



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 25

Licensing: Financial requirements

September 2001

Your comments

You are invited to comment on the proposals and issues for consideration in this paper.

Comments are due by Monday 29 October 2001 and should be sent to:

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**You can also contact the ASIC Infoline on
1300 300 630 for information and assistance.**

What this policy proposal is about

1 This policy proposal sets out some of the financial requirements we propose you will have to meet to receive and keep an Australian Financial Services Licence (licence), given the products and services you offer.

Note: If you are a body regulated by the Australian Prudential Regulation Authority (APRA), this proposal does not apply to you. You must meet APRA's requirements for financial resources.

2 It explains:

- (a) our general approach to financial requirements (**Section A**);
- (b) what financial requirements apply to licensees generally (**Section B**);
- (c) what additional requirements apply (**Section C**) to licensees that are:
 - (i) responsible entities,
 - (ii) investor directed portfolio services (IDPS) operators; or
 - (iii) operators of other custodial or depository services; and
- (d) what financial requirements apply to market participants (**Section D**).

Schedule 1 defines key terms used in calculating financial requirements for licensees.

3 We are considering separately what additional requirements should apply to licensees that:

- (a) hold more than \$100,000 of client assets or money; and
- (b) have financial obligations to clients from transacting with them as part of the business under the licence.

Requirements relating to holding client assets or having financial obligations to clients are characteristic of licensing, at least for dealers in securities in USA, UK and Hong Kong. We will be discussing how to frame any proposals with some affected industry sectors.

4 We are consulting with APRA about all our financial requirement proposals including their implications for entities in groups that have an APRA regulated entity.

5 Under the proposals in this paper, different conduct means that different requirements apply. More than one requirement may apply in your case. Table A at the beginning of this paper summarises the structure of this policy proposal paper and how it might apply to you.

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Table A: Summary of Sections A–D

Note: This summary merely shows how the parts of the proposals relate to each other. For details of our policy proposals, see relevant sections of this paper.

| Section | Who is affected | Summary of our proposals | What attracts financial requirements | What sub-classes of licensee are primarily affected |
|---|--|--|--|--|
| A Our general approach to financial requirements | All licensees not regulated by APRA | Risk management systems must address risk to financial objectives. | Holding a licence. | All except APRA regulated. |
| B Base level requirements | All licensees except licensees regulated by APRA and some market participants | Positive net tangible assets (NTA) and solvent. Have sufficient cash resources to cover 3 months based on unfavourable assumptions. Audit compliance annually and when ASIC asks. Adequate risk management system including addressing financial risks. | All licensees except APRA regulated entities. | Advisers Dealers Responsible entities and IDPS operators Custodial or depository service providers Market makers |
| C Special classes of licensee Additional requirements | Responsible entities and IDPS operators Providers of custodial or depository services | NTA requirement of up to \$5 million for responsible entities, IDPS operators and custodial or depository service operators. NTA calculation based on current formula. | Acting as a responsible entity, IDPS operator or operator of a custodial and depository service (not merely as arranger). The NTA requirements are in addition to the requirement in Section B. | Responsible entities and IDPS operators Custodial or depository service providers |

| Section | Who is affected | Summary of our proposals | What attracts financial requirements | What sub-classes of licensee are primarily affected |
|--------------------------|---------------------|---|---|---|
| D Market participants | Market participants | Meet the requirements in the market's operating rules. Have adequate risk management system including addressing financial risk. | Financial services business connected with participation in the market. Requirements in Sections B and C do not apply. | ASX participants and SFE participants based on current Business Rules Participants in markets conducted by market licence operators if ASIC agrees |

Important note: As a separate process, we are reviewing what policy should apply to licensees who hold client money or have financial obligations to clients.

Policy proposals

We have four sets of policy proposals. For each of these proposed policies we have listed various aspects of those proposals which we are considering and have raised issues which we would like you to comment on. When necessary we have also included some explanations of our proposals.

Special note: We want to provide you with guidance about our plans for policy and processes as soon as we can to help you plan effectively. While we have done our best to cover the main issues, you will need to make your own preparation plans. It is possible we have missed some issues or have not taken into account the way the new legislation will affect specific industry situations. *We are keen to hear from you on our general approach, and what might be missing from it, as well as your answers to specific questions.*

A Our general approach to financial requirements

Note: If you are a body regulated by APRA, these requirements do not apply to you. You must meet APRA's requirements for financial resources.

| Policy proposal | Your feedback |
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| <p>Licensees' obligations</p> <p>A1 As a licensee under 912A you must:</p> <ul style="list-style-type: none"> (a) have available adequate financial resources to provide the financial services covered by the licence and to carry out supervisory arrangements; (b) do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly; and (c) have adequate risk management systems. <p>A2 We propose to set financial requirements by licence conditions. The conditions would operate in this way:</p> <ul style="list-style-type: none"> (a) More than one licence condition can apply to you. If this applies, you have to comply with each of them. (b) If you are required to have assets to meet one licence condition, you can also count those assets in relation to another applicable condition. <p>Note: For example if you are a responsible entity and need to have \$5 million NTA under Section C, you can take into account the assets that give you that NTA to</p> | <p>A1Q1 Should we exclude you from our financial requirements if you are:</p> <ul style="list-style-type: none"> (a) regulated by the Reserve Bank of Australia (RBA) (eg holders of value in stored value cards); or (b) prudentially regulated overseas in accordance with international banking regulation standards? <p>Why or why not?</p> <p>A2Q1 Is there any circumstance in which assets used to satisfy one requirement, should be excluded when applying another requirement?</p> |

