Securities & Futures Compliance Services

• Training • Manuals & Documentation • Compliance Reviews & Administration • Liaison with Regulators

30 March 2023

Investment Managers
Australian Securities and Investments Commission
GPO Box 9827
BRISBANE QLD 4001

Email: IM.sunsettingconsultation@asic.gov.au

SUBMISSION: REMAKING *'SUNSETTING'* CLASS ORDER 13/761

1. INTRODUCTION

Class Order 13/761 has been in operation since 2013 and is scheduled to expire (*'sunset'*) on 1 October 2023. It operates by inserting a *'notional'* **Section 912AC** (***Adequate Financial Resources for Custodial or Depository Services Providers***) in the Corporations Act.

On 3 March 2023, ASIC released **Consultation Paper** (**CP**) **367** ***[Remaking ASIC class orders on financial requirements: CO 13/760, CO 13/761 and ASIC Instrument 2022/449]*** (16 pages), which commenced the necessary consultation process. The deadline for submissions is 31 March 2023.

This submission only addresses concerns in relation to the wording proposed for the **Legislative Instrument** to supersede **Class Order 13/761** (published as **Attachment 2** to **CP 367**). I leave it to others to comment on the wording proposed to address the proposal to combine the purposes of both **Class Order 13/760** and **Legislative Instrument 2022/449** in the one new Legislative Instrument (i.e. **Attachment 1** to **CP 367**).

In short, the Commission's preliminary analysis is that **Class Order 13/761** is operating effectively and efficiently, and continues to form a necessary and useful part of the legislative framework. It believes the fundamental, underpinning policy principles have not changed. As a consequence, the draft of the new **Legislative Instrument** replicates (in almost all respects) the text of **Class Order 13/761**. It is intended the replacement will have a *'life'* of 5 Years.

According to the Commission, the text presented in **Attachment 2** reflects only minor simplifications and no substantive changes to the text of **Class Order 13/761**. In short, this is true. I can't say I've completed a forensic comparison of the current and proposed texts, but I have reviewed them *side-by-side*. The *'notional'* Section 912AC(1) to (12) appears in full. The wording is, in almost all respects, the same as **Class Order 13/761**, but there are two minor differences, one of which is significant.

One 'Definition' has been amended…

With one exception, none of the **definitions** set out in Section 912AC(12) have been amended.

The one exception is the removal of *"…(ea) a right-of-use asset arising under a lease…"* from the exclusions from the definition of **Excluded Assets**.

'Notional' Section 912AC(5) has been 'simplified'…

Only one other provision has been amended (i.e. *'simplified'*); namely Section 912AC(5), which sets out the criteria to be met by an **Incidental Provider** in order to avoid altogether the **concessionary NTA Requirement** that applies generally to **Incidental Providers**.

While the definition of **Incidental Provider** and (where it applies) the level of the **concessionary NTA Requirement** usually required are NOT changing, it is proposed that the words *"…to which the custodial or depository services provided by the licensee relate…"* be deleted from the introduction to Section 912AC(5). These words serve to limit the operation of Section 912AC(5) to arrangements related to the **Custody Services** provided or arranged by the **Incidental Provider**.

As a consequence of their removal, the proposed Section 912AC(5) can be read as requiring, in order for the **Incidental Provider** to avoid the **concessionary NTA Requirement**, ALL client holdings to be subject to the ***'incidental'* Custody Services** provided by the **Incidental Provider**, even if the client uses services that don't actually involve the ***'incidental'* Custody Services**, and even if the client currently holds *'Legal Title'* to their holdings.

If the amendment has this effect, it will limit or prevent various AFS Licensees, currently falling within the definition of **Incidental Provider**, from avoiding the **concessionary NTA Requirement**. They will have to have and maintain **NTA** of the greater of **$150,000** or **10% of Average Revenue**.

How should the DRAFT Legislative Instrument be amended?

The wording of Section 912AC(5) should not be *'simplified'* in the manner proposed. The proposed wording should revert to the current wording of Section 912AC(5) in full.

Section 912AC(5) should also be amended to allow for cross-recognition of Operators of IDPS/IDPS-Like Schemes subject to the Legislative Instrument to supersede **Class Order 13/760**. Currently, **Incidental Providers** that have clients use a third-party ***'SMA'***, for the sake of cost-effective account administration and reporting to support their *'core advisory and transactional services'*, are subject to an inordinate reliance on identifying an **Eligible Custodian** in the *'ownership trail'* of client holdings. The *'investor protections'* and *'capital adequacy obligations'* applying to ***'SMA Providers'*** (i.e. IDPS/IDPS-Like Scheme Operators) are equivalent, yet unless the provider is subject to Section 912AC(5), the only path available is to ensure the involvement of an **Eligible Custodian**, however distant from the **Incidental Provider**.

The definition of **Incidental Provider** [at Section 912AC(12)] should be reworded, in the interests of a *'plainer meaning'*. Doing so would enable AFS Licensees to readily determine their status under the new Legislative Instrument, and would assist your *'Licensing Analysts'* assess *'AFS Licence Applications/Variations'* seeking authorisation to deploy ***'provide custodial or depository services'*** in an ***'incidental manner'***. Being able to qualify unequivocally as an **Incidental Provider** is important because those that don't (whatever the technical circumstances) can only be classified and treated as a **Provider** (i.e. presumed to be the operator of a **stand-alone Custody Service**), in which case the **NTA Requirement** is the greater of **$10 Million** or **10% of Average Revenue**.

The Commission should also consider rewording the definition of ***'Custodial or Depository Services Revenue'***, the calculation of which is relevant for qualifying as an **Incidental Provider**, in order to facilitate a readier and more meaningful calculation where the ***'incidental'* Custody Services** arranged by the **Incidental Provider** are at their most tenuous.

The worth and need for these suggested amendments should be considered through the lens of an **Incidental Provide**r having to navigate the opacity of the current wording of **Class Order 13/761**. To this end, I've chosen to describe the impacts of the **Class Order** on the business of a **Retail MDA Provider**, where an **External MDA Custodian** is not involved.

