

ASIC CLASS ORDER [CO 12/752]

EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (ASIC) makes ASIC Class Order [CO 12/752] under paragraph 926A(2)(c) of the *Corporations Act 2001* (the *Act*).

Paragraph 926A(2)(c) provides that ASIC may declare that provisions to which section 926A applies apply in relation to a person or financial product, or a class of persons or financial products, as if specified provisions were omitted, modified or varied as specified in the declaration.

1. Background

Section 912A sets out the obligations of an Australian financial services (AFS) licensee including that the licensee have available adequate resources (including financial) to provide the financial services covered by the licence and to carry out supervisory arrangements. This does not apply to bodies regulated by the Australian Prudential Regulation Authority (APRA).

ASIC imposes specific financial requirements on AFS licensee that are not regulated by APRA in accordance with ASIC Regulatory Guide 166 *Licensing: Financial requirements* [RG 166].

Meeting the financial requirements will assist AFS licensees in ensuring that they have adequate financial resources as required by paragraph 912A(1)(d) of the Act and adequate risk management systems as required by paragraph 912A(1)(h) Of the Act.

The financial requirements that apply to AFS licensees vary depending on the nature of the financial service activities conducted by the licensee. Previously operators of retail, over-the-counter (OTC) derivatives businesses were subject to the AFS licence requirement to hold adjusted surplus liquid funds (ASLF) based on a proportion of their adjusted liabilities, with a minimum of \$50,000. (These conditions are included under the heading *Financial requirements for licensees transacting with clients* in issuers' AFS licences.)

The requirements in this Class Order replace the ASLF requirements and also amend other relevant licence conditions relating to cash-flow forecasting, trigger points and reporting, as well as audit. These requirements have been developed to take account of:

- (a) the complexity and risks of retail OTC derivatives businesses and the need for adequate supervisory arrangements; and
- (b) comparable regulatory regimes overseas.

2. Purpose of the class order

Since the introduction in 2002 of the current financial requirements, there have been a number of significant developments in retail financial services markets, including a substantial increase in the availability of OTC derivatives, such as contracts for difference and margin foreign exchange.

ASIC's regulatory activities in this sector, as well as the failure of certain retail OTC derivative issuers, have highlighted the need for significant review of the current financial requirements for retail OTC derivative issuers (set out in ASIC Regulatory Guide 166: *Licensing: Financial requirements*) to ensure sufficient rigour in the financial risk frameworks of businesses seeking to deal as principal in OTC derivatives to retail clients.

The purpose of the Class Order is to expand on the requirement in the Corporations Act for retail OTC derivatives issuers to have adequate financial resources, and to assist in ensuring that issuers of retail OTC derivatives:

- (a) have sufficient financial resources to conduct their financial services businesses in compliance with the Corporations Act (including carrying out supervisory arrangements);
- (b) maintain a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if their business fails; and
- (c) are sufficiently capitalised so that there are incentives for issuers' owners to comply through risk of financial loss.

These objectives are the general objectives of the AFS licence requirements, as stated in RG 166. The purpose of CO 12/752 is to establish financial requirements that are designed to meet these objectives in the specific circumstances of retail OTC derivatives issuers.

3. Operation of the class order

Application

Paragraph 4 of the Class Order varies s912A of the Act as it applies to certain retail OTC derivative issuers by requiring those licensees to comply with additional provisions in the Class Order as part of satisfying the obligation to have adequate financial resources under paragraph 912A(1)(d) of the Act. Retail OTC derivative issuers that are market participants or clearing participants are not subject to the requirements, as other requirements apply under ASIC's policy (see subsection 912AB(1)).

Paragraph 4(1) of the Class Order specifies that the inserted section, s912AB, applies to AFS licensees that are authorised to make a market in derivatives to retail clients and who owe liabilities or contingent liabilities to retail clients in respect of derivatives transactions. That is, a licensee must actually be operating a retail OTC derivatives business—rather than merely being authorised under its AFS licence to operate one—in order to be subject to the Class Order.

Requirements

Paragraphs 4-12 of the Class Order contain the terms of the modifications of the Act. In order to comply with the requirement to have adequate financial resources under paragraph 912A(1)(d) of the Act, retail OTC derivatives issuers must at least comply with the requirements under the following provisions of section 912AB that are notionally applied under the modified provisions of the Act applying under the Class Order:

(a) Complying with AFS licence conditions

To avoid duplication, subsection 912AB(2) specifies that a licensee to whom s912AB applies, by complying with the requirements of that section taken to have complied with the following AFS licence conditions:

- (i) cash needs requirement;
- (ii) financial requirements for licensees transacting with clients;
- (iii) reporting triggers and requirements for financial requirement conditions; and
- (iv) the obligation to lodge an audit opinion on the financial requirements to the extent the opinion is for a part of a financial year or other period during which the licensee was covered by subsection 912AB(1).