| Policy proposal | Your feedback |
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| <p>satisfy the requirement to have access to cash resources under policy proposal sub-paragraph B2(c).</p> <p>(c) Your compliance with licence conditions is an additional obligation and may not in itself result in sufficient financial resources to satisfy your other licensee obligations.</p> <p>(d) You must continuously monitor your compliance with each of your obligations and be satisfied that you have complied.</p> | |
| <h3>Risk management</h3> <p>A3 We consider that your risk management systems must address the risk that:</p> <p>(a) your financial resources will not be adequate to address the objectives set out at policy proposal paragraph A5, including in particular that you do not have sufficient financial resources to carry on your business; and</p> <p>(b) you will fail to comply with any financial requirements we set as licence conditions.</p> <p>Note: For guidance about risk management systems, see our FSRB Policy Proposal Paper No 2 <i>Licensing: Organisational capacities</i> (April 2001). We plan to issue a policy statement on organisational capacities by 1 December 2001.</p> | |
| <h3>Objectives of financial requirements</h3> <p>A4 We consider that meeting the financial requirements under our proposed licence conditions will promote compliance with your obligations as a licensee.</p> <p>A5 We consider that meeting our financial requirements will help to ensure that:</p> | <p>A5Q1 Are there any other objectives that are relevant in deciding what</p> |

| Policy proposal | Your feedback |
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| <p>(a) you have capacity to conduct your financial services business;</p> <p>(b) there is a financial buffer that decreases the risk of an disorderly or non-compliant wind down if the business fails; and</p> <p>(c) there are incentives for your owners to comply through risk of financial loss.</p> <p>A6 Meeting our financial requirements will contribute to your capacity to compensate clients for liability to them due to breaches of your obligations under Chapter 7 of the Bill. However, this is not the primary focus of the financial requirements and there may be separate obligations to have particular compensation arrangements under 912B.</p> <p>Note: Under 912B, a licensee must have compensation arrangements that comply with requirements in any regulations, or requirements made by ASIC.</p> <p>As stated in the Supplement (issued in September 2001) to the April 2001 <i>Framework</i> document, we continue to understand that regulations are likely to set out the minimum requirements for compensation arrangements during some or all of the transitional period.</p> <p>Accordingly, we do not plan to issue any policy publication on this topic before 11 March 2002. However, we will monitor developments.</p> <p>On the basis that transitional compensation arrangements will apply under regulations and subject to any contrary Government plans, we plan to establish a project to develop compensation requirements to apply at the end of the transitional arrangements.</p> <p>Any development of policy in this area will be done in consultation with Treasury, industry and consumer groups and will take into account any relevant recommendations of the related CASAC review on market compensation arrangements.</p> | <p>financial requirements should apply?</p> |

| Policy proposal | Your feedback |
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| <p>A7 Meeting our financial requirements will also contribute to ensuring your continuing capacity to meet financial obligations to clients. Again, it is not the primary focus of the financial requirements to protect clients against credit risk.</p> <p>A8 In setting financial requirements, ASIC seeks to set minimum standards that are framed as clearly and simply as possible, while seeking to avoid any:</p> <ul style="list-style-type: none"> (a) unreasonable burden in maintaining certain levels of assets or reporting; and (b) unjustifiable barriers to market entry for providing different kinds of financial services. | |
| <p>When you apply for a licence</p> <p>A9 When you apply for a licence, we will ask you to:</p> <ul style="list-style-type: none"> (a) certify that, to the best of your knowledge, you both meet and will continue to meet our financial requirements; (b) provide: <ul style="list-style-type: none"> (i) the most recent audited financial statement available if any; (ii) a current statement of your financial resources; (iii) estimates of your annual turnover, expenses and profits over at least the next year; and (iv) the basis for your claim that your financial resources are adequate for your business (and will continue to be adequate) and will continue to meet our financial requirements; and | <p>A9Q1 Is there any other kind of information on financial requirements that ASIC should require from applicants? Please briefly explain your view including any examples of information, and why such information should be requested.</p> |

| Policy proposal | Your feedback |
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| <p>(c) describe how your risk management system addresses risks to the achievement of the objectives outlined in policy proposal paragraph A5 and compliance with our financial requirements, in particular how you will monitor your financial resources against the requirements of your business and our policy.</p> <p>Note: For other licensee obligations, see our FSRB Policy Proposal Paper No 2 <i>Licensing: Organisational capacities</i> (April 2001). We plan to issue a policy statement on this topic by 1 December 2001.</p> <p>A10 Some existing applicants will not have to provide supporting documentation to get a licence but only certain information and certifications.</p> <p>Note: See our <i>Licensing: Process Guideline: How do you get an Australian Financial Services Licence?</i> (April 2001). We plan to issue a revised version of this Process Guideline before 1 November 2001.</p> <p><i>If your business is not yet operating</i></p> <p>A11 If your business is not yet operating, you must give enough information in your application to demonstrate that you will meet the financial requirements at the time your business begins operating, ie when the licence is issued.</p> <p>Existing policies</p> <p>A12 We propose that policy based on our proposals will supersede our existing policies on financial requirements.</p> <p>Note: We will review policy on security deposits when we consider what guidance (if any) to issue on compensation arrangements in the light of the final form of the Bill and regulations: see policy proposal paragraph A6.</p> | |

Explanation

Objectives of financial requirements

1 Our objectives are similar to those on which we based our financial requirements for responsible entities under Policy Statement 131 *Managed investments: Financial requirements* [PS 131]. The Bill provides for separate requirements to be imposed as to compensation arrangements, so we do not focus on these arrangements when setting financial requirements.

