Australian Securities & Investments Commission

CONSULTATION PAPER 363

Remaking ASIC class order on financial requirements for retail OTC derivative issuers: [CO 12/752]

June 2022

About this paper

This consultation paper sets out ASIC's proposal to remake, without significant changes, Class Order [CO 12/752] *Financial requirements for retail OTC derivative issuers.*

Under the *Legislation Act 2003*, this class order will expire ('sunset') if not remade. We are seeking feedback on our proposal.

> Note: The draft ASIC instrument is available on our website at www.asic.gov.au/cp under CP 363.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 30 June 2022 and is based on the Corporations Act as at the date of issue.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

Contents

The consultation process

Making a submission

You may choose to remain anonymous or use an alias when making a submission. However, if you do remain anonymous we will not be able to contact you to discuss your submission should we need to.

Please note we will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any personal or financial information) as confidential.

Please refer to our privacy policy at www.asic.gov.au/privacy for more information about how we handle personal information, your rights to seek access to and correct personal information, and your right to complain about breaches of privacy by ASIC.

Comments should be sent by 29 July 2022 to:

Retail Complex Products and Investor Protection
Market Supervision
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001
email: Market.Supervision.OTC@asic.gov.au

What will happen next?

Stage 1	30 June 2022	ASIC consultation paper released
Stage 2	29 July 2022	Comments due on the consultation paper
Stage 3	By 1 October 2022	Commencement of remade instrument(s)

A Background

Key points

Legislative instruments, such as class orders, are repealed automatically, or 'sunset', after 10 years, unless action is taken to preserve them. We consult on all sunsetting legislative instruments that have more than a minor or machinery regulatory impact.

Purpose of 'sunsetting' legislative instruments

1 Under the *Legislation Act 2003*, legislative instruments cease automatically, or 'sunset', after 10 years, unless action is taken to preserve them. Section 50(1) repeals a legislative instrument on either 1 April or 1 October—whichever date occurs first on or after the tenth anniversary of its registration on the Federal Register of Legislation. Repeal does not undo the past effect of the instrument.

2 To preserve its effect, a legislative instrument, such as a class order, must be remade before the sunset date. The purpose of sunsetting is to ensure that instruments are kept up to date and only remain in force while they are fit for purpose, necessary and relevant.

Our approach to remaking legislative instruments

3 If it is necessary to remake a legislative instrument, our focus is on making it clear and user friendly. We will also, where possible, simplify and rationalise its content and conditions. For example, we will remove or reduce an obligation or burden in a legislative instrument if we are able to do so without undermining ASIC's vision of a fair, strong and efficient financial system for all Australians.

4 We will consult affected stakeholders on all ASIC legislative instruments that have more than a minor or machinery regulatory impact, and are subject to sunsetting, to ensure that:

(a) we carefully consider the continuing regulatory and financial impact of the instrument; and

(b) the instrument retains its effectiveness in addressing an identified issue or problem.

5 Generally, a Regulation Impact Statement (RIS) is required for new and amended policy that has a significant regulatory impact: see the Australian Government Guide to Regulatory Impact Analysis. We will review,

including following public consultation, all class orders that have a significant regulatory impact before the scheduled sunset date. Where our review finds that a class order is not operating effectively and efficiently, we will undertake regulatory impact analysis to assess our proposed changes to the class order. Where the class order is operating effectively and efficiently, we will remake the instrument without substantive changes and without preparing a RIS.

B Remaking ASIC class order [CO 12/752]

Key points

We are proposing to remake Class Order [CO 12/752] *Financial requirements for retail OTC derivative issuers,* which sunsets on 1 October 2022. The new instrument will be made for a period of five years.

We have formed the preliminary view that this class order is operating effectively and efficiently, and continues to form a necessary and useful part of the legislative framework.

The class order has been redrafted using ASIC's current style and format, while preserving the current effect of the instrument. The draft ASIC instrument, which reflects the minor amendments proposed in this paper, is available on our website at www.asic.gov.au/cp under CP 363.

Your feedback

6 You are invited to comment on our proposal to remake [CO 12/752], including whether the class order is currently operating effectively and efficiently. This proposal is only an indication of the approach we may take and is not our final policy.