2. *'INCIDENTAL PROVIDERS'* INCLUDE *'RETAIL MDA PROVIDERS'*

A variety of *'service-suites'* are provided by **Incidental Providers**. **Retail MDA Providers** serve as an instructive example. The regulatory landscape for **Retail MDA Services** and the provider of these services (i.e. the **Retail MDA Provider**) is specified by **Legislative Instrument 2016/968**.

Providing 'Retail MDA Services' must involve a 'Custody Service'…

Among the host of its prescriptions, the *'AFS Licence'* to be held by a **Retail MDA Provider** MUST include certain authorisations (see the definition of **MDA Provider** in **Legislative Instrument 2016/968**), which include having to be authorised to provide **Custodial or Depository Services** UNLESS an **External MDA Custodian** contracts directly with **each Retail MDA Client** to hold each **MDA Client Portfolio Asset** that is a **Financial Product** or a **Beneficial Interest** in a **Financial Product**. In other words, if the **Retail MDA Provider** is NOT authorised to provide **Custody Services**, ALL these **Financial Products** or a **Beneficial Interests** (falling within the bounds of the **Retail MDA Service**) must be held by an **External MDA Custodian**, which may in turn arrange for them to be held by their **Sub-Custodian(s)**.

In the interests of a seamless service-relationship with a **MDA Client**, and given so few (if any now) **Custodians** are prepared to act as an **External MDA Custodian** or given (if they are prepared to do so) the backwardness of their systems when compared to IDPS/IDPS-Like Scheme (e.g. SMA) Operators, **Retail MDA Providers** usually secure authorisation to operate a **Custodial Service** other than an **Investor Directed Portfolio Service** (IDPS) [e.g. a WRAP Platform]. Having this authorisation permits the **Retail MDA Provider** to provide **Custody Services** to its **Retail** and **Wholesale Clients** or to arrange for clients to use a third-party **Custody Service**. In short, if they actually exercise this authorisation, it is solely for the purposes of, and ***'incidental'*** to, their **MDA Services**. They do not use it to operate a stand-alone **Custody Service**. It can be the case that arrangements for *'ownership'* of Retail MDA Client Portfolio Assets are structured in a way that does not involve (technically) providing or arranging a Custody Service. In this case, the authorisation to provide **Custody Services** simply serves to negate the need to involve an **External MDA Custodian** and to otherwise ensure compliance with **Legislative Instrument 2016/968**.

As a consequence, regardless of whether and how this authorisation is actually used, the **Retail MDA Provider** is obliged to comply with the **Capital Adequacy** requirements specified by **Class Order 13/761**.

The logic embedded in **Legislative Instrument 2016/968** reflects ASIC's analysis that a **Retail MDA Service** qualifies as a **registrable *'Managed Investment Scheme'*** that would have to be operated by an *'AFS Licensee'* authorised to act in the capacity of **Responsible Entity** for this service in the absence of the many *'conditions of relief'* granted by **Legislative Instrument 2016/968**.

In granting this *'relief'*, and in order to make its treatment of **Retail MDA Providers** broadly consistent with its treatment of **Responsible Entities**, ASIC presumes **Retail MDA Services** provided by a **Retail MDA Provider** necessarily bundle (include) a **Custody Service**.

This logic derives from the fact the one authorisation to operate a **Registered Scheme** bundles authorisation to issue interests in the Scheme AND to hold or arrange the holding of Scheme property (i.e. to provide or arrange **Custody Services**). Therefore, the **Retail MDA Provider** must be so authorised or an **External MDA Custodian** must be involved in providing the **Retail MDA Service.**

The expectation is that, where an **External MDA Custodian** is NOT involved, the **Retail MDA Provider** will be holding or arranging the holding of (on behalf of **Retail MDA Clients**) ALL **Financial Products** or **Beneficial Interests** in **Financial Products** included in **Retail MDA Client Portfolio Assets**. The definition of **MDA Provider** does not recognise that a **Retail MDA Service** could legitimately involve (in the interests of transparency and efficiency) ALL **Retail MDA Clients** actually holding ***'Legal Title'*** to all of their **MDA Portfolio Assets** (i.e. arrangements may be such that authorisation to provide **Custody Services** is NOT

technically required, yet **Legislative Instrument 2026/968** obliges the authorisation or the involvement of an **External MDA Custodian**).

That said, the definition **MDA Service** recognises that the **Retail MDA Client** may hold their **MDA Portfolio Assets** *'legally'* or *'beneficially'*. On the face of it, this is a source of confusion, but the definitions of **MDA Provider** and **MDA Service** are not necessarily inconsistent. The underlying expectation is that holding *'Legal Title'* is likely to be the exception.

Not only does **Legislative Instrument 2016/968** fail to recognise that in certain cases the *'practical reality'* is that **Custody Services** are not an element of the **Retail MDA Service** concerned, it also fails to recognise the growth in the use by **Retail MDA Providers** of third-party **Separately Managed Accounts** (**SMAs**), each in the name of the **Retail MDA Client** (a ***'SMA'*** is a category of **Financial Product** in its own right), which holds all the **Beneficial Interests** of that **Retail MDA Client's** in their underlying **Retail MDA Portfolio Assets**.

Use of 'Separately Managed Accounts'…

The use of third-party **SMAs** is popular because they provide a sophisticated and cost-effective **Retail MDA** administration and reporting solution, facilitating compliance with particular requirements of **Legislative Instrument 2016/968**. Deep in the background of the service arrangements for a **SMA** will be a **Custodian**, which will usually have separate **Sub-Custodians** for particular holdings or interests.

By having **Retail MDA Clients** apply for a **SMA**, or by exercising their '***discretionary authority'*** to open a **SMA** in the name of the **Retail MDA Client**, the **Retail MDA Provider** is arranging acquisition of an interest in a **Managed Investment Scheme** (in the case of an IDPS Platform) or an interest in a **Registered Managed Investment Scheme** (in the case of an IDPS-Like Scheme Platform), rather than use of a **Custody Service**.