2 ASIC is not a prudential regulator. The financial requirements we impose are not intended to safeguard clients of licensees against credit risk. In the case where a licensee does have financial obligations to clients, additional requirements are under consideration. However, any requirements of ASIC are directed at promoting the objectives set out in policy proposal paragraph A5 and should not be relied on as giving assurance that a licensee will meet its financial obligations. We recognise that licensees will fail financially at times and our proposed requirements cannot, and are not intended to, ensure that this does not occur.

B Base level financial requirements

Notes:

- (1) These requirements do not apply to certain market participants: see Section D.
- (2) Some licensees may have to comply with additional requirements: see Section C.
- (3) If you are a body regulated by APRA, these requirements do not apply to you. You must meet APRA's requirements for financial resources.

| Policy proposal | Your feedback |
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| <p>B1 We propose to apply certain general financial requirements to all licensees that are not regulated by APRA.</p> <p>Notes:</p> <ol style="list-style-type: none"> (1) These requirements do not apply to certain market participants: see Section D. (2) Some licensees may have to comply with additional requirements: see Section C. <p>Solvency and cash flow</p> <p>B2 We propose to set as a licence condition that you must at all times:</p> <ol style="list-style-type: none"> (a) be solvent; (b) have assets that exceed liabilities as shown in the most recent accounts lodged with us and have no reason to suspect that assets no longer exceed liabilities on a current balance sheet; and (c) ensure that based on a reasonable projection about assets, liabilities and cash flows you will have access when needed to sufficient financial resources to enable you to meet all financial obligations at least over the next three months. The calculations must be based on the least favourable assumptions about business conditions generally, your revenue and outgoings, access to resources and the obligations that will arise. You do not need to take into | <p>B2Q1 Instead of the requirement in policy proposal sub-paragraph B2(b), should we impose a minimum net tangible assets (NTA) requirement for all licensees of, for example, \$25,000 or some other amount?</p> <p>B2Q2 Is the requirement in policy proposal sub-paragraph B2(c) to consider the least favourable assumptions sufficiently certain to enable it to be applied in practice?</p> <p>B2Q3 Would the requirement in policy proposal sub-paragraph B2(c) to take</p> |

| Policy proposal | Your feedback |
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| <p>account remote or extreme possibilities. You must document:</p> <ul style="list-style-type: none"> (i) your calculations (ii) your assumptions; and (iii) why you did not consider any less favourable possibilities. <p>Note: For example, you would need to consider the risk of losses in value of listed shares you hold if they were realised in 3 months. You also should take into account any risk of financial obligations arising from expenses in taking on extra staff due to growth in business.</p> | <p>into account the least favourable assumptions make the requirement unreasonably onerous, eg where there are large contingent liabilities due to derivatives exposures or merchant banks depending on clients to maintain liquid deposits?</p> <p>B2Q4 Should we clarify that for the purpose of policy proposal paragraph B2(c), any risk of a financial obligation arising that you reasonably estimate has a probability of less than say 5% over 12 months need not be taken into account (in line with accounting guides)?</p> <p>B2Q5 Would policy proposal paragraph B2(c), raise particular problems for members of groups that include APRA regulated entities?</p> <p>B2Q6 Are there practical problems for licensees in complying with policy proposal paragraph B2(c) on a continuous basis?</p> <p>B2Q7 Are there any other financial requirements that should apply in light of the objectives in policy proposal paragraphs A4 to A8?</p> |

| Policy proposal | Your feedback |
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| <p>Audit</p> <p>B3 We propose to require that you provide us with an opinion by a registered company auditor addressed to you and ASIC as to whether at a particular date:</p> <ul style="list-style-type: none"> (a) that based on an audit, you are complying with our financial requirements other than as mentioned at policy proposal paragraph B3(b)(i) or (ii); and (b) based on the procedures required by the audit referred to in policy proposal paragraph B3(a) and other information of which the auditor is aware, the auditor has no reason to believe that you do not satisfy: <ul style="list-style-type: none"> (i) the requirements of 912A(h) for managing the risk of having insufficient financial resources to meet our requirements; or (ii) the condition reflecting policy proposal paragraph B2(c). <p>B4 We will require you to give us the opinion:</p> <ul style="list-style-type: none"> (a) when your balance sheet and profit and loss statement are lodged under 989B in relation to each financial year; and (b) at any other time when we ask in relation to a period and as at a date we specify. <p>Note: For example, we may ask if we receive credible complaints that indicate you may not be complying.</p> | <p>B3Q1 Are there any practical difficulties in arranging for such an audit?</p> |

Explanation

Solvency and cash flow

1 The Act generally requires a company not to trade while insolvent. It is not appropriate that a financial services licensee carry on business with liabilities exceeding its assets. However we do not require you to continuously monitor your balance sheet position unless you have some reason to doubt you have net assets.

2 The requirement to have cash to meet possible expenses for at least 3 months ahead has applied to responsible entities under [PS 131]. We consider that budgeting to meet future expenses is good business practice, and that it is appropriate to require that the continuing short-term operation of a licensed business should not depend on contingencies where it is reasonable that you should be planning to cover. In determining what is reasonable you need to take into the risks you face and the impact of failing to meet your financial obligations on your clients. We believe that this is an appropriate part of business and risk management for both small and large organizations. We do not require that you have cash to meet all liabilities you may have to meet over the next 3 months. It is sufficient if you have reasonably sure access to financial resources, eg an overdraft facility if it will certainly be available.

Audit

3 Audit opinions about compliance with financial requirements have been a feature of regulation of licensed dealers under the old Act and apply appropriately to other kinds of licensee. ASIC considers that as audited accounts are required by the Bill, providing the annual audit would not be a significant additional expense but would substantially enhance compliance. The opinion concerning compliance with the risk management system requirement of the Act and our conditions about your financial calculations, need only be on a negative assurance basis having completed the auditor required to determine compliance with the other requirements.

