTA requirement for custodians to asset holders for responsible entities or IDPS, to achieve competitive neutrality. We are convinced that the custodial functions performed by asset holders are substantially similar to those performed by custodians. In our view, it is appropriate to apply the same benchmark in each case.

NTA for incidental providers

209 Some respondents supported our proposal to introduce a NTA requirement for incidental providers. Other respondents favoured maintaining an NTA exemption for incidental providers. 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.

210 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 custodial or depository services. We have included an exemption from the NTA requirement for incidental providers who have appointed a third-party custodian to hold client assets for them.

D Conclusion and recommended option

211 There is significant uncertainty surrounding the quantitative whole-of-industry costs and benefits associated with the new financial requirements. However, ASIC supports the preferred options in Issues 1–3 of Section B because, on the qualitative evidence available, they address the identified problems and achieve ASIC's objectives: see paragraph 217.

212 As noted at paragraph 69, there have been no instances of business failure directly attributable to inadequate financial requirements for custody providers or asset holders. There have, however, been a number of instances involving this industry which have highlighted the need to review the current financial requirements for these licensees.

213 Further to this, developments such as the growth of assets under custody and industry consolidation have resulted in major providers assuming more systemic importance: see paragraph 54. Meanwhile, inflationary pressures have decreased the utility of the financial requirements in RG 166 for ensuring that custodians hold adequate financial resources.

214 In addition, there has been a significant increase in the number of incidental providers. The financial requirements for these providers do not set minimum financial requirements reflecting the risks associated with providing any custodial or depository services.

215 In view of the above, we consider that it is appropriate to revise the financial requirements for providers and asset holders for registered schemes or IDPS, notwithstanding that the potential risks outlined in this RIS have not materialised in the Australian context. As such, the preferred options are preventative and forward looking in nature, aimed at managing risks that we consider are likely to occur.

216 The preferred options incorporate a number of different elements, which are designed to address weaknesses in the current financial requirements. ASIC considers that each element is important and that the strength of these options lies in the combination of their elements. While it is possible for some or all of these elements to be implemented separately, failure to address all of the elements would dilute the effect of the implemented measures and would not achieve ASIC's objective of ensuring that providers and asset holders have sufficient financial resources to provide custodial or depository services and asset holding services.

217 We consider that the preferred options achieve our objectives because they will:

(a) ensure that providers and asset holders have more financial resources and are better able to meet their operating costs, through more robust cash flow forecasting, greater levels of capital and liquidity, and capital levels better reflecting the operational risk of providing custodial or depository services or asset holding services;

(b) result in more stable providers and asset holders for registered schemes or IDPS, as a consequence of being required to prepare longer and more accurate 12-month cash flow forecasts, that are better able to cope with unexpected expenses;

(c) align the interests of providers and asset holders for registered schemes or IDPS with their clients by imposing increased capital requirements, so that these providers and asset holders are entities of substance with sufficient capital at risk to provide them with a real incentive to ensure the safekeeping of client assets;

(d) provide increased levels of assurance so that, if a provider or asset holder for registered schemes or IDPS does fail, there will be more money available for the orderly transition of client assets to a solvent entity or for winding up the business;

(e) secure accurate and efficient reporting of licensees' NTA position to provide ASIC with meaningful and accurate data on the industry for analytical and compliance purposes;

(f) assist with Australia's implementation of the IOSCO Principles by reducing the risk that self-custody by responsible entities is not considered appropriate to ensure the protection of client assets; and

(g) enhance investor confidence in Australia's reputation as an attractive financial services centre.

218 We do not recommend that the status quo be maintained because it does not offer any solutions to the risks and challenges raised by the existing financial requirements, which is undesirable given the growth of the industry over the last decade and its likely continued development in the future.

E Implementation and review

219 ASIC proposes to implement new financial requirements for custody providers and asset holders. Two class orders will be necessary to implement the changes for custodians (including incidental providers) and asset holders for registered schemes or IDPS. This method was previously used to implement new financial requirements for responsible entities.

220 A class order is a disallowable instrument and is reviewable by the Senate. This means that the Senate could disallow the new financial requirements if they objected to them. We plan to publish the class orders and our updated regulatory guidance by 28 June 2013, ahead of their commencement.

Transition arrangements

221 For new providers, the changes will be effective from 1 July 2013. For existing providers, the changes will be effective from 1 July 2014. A twelve month transition period for existing custody providers and asset holders will enable these licensees to understand and prepare for the new financial requirements.

222 During the transition period for existing custody providers and asset holders, we will:

(a) work with industry to ensure that the new financial requirements are understood and appropriately implemented; and

(b) assess the relevance of our requirements on an ongoing basis to ensure they remain relevant.

223 Following the transition period, we are likely to undertake periodic reviews of the custodial or depository services industry to ensure compliance with our regulatory approach and the currency of our guidance, with the objective of ensuring it adequately addresses key existing and emerging issues and risks for this sector.