However, in order to qualify as an **Incidental Provider**, in accordance with the definition at its Section 912AC(12), the **Retail MDA Provider** must be arranging a **Custody Service** at some level. In order to avoid the **concessionary NTA Requirement** that usually applies, the **Incidental Provider** must be able to demonstrate to its Auditor and ASIC it has a *'reasonable belief'* that an **Eligible Custodian** is embedded in the service arrangements for the **SMA** and that all the **Financial Products** or **Beneficial interests** relevant to this **Custody Service** being arranged are held by that **Eligible Custodian**. This can be a tortuous challenge.

An **Eligible Custodian** is defined as [Section 912AC(12)]:

- an **Australian ADI** (i.e. an Australian registered Bank); or
- an **Market Participant** or **Clearing Participant** [both defined in Section 912AC(12)]; or
- a **Sub-Custodian** appointed by one of the above [Section 912AC(12) does NOT define ***'Sub-Custodian'***].

The inclusion of **Market** and **Clearing Participants** may not be useful because the **Market Integrity Rules** and (for instance) the **ASX Clear Operating Rules** prohibit the Participant itself from **holding** (holding outright ***'Legal Title'*** to, or a ***'Beneficial Interest'*** in) client holdings. If not registered in the name of the client, they must be registered (**held**) in the name of the Participant's **Nominee Company** (designated as **held** on behalf of the client concerned) as part of the **Custody Service** provided by the Participant. However, they are NOT **held** by the Participant, as required for the purpose of qualifying under Section 912AC(5). The **Nominee Company** is certainly providing the **Custody Service** on behalf of the Participant, but unless being ***'held'*** by their **Nominee Company** is equivalent to the Participant being the ***'holder'***, Participants have no practical utility as an **Eligible Custodian**.

According to the Commission, the fact that the **Retail MDA Provider** arranges for each **Retail MDA Client** to open a **SMA** (i.e. an *'IDPS/IDPS-Like Account'*) in the name of that client, to be operated in accordance with the *'discretionary authority'* granted to the **Retail MDA Provider**, which has an embedded **Custodian** in the background, is not a technical impediment to qualifying as an **Incidental Provider**. The **Retail MDA Provider** is not obliged to arrange the *'direct use'* of the services of a particular **Custodian**.

Your **Senior Licensing Analysts** believe that **Class Order 13/761** provides a definition of **Incidental Provider which does NOT impose an obligation to** (actually) **provide** (or even arrange) **a Custody Service** directly. According to this *'guidance'*, ASIC accepts that *'arranging'* for an **IDPS/IDPS-Like Scheme Operator** to ***'hold'*** or ***'arrange the holding'*** of *'Legal Title'* to, or a *'Beneficial Interest'* in, *'Accessible Investments'* on behalf of **Retail MDA Clients** can amount to *'arranging'* a limited **Custody Service** falling within the bounds of the definition of **Incidental Provider**.

Engaging a 'Custodian'…

If, rather than arranging for each **Retail MDA Client** to use a **SMA** for the purposes of their **Retail MDA**, the **Retail MDA Provider** engages a **Custodian** (***directly*** or ***indirectly***) to do so, a ***'Written Agreement'*** between the parties is required and related requirements must also be met.

'Notional' **Section 912AEC** (***Asset Holding***), inserted in the Corporations Act by **Legislative Instrument 2016/968**, states that IF in fact the **Retail MDA Provider holds MDA Client Portfolio Assets**, it must **hold** those Assets *'on trust'* for the **Retail MDA Clients**, AND that IF **Retail MDA Client Portfolio Assets** are **held** by a person the **Retail MDA Provider ENGAGES directly or indirectly**, they must be **held** in such a way that the **Retail MDA Clients** have a ***'Beneficial Interest'*** in the Assets.

Where a **Custodian** is **engaged** to **hold Retail MDA Portfolio Assets**, the arrangement must be the subject of a ***'Written Agreement'*** between the **Retail MDA Provider** and the **Custodian** (the holder of *'Legal Title'*) that addresses (as a minimum) the 17 items listed in Section 912AEC(19)(c) to (e). The terms of this ***'Written Agreement'*** differ depending on whether the **Retail MDA Provider** holds or does not hold a *'Beneficial Interest'* in the **Retail MDA Portfolio Assets**.

Before entering into the Agreement, the arrangement must survive a *'Due Diligence'* and going forward, it must be subject to *'Monitoring'* processes, covering all the matters specified by Section 912AEC. If applicable, the **Retail MDA Provider** must also ensure the terms of the Custodian's ***'Written Agreement'*** with their **Sub-Custodian** also comply for the purposes of Section 912AEC.

Your **Senior Licensing Analysts** have accepted that deploying a **SMA** in the manner described above does NOT amount to engaging a **Custodian**, either directly or indirectly, to hold **Retail MDA Portfolio Assets**, and therefore the requirement to enter into a ***'Written Agreement'*** does not apply.

Having to conduct business under the simultaneous operation of Legislative Instrument 2016/968 and Class Order 13/761 in relation to *'Custody Services'* is difficult…

It's not the place of **Class Order 13/761** or its replacement to correct or compensate for the many short-comings of **Legislative Instrument 2016/968**, but the example of **Retail MDA Providers** highlights the importance of working through the likely impacts on AFS Licensees subject to *'regulatory landscapes'* imposed by **Class Order** or **Legislative Instrument** that require authorisation to provide **Custody Services**, and may make it necessary to qualify legitimately as an **Incidental Provider** and for the purposes of Section 912AC(5) in order to avoid the **concessionary NTA Requirement** usually applying to an **Incidental Provider**.

3. WHAT *'CAPITAL ADEQUACY'* REQUIREMENTS APPLY CURRENTLY TO THOSE PROVIDING *'INCIDENTAL CUSTODY SERVICES'*?

Class Order 13/761 imposes:

- a **special Cash Needs Requirement**; AND
- a **NTA Requirement**; AND
- a **special Audit Requirement**.