4 We will not be routinely monitoring compliance by licensees with financial requirements. When we want to check compliance we will consider asking for an audit. We envisage asking for an audit under policy proposal paragraph B4(b) only if we suspect that you may not be complying. We will allow a reasonable time for you to comply as appropriate in the circumstances.

C Managed investments and custody services

Notes:

- (1) See also Section B for our general financial requirements for all licensees.
- (2) These requirements do not apply to certain market participants: see Section D.
- (3) If you are a body regulated by APRA, these requirements do not apply to you. You must meet APRA's requirements for financial resources.

| Policy proposal | Your feedback |
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| <p>Responsible entities</p> <p>C1 We propose that if you are a responsible entity, you must hold at all times a minimum of net tangible assets (NTA) of 0.5% of the value of:</p> <ul style="list-style-type: none"> (a) assets; plus (b) any other scheme property not counted in calculating the value of assets, <p>of the registered schemes you operate with a minimum requirement of \$50,000 and a maximum requirement of \$5 million.</p> <p>This requirement will expressly include as assets of a mortgage scheme any mortgages to which a mortgage scheme relates.</p> <p>Note: See Schedule 1 for the definition of "net tangible assets" (NTA).</p> <p>Requirements relating to custody</p> <p>C2 We propose to require you as a responsible entity to hold \$5 million NTA rather than the amount required by policy proposal paragraph C1, unless for each registered scheme you operate:</p> <ul style="list-style-type: none"> (a) the scheme property and other assets of the scheme not held by members are | |

| Policy proposal | Your feedback |
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| <p>held by you or a custodian appointed by you, when at least either you or the custodian:</p> <ul style="list-style-type: none"> (i) has \$5 million NTA; (ii) has \$500,000 NTA if all the scheme property or assets of the scheme not held by members are special custody assets or the tier \$500,000 class assets; or (iii) is an Australian authorised deposit-taking institution (ADI); or <p>(b) the only scheme property and other assets of the scheme that are not held under policy proposal sub-paragraph C2(a) are special custody assets each of which is held by:</p> <ul style="list-style-type: none"> (i) you; or (ii) a custodian that has the level of NTA that you are required to have; or (iii) the members. <p>Notes: See Schedule 1 for the definition of “special custody assets” and “tier \$500,000 class assets”.</p> <p>In the case where assets are held by a custodian who only holds special custody assets, the custodian need not have the required NTA if the only assets it holds for the scheme are those in definition sub-paragraphs 16(a), (c) and (g) for “special custody assets” (see Schedule 1) or sub-paragraph 16(d) of that definition if the audited trust account is a regulated trust account.</p> <p>IDPS</p> <p>C3 If you operate an IDPS (as defined in Policy Statement 148 <i>Investor directed portfolio services</i> [PS 148]), we propose that you need</p> | |

| Policy proposal | Your feedback |
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| <p>to hold at all times \$50,000 NTA if you:</p> <ul style="list-style-type: none"> (a) do not perform transactional functions or hold scheme property of other assets of the IDPS; and (b) ensure that any person for whom you are responsible to clients for: <ul style="list-style-type: none"> (i) transactional functions – holds a minimum of NTA of 0.5% of the value of: <ul style="list-style-type: none"> (A) assets; plus (B) any other scheme property not counted in calculating the value of assets, <p>of the registered schemes for which they are responsible entity and IDPS they operate or in relation to which they perform transactional functions with a minimum requirement of \$50,000 and a maximum requirement of \$5 million; and</p> (ii) holding scheme property or other assets of the IDPS – holds \$5 million NTA. <p>C4 If you operate an IDPS, we propose that you must have \$5 million NTA at any time that you hold scheme property or other assets of the IDPS or any other person:</p> <ul style="list-style-type: none"> (a) that holds scheme property or other assets of the IDPS; and (b) for whom you are responsible to clients of the IDPS, <p>does not have \$5 million NTA.</p> <p>C5 If you operate an IDPS and policy proposal paragraphs C3 and C4 do not apply, we propose that you must hold at all times a minimum of NTA of 0.5% of the value of:</p> | |

| Policy proposal | Your feedback |
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| <p>(a) assets; plus</p> <p>(b) any other scheme property not counted in calculating the value of assets,</p> <p>of the registered schemes for which you are responsible entity and IDPS you operate or for which you perform transactional functions with a minimum requirement of \$50,000 and a maximum requirement of \$5 million.</p> <p>Note: Under policy proposal paragraph C6, a custodian of an IDPS that is licensed to conduct a custodial or depository service must have NTA of \$5 million.</p> <p>Custodial or depository services</p> <p>C6 If you operate a custodial or depository service that:</p> <p>(a) has custody of client assets other than incidentally to another financial services business of yours or your related body corporate; or</p> <p>(b) acts as custodian in relation to an IDPS, you must have at all times \$5 million NTA.</p> <p>Definition of terms</p> <p>C7 See Schedule 1 for definitions of key terms used in calculating our financial requirements.</p> | <p>C6Q1 What kinds of licensees would have to hold more NTA than they currently hold because of this requirement?</p> |

Explanation

Responsible entities

1 Our proposals substantially maintain financial requirements that currently apply to responsible entities under [PS 131]. We will calculate the required NTA based on all scheme assets including but not limited to scheme property. This will overcome uncertainties about whether the value of certain assets of schemes (eg mortgages held by investors in a mortgage syndicate) must be taken into account.

IDPS

2 We propose to substantially continue the requirements for NTA that have applied to operators and custodians of IDPS under [PS 148].