Class Order [CO 12/752] *Financial requirements for retail OTC derivative issuers*

Background

7 The *Corporations Act 2001* (Corporations Act) sets out the obligations of an Australian financial services (AFS) licensee: see s912A. These obligations include that the licensee have available adequate resources (including financial) to provide the financial services covered by the AFS licence and to carry out supervisory arrangements: see s912A(1)(d). This obligation does not apply to bodies regulated by the Australian Prudential Regulation Authority (APRA).

8 We impose specific financial requirements on AFS licensees that are not regulated by APRA to ensure that they meet those obligations under the Corporations Act. We apply these financial requirements using ASIC's statutory power to modify Pt 7.6 of the Corporations Act, or by AFS licence conditions. The financial requirements that apply to AFS licensees vary depending on the nature of the financial service activities conducted by the AFS licensee.

9 In 2012, we introduced specific financial requirements for issuers of over-the-counter (OTC) derivatives to retail clients (retail OTC derivative issuers): see s912AB of the Corporations Act (as inserted by [CO 12/752]).

10 Currently, approximately 84 retail OTC derivative issuers must comply with these financial requirements.

Summary of financial requirements

11 Table 1 sets out the requirements imposed on retail OTC derivative issuers by s912AB (as inserted by [CO 12/752]).

Table 1: Financial requirements imposed by s912AB

Requirement	Description
Cash needs requirement (12-month cash flow forecasts)	Each quarter, the retail OTC derivative issuer must prepare projections of cash flows over at least a 12-month period. These projections must be: • based on the issuer's reasonable estimate of revenues and expenses over that term; and • approved in writing, as reasonable, by the issuer's directors (or trustee, if the AFS licensee is a partnership). Using these forecasts, the issuer must demonstrate that it can meet its financial obligations when they fall due.
NTA requirement	The retail OTC derivative issuer must have net tangible assets (NTA) of at least $1,000,000 or 10% of the issuer's average revenue (whichever is greater). The issuer must hold half of the required NTA as cash or cash equivalents (excluding cash in client segregated or trust accounts) and the other half in liquid assets.
Reporting requirements	If a retail OTC derivative issuer's NTA: • decreases from an amount greater than 110% of the required NTA, the issuer must report to ASIC within three business days, and on a monthly basis, until the NTA has returned to 110% of the required NTA; • is less than 100% of the required NTA for a continuous period of two months, the issuer must: – disclose the deficiency to its clients within three business days; and – not enter into any transactions with any persons to whom it provides financial services that could give rise to any further liabilities, contingent liabilities or other financial obligations, until its board of directors or other governing body has certified in writing that, having conducted reasonable inquiries into its financial position, there is no reason to believe that it may fail to meet its other AFS licence obligations; and • is equal to or less than 75% of the required NTA, the issuer must not enter into any transactions with clients that could give rise to any liabilities, contingent liabilities or financial obligations.
Audit opinion	A retail OTC derivative issuer must lodge an auditor report each financial year that, among other things, provides an auditor's opinion that the issuer has complied with the financial requirements of its AFS licence conditions.

Purpose of the financial requirements

12 The financial requirements in s912AB reflect the general objectives of the AFS licence requirements in Regulatory Guide 166 *AFS licensing: Financial requirements* (RG 166). The requirements aim to:

(a) ensure that equity owners of a retail OTC derivative issuer have sufficient 'skin in the game' to demonstrate that they are committed to the success of the business and compliance with the issuer's obligations under the Corporations Act;

(b) ensure that a retail OTC derivative issuer makes adequate provision for expected expenses and carries sufficient financial resources to protect against operational risk that could lead to unexpected losses or expenses;

(c) increase the financial buffer held by a retail OTC derivative issuer to decrease the risk of a disorderly or non-compliant wind up if the business fails, and ensure that the buffer is adequate to meet the administration costs of smaller issuers;

(d) align Australia's financial requirements for retail OTC derivative issuers with the requirements for equivalent entities in Australia's peer jurisdictions; and

(e) simplify the financial requirements to decrease compliance and regulatory costs and burden.

13 The requirements in [CO 12/752] replaced the AFS licence requirement to hold adjusted surplus liquid funds (ASLF) based on a proportion of the licensee's adjusted liabilities, with a minimum of $50,000. The requirements also expanded on other relevant licence conditions relating to cash-flow forecasting, trigger points and reporting, as well as audit.