For the purposes of the **NTA Requirement**, **Class Order 13/761** recognises only two types of provider of **Custody Services**, namely:

- a **Provider** (i.e. the operator of a **stand-alone Custody Service**); or
- an **Incidental Provider**.

The minimum **NTA Requirement** applying to a **Provider** is the greater of **$10 Million** or **10% of Average Revenue**.

In the case of an **Incidental Provider** [i.e. where the **Custody Service** is embedded in, and only accessible by using, another service/product provided or arranged by the **Incidental Provider**] it is:

- the greater of **$150,000** or **10% of Average Revenue** (i.e. the **concessionary NTA Requirement**); OR
- does NOT APPLY if the ownership of client holdings using this service/product is structured a certain way, so that an **Eligible Custodian** is involved.

If the **NTA Requirement** applies, the projections made for the purposes of the **special Cash Needs Requirement** must demonstrate compliance (during the projected period) with the required quantum of **NTA**, and its make-up (i.e. its mix of *'cash/cash-equivalents'* and *'liquid assets'*).

The **NTA Requirement** reduces (ultimately to *'Zero'*) as the **Provider** becomes more distant from the *'ownership'* of client holdings. **Class Order 13/761** and the proposed **Legislative Instrument** recognise a gradation of the *'risks'* faced by clients, depending on the degree of **Custody Service** provided by the AFS Licensee with whom they interact. This logic is appropriate.

Interaction with 'Capital Adequacy' requirements imposed by 'Licence Condition'…

In short, **Class Order 13/761** overrides elements of the **Base-Level Financial Requirements** specified by **Licence Condition No. 13** of **PF209**. Given the requirements of **Class Order 13/761**, **Condition No. 13** operates to the extent the **Incidental Provider** must remain ***'solvent'***. Compliance with the **SLF Requirement** (or, if it applies, the **NTA Requirement**) ensures **Total Assets** exceed **Total Liabilities** or **Adjusted Assets** exceed **Adjusted Liabilities**. The **special Cash Needs Requirement** [i.e. Rolling 12 (instead of the usual 3) Month Projections, supported by detailed (documented) assumptions, signed-off Quarterly by all Directors] supersedes the **standard requirement** specified by **Condition No. 13**.

If the **NTA Requirement** DOES NOT apply, the **Incidental Provider** may nevertheless have to comply with the **Surplus Liquid Funds** (**SLF**) **Requirement** [i.e. a flat minimum of **$50,000** in **SLF** must be held within the business], in accordance with **Condition No. 21** of **PF209**. Where the **Incidental Provider** is a **MDA Provider** and continues to have standing *'discretionary authority'* to dispose of **MDA Client** property having a value (collectively) of $100,000 or more, the **SLF Requirement** applies for the life of this *'discretionary authority'*. If the **NTA Requirement** DOES apply and is met, then the **Incidental Provider** will more than comply with its **SLF Requirement**. The calculations of **NTA** and **SLF** are very similar.

The **Adjusted Surplus Liquid Funds (ASLF) Requirement**, specified by **Condition Nos. 22** to **26** of **PF209** can also apply if the **Incidental Provider** acts ***'As Principal'*** in a transaction *'with'* (not *'for'*) a client(s) [i.e. as counter-part to the client(s)].

The obligation to comply with the **special Audit Requirement** specified by **Class Order 13/761** is supported by **Condition No. 28A** of **PF209**. It overrides the **standard Audit Requirement** specified by **Condition No. 28 of PF209**.

4. HOW DOES THE PROPOSED *'LEGISLATIVE INSTRUMENT'* CHANGE THESE *'CAPITAL ADEQUACY'* REQUIREMENTS?

The proposed Legislative Instrument will continue to act by inserting *'notional'* **Section 912AC** in the Corporations Act.

Conditions Nos 13, **21** and **22** to **26** of **PF209** are not affected and will continue to operate as and when they apply.

NO CHANGE is proposed to the following:

- the **special Cash Needs Requirement**; OR
- the **special Audit Requirement**.

In the case of the **NTA Requirement**:

- the quantum of **NTA** required (as a minimum) in the case of a **Provider** is NOT CHANGING;
- the quantum of **NTA** required (when it applies), as a minimum, in the case of an **Incidental Provider** is NOT CHANGING;
- the definition of **Average Revenue** is NOT CHANGING;
- the definition of **Incidental Provider** is NOT CHANGING;
- the definitions of **Custodial Services Revenue** and **Financial Services Business Revenue**, their ratio being one of the qualifying criteria for an **Incidental Provider**, are NOT CHANGING; AND
- the definition of **Eligible Custodian** is NOT CHANGING.

However, it is proposed that a few particular words be deleted from the introduction of ***'notional'*** **Section 912AC(5)**. Depending on how the new *'simplified wording'* is read, the change may restrict the ability of existing **Incidental Providers** to continue to avoid the **NTA Requirement**.

5. KEY CONCEPTS RELEVANT TO THE KEY DEFINITIONS

'Providing' versus 'Arranging'…

Those in the business of providing, or arranging access to another's, **Custodial Services**, which is a class of **Financial Service** [see Section 766A(1)], must hold or operate under an AFS Licence which *'authorises'* providing **Custody Services**.

Actually providing, rather than just arranging, **Custody Services** involves the AFS Licensee holding ***'Legal Title'*** to, or a ***'Beneficial Interest'*** in, somebody else's **Financial Product(s)**, for the benefit of the person entitled to the holding(s).

Arranging a **Custody Service** involves facilitating the process by which another AFS Licensee holds this ***'Legal Title'*** or a ***'Beneficial Interest'***. The arranger may or may not also hold a ***'Beneficial Interest'*** at the same time. If a third-party provider holds ***'Legal Title'***, or their **Sub-Custodian** does so, then the chain of ***'Beneficial Ownership'*** can be lengthy.

The definition of 'Custodial or Depository Service' is key…

'Custodian' is NOT defined (in either Section 9 or Section 761A of the Corporations Act). [**Note**: **Legislative Instrument 2016/968** does include a definition of ***'Custodian'*** and ***'Sub-Custodian'***.]