Custodial and depository services

3 Some businesses are set up mainly to provide custodial services, as opposed to businesses where these services are merely incidental. Clients of stand-alone custody businesses characteristically place substantial trust in the custodian. This contrasts to a degree, for example, with the more limited role undertaken by nominee services provided in conjunction with stockbroking. Substantial operating capacity is usually required for stand-alone custody businesses. It is particularly important that there is opportunity for an orderly wind down of any stand-alone custody business in order to prevent client loss as it may hold assets of many different clients coming from different sources.

4 ASIC has required custodians of IDPS (see [PS 148]) and of registered schemes (except for certain specialised asset holdings set out in [PS 131]) to have \$5 million NTA. This is also the appropriate benchmark for stand-alone custody businesses. A person that is merely acting as a custodian of a registered scheme is not performing a custodial or depository service under 766E. Consistent with the focus of regulation of operation of registered schemes being on the responsible entity we impose the requirements to ensure adequate financial standing of custodians of registered schemes on the responsible entity.

D Market participants

| Policy proposal | Your feedback |
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| <p>Regulated markets</p> <p>D1 If you are a participant in markets conducted by a market licensee, we propose not to apply our financial requirements to you as long as we consider the market's requirements are an adequate substitute for our financial requirements.</p> <p>How will we assess a market's requirements?</p> <p>D2 When assessing whether a market's requirements are an adequate substitute, we will see if the requirements are equivalent in effectiveness to:</p> <ul style="list-style-type: none"> (a) the requirements we impose on other licensees; and (b) requirements that apply to market participants in major overseas jurisdictions. <p>We will focus on the operating rules of the market and how they are enforced. We will take into account the extent and nature of waivers that are given by the market licensee in relation to participants in that market.</p> <p>D3 We may consider that the financial requirements applying to participants in a market only adequately address our objectives for licensees whose <i>only</i> financial service business is as a participant in that market. In this case, our financial requirements will not apply only while you limit your financial service business to participating in that market and incidental business.</p> | <p>D3Q1 Are there practical problems in limiting the scope of this exclusion to acts in connection with participating in the licensed markets?</p> |

| Policy proposal | Your feedback |
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| <p>When will we review adequacy?</p> <p>D4 We propose to evaluate the adequacy of the financial requirements applying to participants under a market's operating rules (or business rules under the old Act) when:</p> <ul style="list-style-type: none"> (a) an application for an Australian market licence is made; or (b) there is a material change in relevant operating or business rules or licence conditions. <p>We may also review the adequacy of the financial requirements under the operating rules at any time.</p> <p>We will publish which markets we have been satisfied have adequate substitute requirements for this purpose.</p> <p>How will our proposed policy affect your licence?</p> <p>D5 If you are a participant in a market that we consider has requirements that are an adequate substitute for our financial requirements, we will include our financial requirements in your licence conditions. However we will provide that they do not apply while:</p> <ul style="list-style-type: none"> (a) you comply with the market's operating rules that relate to financial requirements taking into account any waiver by the market operator; and (b) where policy proposal paragraph D3 applies, your financial services business is limited to participating in the market and incidental business. | |

| Policy proposal | Your feedback |
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| <p>What if a market's operating rules cease to be an adequate substitute?</p> <p>D6 If we consider that the operating rules of a market are no longer an adequate substitute for the financial requirements that would otherwise apply, we propose to give notice to affected licensees that our financial requirements will apply from a specified date.</p> <p>Under the licence conditions, this notice will mean that, from that date, our financial requirements apply, rather than the obligation to comply with the financial requirements under the market's operating rules.</p> <p>ASX and SFE</p> <p>D7 We will also apply this policy to participants in the markets conducted by ASX and the Sydney Futures Exchange (SFE) from commencement.</p> <p>We consider that the financial requirements of SFE are currently an adequate substitute for our financial requirements for licensees whose financial services are only as a participant in SFE's market.</p> <p>We consider that the financial requirements of ASX are currently an adequate substitute for our financial requirements for any financial service.</p> | <p>D7Q1 Is it appropriate to allow ASX participants that undertake activities such as underwriting that go beyond participating in the market or incidental business not to be subject to our financial requirements?</p> <p>D7Q2 Should our usual licence conditions apply to participants in any other markets operated by a market licensee from commencement?</p> |

Explanation

1 We consider our financial requirements could apply appropriately to market participants. To avoid duplication, we will not apply them while market participants have to meet other financial requirements that we consider an adequate substitute.

2 In forming this view, we have taken into account obligations the market participant will have as a licensee, including the obligation to:

- (a) have available adequate financial resources to provide the financial services covered by the licence and to carry out supervisory arrangements;
- (b) have an adequate risk management system, which would include addressing risks relevant to the objectives in policy proposal paragraph D5; and
- (c) comply with our proposed licence condition requiring the licensee to comply with financial requirements under the market's operating rules.

3 We believe that, given the package of financial requirements for ASX and SFE participants under current business rules and noting the role taken by ASX and SFE and other circumstances, we do not need to make further financial requirements of those participants at this stage. We will take the same view of other markets conducted by markets licensees if we form the view that the operating rules are, in all the circumstances, an adequate substitute for our financial requirements.

4 In the case of SFE participants (that are not ASX participants), this proposed policy applies only to those participants who provide financial services solely as a participant in SFE's market or incidentally to participation.

5 We note that ASX's requirements are based on an approach that is consistent with the European Capital Adequacy Directive. As these requirements take into account and address the risks arising from other forms of business beyond stockbroking, they provide a basis to exclude ASIC financial requirements for participants in ASX generally. We will review this approach in relation to ASX and SFE when there is any change to their operating rules, or before the Bill applies, their business rules.

Schedule 1: Definition of terms for calculating financial requirements

This Schedule defines key terms used in calculating financial requirements for licensees.