Proposal

B1 To preserve its effect beyond the sunset date of 1 October 2022, we propose to continue the relief currently given by [CO 12/752] in a new legislative instrument that reflects current drafting practice, without any significant changes: see draft *ASIC Corporations (Financial Requirements for Issuers of Retail OTC Derivatives) Instrument 2022/XXX* at the attachment to this consultation paper. You can access the current instrument at www.legislation.gov.au by clicking on the following direct link: [CO 12/752].

The only changes proposed are to:

(a) remove the required NTA requirement for AFS licensees that applied until 31 January 2014;

(b) provide an expiry date of 1 October 2027;

(c) update the name of the legislative instrument;

(d) reflect current drafting practice and update the format of the current document;

(e) simplify the drafting to give greater clarity;

(f) update legislative references and definitions; and

(g) correct any minor drafting errors.

Rationale

14 We have reached the preliminary view that [CO 12/752] is operating effectively and efficiently and continues to form a necessary and useful part of the legislative framework. We are not aware of significant issues with the current operation of this class order.

15 We consider that the existing financial requirements in s912AB (as inserted by [CO 12/752]) are meeting the policy objectives of the financial requirements for AFS licensees (summarised in paragraph 12). We have not identified any concerns that, under the current financial requirements, retail OTC derivative issuers have insufficient financial resources to:

(a) operate their business effectively and in compliance with their obligations under the Corporations Act; or

(b) fund an orderly and compliant wind up of a failed retail OTC derivative issuer.

16 Further, we consider that:

(a) the existing financial requirements appropriately balance the need for sufficiently rigorous risk management frameworks and resources to support the compliant operation of a retail OTC derivative issuer’s business, while not imposing financial resource requirements that are an unreasonable burden or barrier to market entry;

(b) calculating the required NTA based on revenue better reflects the operating risks faced by some retail OTC derivative issuers, compared with the ASLF requirements that apply to certain other AFS licensees. Revenue is the primary cash inflow used by retail OTC derivative issuers to meet their liabilities and satisfy other obligations imposed on them. Consequently, we believe that revenue is the better indicator of an issuer’s overall operating risk;

(c) the minimum NTA requirement ensures that retail OTC derivative issuers carry sufficient financial resources to protect against operational risk and associated unexpected losses. An issuer can use the minimum NTA requirement to easily determine how much NTA it must hold. Therefore, the issuer can also quickly identify if it is not meeting the financial requirements;

(d) the existing minimum financial requirements for retail OTC derivatives issuers is comparable to overseas jurisdictions. The United Kingdom and Germany impose minimum financial requirements of €730,000 and €750,000, respectively, plus additional risk-based capital. However, the requirements are less than the base-level requirements in the United States (US$20 million) and Singapore (S$5 million); and

(e) requiring rolling 12-month cash flow forecasting addresses expected operating expenses. It also assists a retail OTC derivative issuer to identify potential cash flow problems at an earlier stage, providing the opportunity to take corrective action.

17 Accordingly, at this time, we have not proposed to adopt a different approach to the financial resource requirements for retail OTC derivative issuers—for example, a risk-based capital approach similar to that required in some major overseas jurisdictions such as the United Kingdom, the European Union, Singapore and the United States.

Required NTA requirement that applied before 31 January 2014

18 We have proposed to remove the required NTA requirement for AFS licensees that applied before 31 January 2014 because this is no longer relevant.

Expiry date of 1 October 2027

19 We have proposed to make the instrument for a period of five years, so that it expires on 1 October 2027. We consider that this period will provide sufficient certainty for industry and, if required, allow progress to be made in amending the primary law or regulations.

Key terms

Term	Meaning in this document
adjusted surplus liquid funds (ASLF)	See Section E of RG 166 for the meaning of this term
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
[CO 12/752]	An ASIC class order (in this example numbered 12/752) Note: Legislative instruments made from 2015 are referred to as ASIC instruments.
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
net tangible assets (NTA)	See Section E of RG 166 for the meaning of this term
OTC	Over the counter
retail client	A client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the *Corporations Regulations 2001*
retail OTC derivative issuer	Issuers of OTC derivatives that incur actual or contingent liabilities by issuing derivatives to persons as retail clients
RG 166 (for example)	An ASIC regulatory guide (in this example numbered 166)
RIS	Regulation Impact Statement
s912A (for example)	A section of the Corporations Act (in this example numbered 912A), unless otherwise specified
sunsetting	The practice of specifying a date at which a given regulation or legislative instrument will cease to have effect