A ***'Custodial or Depository Service'*** is provided (not just *'arranged'*) in circumstances where [Section 766E(1)]:

> *"…a person (the **'Provider'**) provides a **'Custodial or Depository Service'** to another person (the **'Client'**) if, under an arrangement between the **'Provider'** and the **'Client'**, or between the **'Provider'** and another person with whom the '**Client'** has an arrangement, (whether or not there are also other parties to such 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'**…"*.

This definition allows for the possibility of this activity being provided or arranged as a *'Service'*, or as an integral (or embedded) element of a *'Financial Product'* (e.g. a Managed Product, an IDPS/IDPS-Like Scheme) acquired by a client. ASIC's **Licensing Analysts** interpret this definition broadly, which is very helpful given the drafting of **Class Order 13/761** and **Legislative Instrument 2016/968**.

I presume that the absence of any reference to **Funds/Cash** is a consequence of the fact that **Cash** (i.e. *hard currency*) is NOT a **Financial Product**.

The definition of 'Hold'…

'Holder' is defined in Section 761A (***'Definitions'***) as the:

> *"…person to whom the Financial Product was issued, or if it has (since issue) been disposed of to another person who has not themselves disposed of it, that other person (and **'Hold'** as a corresponding meaning)…".*

In short, the ***'Holder'*** is identified in the Registration/Ownership details for the holding, either as the **holder** of ***'Legal Title'*** to, or of (if recorded in the *'Designation'*) a ***'Beneficial Interest'*** in, the holding.

'Hold' does not merely involve ***'controlling access to'*** a holding(s) registered in the name of the client (e.g. an ASX Settlement Participant sponsors but does NOT hold CHESS Holdings held in the name of CHESS Sponsored clients).

6. THE DEFINITION OF *'INCIDENTAL PROVIDER'* SHOULD BE AMENDED

For the purposes of the **NTA Requirement**, **Class Order 13/761** (and the draft **Legislative Instrument**) recognise only two types of provider of **Custody Services**, namely:

- a **Provider**; or
- an **Incidental Provider**.

The definition of 'Provider'…

The term **Provider** is NOT defined (its meaning is self-evident).

Being able to qualify unequivocally as an **Incidental Provider** is important because those that don't (whatever the technical circumstances) can only be classified and treated as a **Provider** (they are presumed to be the operator of a **stand-alone Custody Service**), in which case the **NTA Requirement** is the greater of **$10 Million** or **10% of Average Revenue**.

The definition of 'Incidental Provider' under Class Order 13/761 and the draft Legislative Instrument…

'Notional' Section 912AC(12) defines an **Incidental Provider** as follows:

'Incidental Provider' means an AFS Licensee that authorised to provide a custodial or depository service:

- that does NOT provide any custodial or depository services other than (custodial or depository?) services which:
  - 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 (e.g. **MDA Services**) by the AFS Licensee or its related bodies corporate; AND
  - do not form part of an **Investor Directed Portfolio Service** (**IDPS**) [**Note 1**: an **IDPS** is defined in CO 13/763] [**Note 2**: if the AFS Licensee is NOT authorised to provide (i.e. operate) an **IDPS**, simply requiring clients use an IDPS Account does NOT amount to providing an **IDPS** or services which form part of an **IDPS**]; AND
- whose **custodial or depository services revenue** (as defined) is **less than 10%** of its **financial services business revenue** (as defined).

Interpreting the definition of 'Incidental Provider'…

To qualify as an **Incidental Provider**, the **AFS Licensee** must provide a limited **Custodial Service** *'indirectly'* to a client(s). This interpretation is reinforced by the need to calculate **Custodial or Depository Services Revenue**.

The AFS Licensee is still permitted to hold *'Legal Title'* or a *'Beneficial Interest'* on behalf of clients, but NOT for the purposes of a **stand-alone Custody Service** (i.e. where the client

applies to access **Custody Services** directly). The **Custody Services** must only be accessible through use of another type of **Financial Service** being provided to the client(s).

Therefore, on a plain reading, IF the **AFS Licensee** does NOT actually provide a **Custody Service** (chooses not to hold ***'Legal Title'*** to, or a ***'Beneficial Interest'*** in, client holdings), it can't qualify as an **Incidental Provider**, and is classified as a **Provider** (a nonsensical, counter-intuitive outcome).

It is here that the fact that ***'providing'*** includes ***'arranging'*** the **Custody Services** comes to the fore, and the definition should be explicit in this regard, in the interests of facilitating a *'plain interpretation'*. The AFS Licensee can still qualify by *'arranging'* for a third-party AFS Licensee to provide a **Custody Service** to its client(s), as part of another service provided (or arranged) by the AFS Licensee.

The definition should also make it clear that the service arranged may include the acquisition of a **Financial Product** which embeds a **Custody Service**.

It should be made plain that the AFS Licensee can qualify as an **Incidental Provider** even though it does NOT end up holding *'Legal Title'* to, or a *'Beneficial Interest'* in, any **Financial Products** on behalf of a client(s). The AFS Licensee must at least *'arrange'* the ***'incidental'*** **Custody Services**, and (to qualify) is permitted to look through *'intermediating service providers'* and their *'underlying holding arrangements'* to *'find'* and *'access'* an AFS Licensee actually providing **Custody Services** (e.g. an **Eligible Custodian** well in the background).

It should be made clear that *'arranging'* for clients to use a **SMA** (i.e. an IDPS/IDPS-Like Account, in the name of each client), with an embedded **Custodian** in the background, and not a particular **Custodian** accessible more directly, is not a technical impediment to qualifying as an **Incidental Provider**. If this is an acceptable arrangement, it raises two questions. Firstly, why should it be necessary to *'discern'* the involvement of a **Custodian** if the **SMA Provider** (the **IDPS/IDPS-Like Scheme Operator**) is subject to equivalent *'financial resources requirements'* under a separate **Class Order**? And secondly, how can a meaningful calculation of **Custody Services Revenue** be made in circumstances where the *'service-relationship'* with the Custodian is so distant and tenuous?