Some definitions include questions for your feedback.

Adjusted assets

1 Adjusted assets means the value of assets:

- (a) minus excluded assets,
- (b) minus any receivable of the licensee if the licensee has excluded a liability from adjusted liabilities on the basis that there is an enforceable right of set off with that receivable,
- (b) plus the value of any eligible undertaking (eg certain unconditional bank guarantees) that is not an asset.

Adjusted liabilities

2 Adjusted liabilities means liabilities less:

- (a) any subordinated debt approved by us; and
- (b) any liability the subject of an enforceable right of set off if the corresponding receivable is excluded from adjusted assets.

3 We propose to publish a revised pro forma deed of subordination that will clarify that the debt may not be repaid even after the licence has been revoked if we consider that it may assist the former licensee in meeting obligations to clients.

Eligible undertaking

4 Eligible undertaking means the amount of a financial commitment provided by one of the following entities (“guarantor”):

- (a) an Australian ADI;

- (b) a foreign bank approved in writing by ASIC for the purpose (on the basis it is regulated under Basel guidelines); or
- (c) a disclosing entity (other than a registered scheme of which the licensee or the licensee's associate of the licensee is the responsible entity) that has NTA of:
 - (i) more than \$50 million; or
 - (ii) at least 4 times the amount of the undertaking;

whichever is the greater, as shown in the most recent audited accounts of the guarantor lodged with us.

5 The eligible undertaking must be in the form of an undertaking to pay the amount of the financial commitment to the licensee, that:

- (a) is enforceable and unqualified;
- (b) is to pay on written demand by the licensee, except to the extent that payment has previously been made by the guarantor to you under the undertaking;
- (c) remains operative (even if, for example you cease to hold a licence) until we consent in writing to the cancellation of the undertaking or the undertaking is discharged by payment to you of the maximum amount payable under the undertaking (either at your request or at the guarantor's initiative).

Question

S1Q1 Should ASIC settle a pro forma eligible undertaking proposed by industry in consultation with bodies that represent ADIs?

Excluded assets

6 Excluded assets means:

- (a) intangible assets;
- (b) except when allowed under definition paragraph 7, assets owing from, or invested in, any person who:
 - (i) is an associate of the licensee;
 - (ii) was an associate of the licensee at the time the liability was incurred or the investment was made; or
 - (iii) became liable to the licensee because of, or in connection with, the acquisition of interests in a

managed investment scheme the licensee operates;
and

- (c) except when allowed under definition paragraph 9, assets invested in any:
 - (i) beneficial interest or interest in a managed investment scheme; or
 - (ii) superannuation product,
 in respect of which the licensee or its associate may exercise any form of power or control;
- (d) except when allowed under definition paragraphs 8 or 9; amounts owing from the trustee of any trust in respect of which the licensee or its associate may exercise any form of power or control; and
- (e) assets that secure any current or future liability of another person to the extent of that liability.

Questions

S1Q2 Should any of these assets be taken into account in particular circumstances?

S1Q3 Are there any other assets that should be excluded?

7 Despite definition sub-paragraphs 6(b) and (d), an amount owing is not excluded if it is “secured adequately” as defined in this Schedule.

8 Despite definition sub-paragraph 6(d), the licensee can include an amount owing to the extent that it is owing by way of fees from, or under rights of reimbursement for expenditure by the licensee out of property of, a superannuation scheme, an IDPS or a registered scheme (Scheme) to the extent that that amount:

- (a) exceeds amounts invested by the Scheme in or lent (other than by way of a deposit with an Australian ADI in the ordinary course of its banking business) directly or indirectly by the Scheme to the licensee or a body corporate the licensee controls, a body corporate that controls the licensee or a body corporate that the licensee’s controller controls;
- (b) if owing by way of fees, represents no more than fees owing for the last 3 months; and

- (c) if owing under rights of reimbursement for expenditure by the licensee, has not been owing for more than 3 months.

9 Despite definition sub-paragraph 6(c), the licensee does not have to exclude a managed investment product unless any part of the amount invested is, in substance, directly or indirectly, invested in the licensee.

Net tangible assets (NTA)

10 NTA means the licensee's adjusted assets less adjusted liabilities.

11 You must value assets as they would appear on a balance sheet made up for lodgement as part of a financial report under Chapter 2M of the Act at the time of calculation on the basis that you are a reporting entity.

Explanation

12 Our approach to calculating NTA for responsible entities, IDPS operators and their custodians is set out in [PS 131]. We propose to continue to apply this approach, with some modifications. Assets that are security for another person's liability will not be counted.

13 We will not require that the NTA calculation address market or credit risks to assets or the risk of contingent liabilities crystallising. NTA is a measure of general financial standing as it includes non current assets and not specifically a measure of capacity to meet financial obligations.

Regulated trust account

14 Regulated trust account means:

- (a) a trust account maintained by an authorised trustee corporation under State or Territory legislation; or
- (b) a solicitor's trust account; or
- (c) a real estate agent's trust account; or
- (d) a trust account maintained by an entity other than the licensee that provides protections similar to the accounts described in sub-paragraphs 14(a) to (c) and is approved by ASIC for the purpose.

Secured adequately

15 Secured adequately means:

- (a) secured by an enforceable charge over financial products (other than financial products issued by the licensee or its associate) if:
 - (i) the financial products are:
 - (A) traded in a market conducted by a licensed market operator or a foreign market approved in writing for the purpose by us (ie markets in which independent, bona fide offers to buy and sell are regularly made so that a price reasonably related to the last sale price or current bona fide competitive bid and offer quotations can be determined promptly and payment may reasonably be expected to be received within the customary period); or
 - (B) the financial products are interests in a registered scheme for which withdrawal prices are regularly quoted by the responsible entity and the licensee believes on reasonable grounds that withdrawal may be effected with 5 business days; and
 - (ii) the market value of these financial products equals not less than 125% of the particular amount owing or 111% if the financial products are debt instruments;
- (b) secured by a registered first mortgage over real estate that has a fair market valuation at least equal to 125% of the amount owing;
- (c) owing from
 - (i) an Australian ADI;
 - (ii) a foreign bank approved in writing by ASIC for the purpose (on the basis it is regulated under Basel guidelines); or
 - (iii) a disclosing entity (other than a registered scheme of which the licensee or the licensee's associate of the licensee is the responsible entity) that has NTA of:
 - (A) more than \$50 million; or
 - (B) at least 4 times the amount of the undertaking; or
- (d) otherwise approved for the purpose in writing by us.

Special custody assets

16 Special custody assets means:

- (a) for serviced strata schemes, cash held in a regulated trust account:
 - (i) for the purpose of refurbishment or improvement of real property associated with the scheme; or
 - (ii) for the purpose of alleviating seasonal fluctuations in payments of income from the scheme in accordance with provisions in the constitution,

provided that no more is held than the licensee reasonably consider necessary for the stated purpose;
- (b) currency and chattels other than documents that it would not be reasonably practicable for a person other than the responsible entity to hold;
- (c) funds received from members within the previous 6 months held in a regulated trust account;
- (d) cash held for up to 3 months in an account with an Australian ADI styled as a trust account that is audited at least once every 6 months by a registered company auditor and for which the auditor's report is provided to the board or compliance committee (as appropriate) of the licensee that is held:
 - (i) pending payment to members;
 - (ii) to meet expected expenses (not including investments) over a 3 month period; or
 - (iii) pending application in acquiring a mortgage and paying any fees and costs incidental to the acquisition;
- (e) contractual, lease or licence rights which are not assignable except with the consent of the member or which it would not be reasonably practicable to assign (other than to a new responsible entity) and any documents evidencing those contractual, lease or licence rights;
- (f) assets of trivial value;
- (g) scheme levies of a time sharing scheme which are held in an account with an Australian ADI styled as a trust account that is audited at least twice annually by a registered company auditor where the report from the auditor is provided to the responsible entity; and

- (h) mortgages or documents of title held under a mortgage where:
 - (i) particular members have a specific beneficial or legal interest in the mortgage;
 - (ii) the mortgage was acquired after disclosure in writing to the relevant members (at the time of the acquisition) of all information that would have been required to be in a Product Disclosure Statement (PDS) if an offer of interests in the registered scheme conferring rights in connection with that mortgage had been made immediately prior to the mortgage;
 - (iii) either of the following applies:
 - (A) the mortgage was acquired on the specific direction of the relevant members (at the time of acquisition of the interest); or
 - (B) members are able to withdraw from that mortgage for a period of 14 days commencing on the date of disclosure under sub-paragraph 16(h)(ii); and
 - (iv) the scheme does not involve the mortgage being sold prior to its discharge.

Question

S1Q4 Are there any other assets that a responsible entity could hold without there being significant risks that the presence of a substantial custodian holding the assets would reduce?

Tier \$500,000 class assets

17 Tier \$500,000 class assets means:

- (a) real property (including mortgages or leases over or licences in relation to real property) that is intended to be kept for the whole duration of the scheme or, the relevant mortgage;
- (b) physical assets including currency which as a matter of reasonable practice can be held by a custodian (such as valuables or precious metals);

- (c) funds received from members within the previous:
 - (i) 6 months if held for the purposes of the initial investment by the responsible entity as part of the scheme; or
 - (ii) 13 months if held pending payment of expenses of the scheme;held in a regulated trust account; or
- (d) special custody assets: see definition in this Schedule.

Regulatory and financial impact

We have considered the likely regulatory and financial impact of the policy proposals in this paper. Based on the information that we currently have, we believe that our proposals strike an appropriate balance between facilitating financial services activity and investor protection. To ensure that we have achieved an appropriate balance, we are also developing a Regulatory and Financial Impact Statement (RIS).

The RIS will address the following seven key elements:

1 Issue / problem

This will discuss the nature and magnitude of the problem.

2 Objective(s) / analysis of the problem

The objective(s), or the outcome sought in relation to the identified issue / problem, will be addressed.

3 Options / solutions

This will identify all the alternative options that could achieve the objective(s) stated above for dealing with the issue being considered (eg no specific action; ASIC policy proposal; media release; information statement; self regulation/quasi regulation; codes of conduct; and co-regulation, compliance and enforcement strategies).

4 Impact analysis (costs and benefits) of each option

Impact analysis will include:

- (a) analysis of the benefits and costs of the options, including any restriction on competition for different persons affected;
- (b) identification of persons or bodies affected by the problem; and those that will be affected by the solutions or options identified (ie applicant/proponent of issue; other interested parties, consumers, business and government);
- (c) a consideration of how each of the proposed options will affect existing Act, regulations or policies;

- (d) identification and categorisation of the expected impacts of the proposed options as likely benefits or likely costs against each of the persons/bodies identified as likely to be affected;

We will try to quantify these effects where possible (for example, will there be any restriction on competition as a result of the proposed regulation?)

Costs to business affected by a regulatory initiative might include: administrative costs; complying with new regulatory standards; licence fees; delays etc.

Costs to consumers affected could also include higher prices for goods and services; reduced utility of goods and services; delays and more difficult or expensive options for seeking redress.

- (e) benefits of the options will also be identified (even where they are not quantifiable); and
- (f) the data sources used and assumptions made in making these assessments will be identified.

5 Consultation

The consultation undertaken in the policy process will be detailed.