The definition of *'Custodial or Depository Services Revenue'…*

'Notional' Section 912AC(12) defines an **Custodial or Depository Services Revenue** as follows:

custodial or depository services revenue means, in relation to a financial services licensee, the aggregate of the licensee's:

- estimate of the revenue attributable to custodial or depository services **provided** by the licensee and its related bodies corporate for the current financial year to date; and
- forecast of such revenue for the remainder of the financial year;

determined on the basis that such revenue must at least include the cost of providing those services.

This definition should be amended to facilitate a readier and more meaningful calculation where the ***'incidental'*** **Custody Services** arranged by the **Incidental Provider** are at their most tenuous.

This calculation should not be considered necessary where the scope of the ***'incidental'*** **Custody Services** being provided is limited *'arranging'* use of **Financial Product** issued by an AFS Licensee subject to a **Legislative Instrument** specifying equivalent ***'financial resources requirements'***.

The definition of *'Financial Services Business Revenue'…*

'Notional' Section 912AC(12) defines an **Financial Services Business Revenue** as follows:

financial services business revenue means, in relation to a financial services licensee, the **aggregate** of the licensee's:

- estimate of the revenue attributable to the financial services business of the licensee and its related bodies corporate for the current financial year to date, **excluding** any revenue attributable to custodial or depository services provided by the licensee or a related body corporate; and
- forecast of such revenue for the remainder of the financial year;

determined on the basis that the revenue attributable to custodial or depository services must at least include the cost of providing those services.

Where it applies, this calculation of **Financial Services Business Revenue** should NOT exclude ANY revenue attributable (how is this to be done meaningfully) to **Custodial or Depository Services**.

7. HOW DOES SECTION 912AC(5) OPERATE CURRENTLY?

The **NTA Requirement** can fall to *'Zero'* where the **Incidental Provider** meets the pre-requisites of *'notional'* Section 912AC(5).

Current wording of Section 912AC(5)….

(5) This subsection applies if the licensee is an incidental provider and **all** the financial products or beneficial interests in financial products to which the custodial or depository services **provided** by the licensee relate are **held** by:

(a) a (third-party) financial services licensee that is authorised to provide a custodial or depository service and that the licensee reasonably believes:

(i) is not an incidental provider; and

(ii) complies with the requirements of this section (i.e. Section 912AC, as inserted by **Class Order 13/761**); or

(b) a sub-custodian appointed by such a (the third-party) financial services licensee; or

(c) an **eligible custodian**.

Currently, to avoid the **NTA Requirement** entirely, the **Incidental Provider** may only *'arrange'* the **Custody Services** and must NOT **hold** *'Legal Title'* to, or a *'Beneficial Interest'* in, ANY Financial Product(s) on behalf of a client(s).

They must be held by an AFS Licensee *'reasonably believed'* to be a **Provider** (NOT an **Incidental Provider**) that complies with *'notional'* Section 912AC (i.e. is subject to **Class Order 13/761**), a **Sub-Custodian** appointed by the **Provider** or an **Eligible Custodian**.

The significance of the 'Provider' having to comply with Class Order 13/761…

If the **holder** is NOT subject to the **Class Order 13/761**, then the **Incidental Provider** must rely on the involvement of an **Eligible Custodian**. By not recognising other potential (and suitable) holders, subject to a separate but equivalent *'financial resources requirements'* is unnecessarily restrictive.

In the interests of service flexibility and efficiency, while maintaining *'investor protections'*, **Providers** (e.g. **SMA Providers**) subject to **Class Order 13/760** and its successor **Legislative Instrument** should be recognised for the purposes of Section 912AC(5).

The AFS Licence held by a ***'Responsible Entity'*** authorises it to operate its ***'Registered Scheme(s)'***. This one authorisation bundles authorisation to **issuing *'MIS Interests'*** in the ***'Registered Scheme(s)'*** AND to act as **Custodian** for ***'Scheme Property'***. The AFS Licence does NOT have to include a separate authorisation to provide **Custody Services**, and therefore they are NOT subject to **Class Order 13/761**, but it is subject to the equivalent

the **Capital Adequacy** requirements of **Class Order 13/760** (which is also *'sunsetting'* on 1 October 2023).

Investment Platforms (e.g. SMA/WRAP Providers) are ***'Managed Investment Schemes'*** that are either an **Investor Directed Portfolio Service** (an **IDPS**) or an **IDPS-Like Registered Scheme**. An **IDPS** is operated by an **IDPS Operator** (in accordance with **Class Order 13/763**). An **IDPS-Like Registered Scheme** must be operated by a **Responsible Entity** (in accordance with **Class Order 13/762**). Both are subject to the **Capital Adequacy** requirements of **Class Order 13/760**.

IDPS Operators have authorisation to provide **Custody Services** as part of their **IDPS**, but may also have authorisation to provide **Custody Services** unrelated to their **IDPS**. Whatever the case, they are subject to the **Capital Adequacy** requirements of **Class Order 13/760**, not **Class Order 13/761**.

Operators of IDPS-Like Schemes may also have a separate authorisation to provide **Custody Services** unrelated to the operation of their ***'Registered Schemes'***, but they remain only subject to **Class Order 13/760**.

Why can't other 'Providers' be recognised as acceptable 'Holders'?

Given the prevalence of the use of **IDPS** or **IDPS-Like Schemes** (e.g. SMA Services) as an efficient client-administration and reporting solution for **MDA Providers** and (no doubt) other **Incidental Providers**, rather than having to rely on identifying an **Eligible Custodian** in the *'ownership-chain'*, the exemption should also be extended to cover use of the services provided by AFS Licensees subject to **Class Order 13/760** (or its successor Legislative Instrument) or a Sub-Custodian appointed by them. There should be cross-recognition between the **Legislative Instruments** replacing **Class Orders 13/761** and **13/760**.

The definition of 'Eligible Custodian'

Amendment of the definition of **Eligible Custodian** is not proposed, but my view is that some fine-tuning is necessary. I've addressed these matters in the next section.