6 Conclusions and recommended option

The preferred option(s) will be given, and reasons why.

7 Implementation and review

This will discuss how the proposed option will be administered, implemented, or enforced (eg instrument of relief; policy statement; practice note; no action letter).

In order for us to fully assess the financial and regulatory impact of our proposals, we invite you to consider possible options that would achieve our objectives, comment on the impact that these policy proposals might have, and in particular, give consideration to the costs and benefits of these proposals. Where possible, we are seeking both quantitative and qualitative data.

Any comments that we receive will be taken into account when preparing our final RIS.

Development of policy proposal

We have developed this policy proposal paper by considering:

- (a) the intention of the Bill as indicated in the Explanatory Memorandum to the Bill and the Second Reading Speech in the House of Representatives (including as amended by Parliament during the passage of the Bill);
- (b) the Reports on the Bill issued in August 2000 and 2001 by the Parliamentary Joint Committee on Corporations and Securities;
- (c) the Government's response (issued on 29 March 2001) to the Report of August 2000;
- (d) relevant comparisons with current legislative requirements for the regulation of financial services activity under the Bill;
- (e) a review of existing ASIC policies and practices relevant to the regulation of financial services activity under the Bill; and
- (f) a review of public submissions on the Exposure Draft Bill issued by the Government in February 2000.

Key terms

Note: See Schedule 1 for definitions of key terms used in calculating our financial requirements.

In this policy proposal:

“Act” means the *Corporations Act 2001* and includes regulations made for the purposes of the Act;

“APRA” means the Australian Prudential Regulation Authority;

“ASIC” means the Australian Securities and Investments Commission;

“ASX” means the Australian Stock Exchange Ltd;

“Bill” means the *Financial Services Reform Bill 2001*, the Act as amended by the Bill or that Bill as enacted as applicable and includes and regulations made for the purposes of the Bill;

“fees” means costs that a consumer will pay for a product or service. It includes commissions and unless the context otherwise requires all government charges;

“financial product” means a facility through which, or through the acquisition of which, a person does one or more of the following:

- (a) makes a financial investment (see s763B);
- (b) manages financial risk (see s763C);
- (c) makes non-cash payments (see s763D)

and anything included by 764A but does not include anything excluded by 765A;

Note: This is a definition contained in 763A

“IDPS” means a service of that name as defined in Policy Statement 148 *Investor directed portfolio services* [PS 148];

“licence” means an Australian Financial Services Licence as defined in 761A;

“licensee” means a person who holds an Australian Financial Services Licence;

Note: This is a definition is contained in 761A

“licensee obligations” means the obligations of a licensee as set out in 912A, 912B and 917E;

“old Act” means the various regulatory regimes for financial products that existed before amendment by the Bill;

“PDS” means Product Disclosure Statement;

“Product Disclosure Statement” means a document that that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Part 7.9 Division 2;

“PS 136” (for example) means an ASIC Policy Statement (in this example numbered 136);

“retail client” means a client defined as such under 761G;

“982A” (for example) means a clause of the Bill;

“s782” (for example) means a section of the Act.

What will happen next?

Stage 1

| | |
|-------------------|-------------------------------------|
| 21 September 2001 | ASIC policy proposal paper released |
|-------------------|-------------------------------------|

Stage 2

| | |
|------------------------|---|
| September/October 2001 | Consultation period on the contents of this policy proposal paper |
|------------------------|---|

| | |
|-----------------|-------------------------------------|
| 29 October 2001 | Comments due on the policy proposal |
|-----------------|-------------------------------------|

Stage 3

| | |
|---------------------------------|---|
| 29 October 2001 to end November | Consideration of comments received; policy developed and issued |
|---------------------------------|---|

Your comments

You are invited to comment on the proposals and issues for consideration in this paper.

Comments are due by Monday 29 October 2001 and should be sent to:

Roxanna Irvin
FSR Project Office
Regulatory Policy Branch
Australian Securities & Investments Commission
GPO Box 4866
Sydney NSW 1042
email: FSRProjectOffice@asic.gov.au

You can also contact the ASIC Infoline on 1300 300 630 for information and assistance.

Related papers

This policy proposal paper is on the implementation of the *Financial Services Reform Bill 2001*. As outlined in our paper *Building the FSRB Administrative Framework*, we issued earlier sets of policy proposal papers in April 2001 and June 2001. Further proposal and related papers may be issued on the implementation of the Bill.

The related documents issued together in April are:

Building the FSRB Administrative Framework – Policy to implement the Financial Services Reform Bill 2001 (the April 2001 Framework document)

Licensing: The scope of the licensing regime: Financial product advice and dealing
FSRB Policy Proposal Paper No 1

Licensing: Organisational capacities
FSRB Policy Proposal Paper No 2

Licensing: Adapting IPS 146 to the Financial Services Reform regime
FSRB Policy Proposal Paper No 3

Disclosure: Product Disclosure Statements (and other disclosure obligations)
FSRB Policy Proposal Paper No 4

Disclosure: Discretionary powers and transition
FSRB Policy Proposal Paper No 5

Licensing Process Guideline: How do you get an Australian Financial Services Licence?

The related documents issued together in June are:

Licensing: Principles and representatives
FSRB Policy Proposal Paper No 6

Licensing: External and internal dispute resolution
FSRB Policy Proposal Paper No 7

Licensing: Discretionary powers
FSRB Policy Proposal Paper No 8

Approval of codes

FSRB Policy Proposal Paper No 9

In September, we issued a Supplement updating the April 2001 *Framework* document.

Copies of policy proposal papers

Download them from the ASIC home page:

<http://www.asic.gov.au>

(follow the links from “Financial services reform” that is on the top right of our home page)

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