8. THE AMENDMENT PROPOSED IN RELATION TO SECTION 912AC(5)

The **NTA Requirement** can fall to *'Zero'* where the **Incidental Provider** meets the pre-requisites of the new *'notional'* Section 912AC(5).

The proposed wording of Section 912AC(5)…

(5) This subsection applies if the licensee is an incidental provider and all the financial products or beneficial interests in financial products are held by:

(a) a (third-party) financial services licensee that is authorised to provide a custodial or depository service and that the licensee reasonably believes:

(i) is not an incidental provider; and

(ii) complies with the requirements of this section(i.e. Section 912AC, to be inserted by the new Legislative Instrument); or

(b) a sub-custodian appointed by such a (the third-party) financial services licensee; or

(c) an **eligible custodian**.

On a plain reading, the new wording is problematic…

The current introduction to Section 912AC(5) stipulates that all the financial products or beneficial interests in financial products **to which the custodial or depository services provided by the licensee relate** are to be held a certain way. It does NOT require ALL client holdings or beneficial interests to be users of the **Custody Service**. It simply requires

holdings and interests that are subject to the ***'incidental'*** **Custody Service** to be held a certain way.

Although presented as a *'simplification'*, the deletion of the words *"…to which the custodial or depository services provided by the licensee relate…"* is significant. These few words limit the reach of the *'ownership pre-requisites'*.

The *'simplified'* introduction to Section 912AC(5) can be read as limiting significantly the ability of **Incidental Providers** to avoid the **concessionary NTA Requirement**. This may be intentional. It may be unintended.

The AFS Licensee must still qualify as an **Incidental Provider**, which is very relevant context, but the *'ownership arrangements'* specified will no longer just be linked to the **Custody Services** provided (i.e. *'arranged'*) as an **Incidental Provider**. .

The new wording can be read as requiring ALL ***'Financial Products'*** or ***'Beneficial Interests'*** in ***'Financial Products'*** *'owned'* by ALL clients (not just those clients of the ***'incidental'*** **Custody Services**) to be **held** by:

- a **Provider** subject to the new Legislative Instrument;
- a **Sub-Custodian** appointed by the **Provider**; or
- an **Eligible Custodian**.

Clients using other services provided by the AFS Licensee may hold *'legal title'* to their holdings and (quite rightly) not wish to be obliged to transition to *'regressive ownership arrangements'*, given the reduced transparency and efficiency, and increased administrative costs that would be expected to apply as a consequence.

That said, the new wording can also be construed (as a matter of context) as only applying to holdings or beneficial interests covered by the ***'incidental'*** **Custody Services**, in which case no issue arises, but relying on this presumption is a source of *'significant risk'*, given compliance with the **concessionary NTA Requirement** is at stake. Let's keep in mind that the *'audience'* here is the Auditor and the Commission. The reach of the exemption under the new wording should be have a *'plain and clear'* to those exploring whether they are likely to qualify.

Therefore, the wording proposed for Section 912AC(5) under the new Legislative Instrument should revert to the current wording in operation under **Class Order 13/761**.

The definition of 'Eligible Custodian'

The definition of **Eligible Custodian** is not changing, but in my opinion, some fine-tuning is necessary to ensure the underlying logic is evident and applied consistently, all for the sake of clarity.

An **Eligible Custodian** is defined as [Section 912AC(12)]:

- an **Australian ADI** (i.e. an Australian registered Bank); or
- an **Market Participant** or **Clearing Participant** [both defined in Section 912AC(12)]; or
- a **Sub-Custodian** appointed by one of the above [Section 912AC(12) does NOT define ***'Sub-Custodian'***].

[**Note**: this definition does NOT include an ***'ASX Settlement Participant'*** (e.g. a General CHESS Participant). However, an ASX/Cboe Market Participant or ASX Clear Participant will usually also be a CHESS Participant.]

Can a Market or Clearing Participant act as required?

The inclusion of **Market** and **Clearing Participants** may not be useful because the **Market Integrity Rules** and (for instance) the **ASX Clear Operating Rules** prohibit the Participant itself from **holding** (holding outright ***'Legal Title'*** to, or a ***'Beneficial Interest'*** in) client holdings [see Market Integrity Rule 3.7.3; ASX Clear Rule 4.11].

If a client holding can't be registered in the name of the client, it must be registered (**held**) in the name of the Market or Clear Participant's **Nominee Company** (and the holding

designated as **held on behalf of the client concerned**) as part of the **Custody Service** provided by the Participant.

The **Nominee Company** must, in accordance with the Rules, be owned and operated by the Participant, and the Participant is held responsible for its conduct under a Licence Condition imposed by a Corporations Regulation. The **Constitution** of this **Nominee Company** must prohibit it from holding any Property/Assets (except *'Cash'*) *'beneficially'* (i.e. it may hold *'Legal Title'* to, or *'Beneficial Interests'* in, holdings, but only on behalf of clients of the Nominee Service).

Such a **Nominee Company** does NOT qualify as a **Sub-Custodian** because it is a fundamental element of the **Custody Services** provided by the Participant (it may be a **Corporate Authorised Representative** of the Participant, but isn't a *third-party* AFS Licensee in its own right).

These holdings or interests are NOT **held** by the Participant, as required for the purpose of qualifying under Section 912AC(5). The **Nominee Company** is certainly providing the **Custody Service** on behalf of the Participant, but unless being ***'held'*** by their **Nominee Company** is equivalent to the Participant being the ***'holder'***, Participants have no practical utility as an **Eligible Custodian**.

Therefore, currently, in order to avoid the **NTA Requirement**, the **Incidental Provider** must be able to confirm an **Australian ADI** anchors the *'ownership-chain'*.

Therefore, to ensure the inclusion of **Market** and **Clearing Participants** in the definition of **Eligible Custodian** has *'practical value'*, the references to holdings or interests being **held** by a Participant must be extended to include the holding or interest being held by their **Nominee Company** as required by the **MIRs/ORs** applying to their **Custody Services**.

9. CONCLUSION

Practical guidance is required…

The reason I've taken this opportunity to present my understanding of the relevant concepts, definitions and provisions is to demonstrate how difficult it can be for even those like myself, who have some experience of the *'AFS Licensing Environment'* and the different *'Capital Adequacy'* requirements applying to particular AFS Licensees, to be clear as to the meaning and reach of the **Class Orders** and **Legislative Instruments**.

If I've been in error, I'm not alone, and it highlights the need for clarity in drafting and meaningful guidance. That said, I do appreciate that these Instruments have *'legal force'* and must be drafted accordingly, but it is very much in the interests of *'regulatory efficiency'* to avoid, as far as possible, any *'opacity'*.

This *'guidance'* could appear in the already lengthy **Regulatory Guide 166** or in the **Regulatory Guide** published for the particular **Incidental Provider** (e.g. **RG 179** in the case of **Retail MDA Providers**). Alternatively, they could be addressed in separate **Information Sheets**.

Amendments have long been required to Legislative Instrument 2016/968…

It's not the place of **Class Order 13/761** or its replacement to correct the many short-comings of **Legislative Instrument 2016/968**, but the example of **Retail MDA Providers** highlights the importance of working through the likely impacts on AFS Licensees subject to *'regulatory landscapes'* imposed by **Class Order** or **Legislative Instrument** that require authorisation to provide **Custody Services**, and may make it necessary to qualify legitimately as an **Incidental Provider** and for the purposes of Section 912AC(5) in order to avoid the **concessionary NTA Requirement** usually applying to an **Incidental Provider**.

No change is proposed in relation to…

NO CHANGE is proposed to the following:

- the **special Cash Needs Requirement**; OR
- the **special Audit Requirement**.

In the case of the **NTA Requirement**:

- the quantum of **NTA** required (as a minimum) in the case of a **Provider** is NOT CHANGING;
- the quantum of **NTA** required (when it applies), as a minimum, in the case of an **Incidental Provider** is NOT CHANGING;
- the definition of **Average Revenue** is NOT CHANGING;
- the definition of **Incidental Provider** is NOT CHANGING;
- the definitions of **Custodial Services Revenue** and **Financial Services Business Revenue**, their ratio being one of the qualifying criteria for an **Incidental Provider**, are NOT CHANGING; AND
- the definition of **Eligible Custodian** is NOT CHANGING.

How should the DRAFT Legislative Instrument be amended?

In summary, the proposed Legislative Instrument should be amended as follows:

- The definition of **Incidental Provider** should be amended in the interests of a *'plainer meaning'* and to recognise explicitly that:
    - providing **Custody Services** includes ***'arranging'*** the **Custody Services**; and
    - ***'arranging'*** the **Custody Services** includes ***'arranging'*** acquisition by the client of a **Financial Product**, in which a regulated **Custody Service** is embedded (e.g. **SMAs**), that is issued by an AFS Licensee subject to a **Legislative Instrument** specifying equivalent ***'financial resources requirements'*** to those applying to a **Provider** of **Custody Services** [**Note**: it should be clear that the AFS Licensee is permitted to look through *'intermediating service providers'* and their *'underlying holding arrangements'* to *'find'* and *'access'* an AFS Licensee actually providing **Custody Services** (e.g. an **Eligible Custodian** well in the background).];
- The calculation of the ratio of **Custodial or Depository Services Revenue** to **Financial Services Business Revenue** should NOT apply where the ***'incidental'*** **Custody Service** is limited to *'arranging'* client use of a **Financial Product**, in which a regulated **Custody Service** is embedded, that is issued by an AFS Licensee subject to a **Legislative Instrument** specifying equivalent ***'financial resources requirements'*** to those applying to a **Provider** of **Custody Services**;
- Where is does apply, the definition of **Custodial or Depository Services Revenue** should be amended to facilitate a readier and more meaningful calculation where the ***'incidental'*** **Custody Services** arranged by the **Incidental Provider** are at their most tenuous;
- Where it does apply, the definition of **Financial Services Business Revenue** should NOT exclude ANY revenue attributable (how is this to be done meaningfully) to **Custodial or Depository Services**;
- The wording of ***'notional'*** **Section 912AC(5)** should not be *'simplified'* in the manner proposed. The wording proposed for Section 912AC(5) under the new Legislative Instrument should revert to the current wording in operation under **Class Order 13/761**;
- Given the prevalence of the use of **IDPS** or **IDPS-Like Schemes** (e.g. SMA Services) as an efficient client-administration and reporting solution for **Incidental Providers**, rather than having to rely on identifying an **Eligible Custodian** in the *'ownership-chain'*, the exemption should also be extended to recognise use of the services provided by AFS Licensees subject to **Class Order 13/760** (or its successor Legislative Instrument) or a Sub-Custodian appointed by them. There should be cross-recognition between the **Legislative Instruments** replacing **Class Orders 13/761** and **13/760**; and

- With reference to the definition of **Eligible Custodian**, in the interests of ensuring the utility of the **Custody Services** provided by a **Market** or **Clearing Participant** for the purposes pf Section 912AC(5), the references to holdings or interests being **held** by a Participant must be extended to include the holding or interest being held by their **Nominee Company** as required by the **Market Integrity Rules/Operating Rules** applying to their **Custody Services**.

It's not the place of **Class Order 13/761** or its replacement to correct or compensate for the many short-comings of **Legislative Instrument 2016/968**, but the example of **Retail MDA Providers** highlights the importance of working through the likely impacts on AFS Licensees subject to *'regulatory landscapes'* imposed by **Class Order** or **Legislative Instrument** that require authorisation to provide **Custody Services**, and may make it necessary to qualify legitimately as an **Incidental Provider** and for the purposes of Section 912AC(5) in order to avoid the **concessionary NTA Requirement** usually applying to an **Incidental Provider**.

I'm happy to assist further, and to be corrected in relation to any of the above, and to these ends, I'm best contacted at [redacted]

Authorised by
[redacted]
[redacted]