(b) Cash needs requirement

- (i) Paragraph 912AB(3)(a) requires the licensee to prepare in each March, June, September and December, a projection of the licensee's cash flows over at least the next 12 months based on the licensee's reasonable estimate of revenues and expenses over this period; and
- (ii) Paragraph 912AB(3)(b) requires the licensee to have the projection certified by the following persons as being based on the licensee's reasonable estimate of revenues and expenses over the relevant period:
 - (A) if the licensee is a body corporate—the directors of the licensee;
 - (B) if the licensee is a partnership or the trustees of a trust—the partners of the licensee or the trustees;
 - (C) if the licensee is a natural person—the person; and

- (iii) Paragraph 912AB(3)(c) requires the licensee to document the calculations and assumptions used in preparing the projection, and describe in writing why the assumptions are appropriate; and
- (iv) Paragraph 912AB(3)(d) requires the licensee to update the projection of the licensee's cash flows if there is reason to suspect that an updated projection would show the licensee was not meeting the requirements in paragraphs (e) or (f); and
- (v) The licensee must demonstrate, based on the projection of the licensee's cash flows, that the licensee will have access when needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months, including any additional liabilities it projects will be incurred during that period (see paragraph 912AB(3)(e)(i)); and
- (vi) The licensee must demonstrate, based on the projection of the licensee's cash flows, that the licensee will hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or greater than the current amount the licensee is required to hold in cash or cash equivalents under subsection 912AB(5) (see paragraph 912AB(3)(e)(ii)); and
- (vii) The licensee must make the cash flow projections available to ASIC upon request (see paragraph 912AB(3)(f)).

The Class Order requires that retail OTC derivatives issuers meet the cash needs component of the base level financial requirements in their AFS licences conditions by demonstrating, based on cash flow forecasts, that they will have access to adequate cash to meet expected cash needs. The Class Order also obliges issuers to prepare these cash flow forecasts over a longer time-period (twelve months instead of three). This is to ensure that issuers are pro-active in their cash flow planning.

(c) Net tangible assets

Subsection 912AB(4) provides that the licensee must

- (i) until 31 January 2014—have at all times NTA of at least the greater of:
 - (A) \$500,000; or
 - (B) 5% of average revenue of the licensee; and
- (ii) from 1 February 2014—have at all times NTA of at least the greater of:
 - (A) \$1,000,000; or
 - (B) 10% of average revenue of the licensee;

The NTA requirement replaces the obligation to meet the adjusted surplus liquid funds (**ASLF**) requirement formerly imposed on retail OTC derivatives issuers under their AFS licence conditions.

NTA is defined at s912AB(13) as assets less liabilities subject to certain adjustments to make it an appropriate measure for the purpose. NTA has been selected as a relatively straightforward measure of financial resources. The amount of NTA required to be held is based on an issuer's total average revenue. Basing the requirement on revenue makes the NTA requirement less subject to the different accounting treatments that may be applied to financial assets and liabilities than the ASLF requirement, which is based on an issuer's adjusted liabilities.

The NTA requirement is complemented by a liquidity requirement.

(d) Liquidity requirement

Subsection 912AB(5) provides that the licensee must hold at all times:

- (i) cash and cash equivalents in an amount that is at least 50% of the required NTA; and
- (ii) liquid assets in an amount that is at least 50% of the required NTA.

The subsection also requires that money that is in an account held by the licensee for the purposes of section 981B or other cash or cash equivalents that are held in respect of any liability or obligation to clients not be counted towards either requirement.

The liquidity requirement ensures that the NTA requirement is held in such a form that it can be accessed when needed to meet operational costs and contingencies. The trigger points and reporting triggers have also been amended to enable issuers to make use of NTA where required (see below).

By the same time it must lodge its balance sheet in accordance with s989B of the Act, the licensee must lodge with ASIC a statement setting out its NTA at the end of its financial year and details of the calculation (see subsection 912AB(6)).

(e) Reporting triggers and requirements for financial requirement conditions

Subsection 912AB(7) defines as a notifiable event any instance where the NTA of the licensee is at any time less than the required NTA or greater than the required NTA but equal to or less than 110% of the required NTA.

The issuer must, by the following times, lodge a written report with ASIC that specifies the NTA of the licensee as at the date of the report:

- (i) within three business days after becoming aware of the notifiable event; and
- (ii) on the first day of every month unless, as at the last day of the preceding month, the NTA is greater than 110% of the required NTA;

This notification requirement provides ASIC with an ‘early warning’ of an issuer who may be likely to breach the NTA requirement. It also provides an ongoing reporting framework. These reporting requirements do not replace, and are in addition to, the licensees’ breach reporting obligations under section 912D of the Act.

Furthermore, subsection 912AB(8) provides that where the NTA of the licensee is less than the required NTA for any consecutive period of two months, the licensee must, within three business days after that two month period and in the form approved by ASIC in writing for the purposes of this section, disclose the deficiency to each person to whom it provides financial services.

This requirement ensures that the issuer’s clients are made aware of the issuer’s failure to meet the NTA requirement for an extended period of time. The required form of the notification is included as an appendix to Regulatory Guide 239 *Retail OTC derivative issuers: Financial requirements* [RG 239]. This Guide also includes instructions on how this notification should be given.

Subsection 912AB(9) provides that, subject to subsection 912AB(10), where the NTA of the licensee is at any time less than the required NTA, the licensee must not enter into a transaction with any person to whom it provides financial services that could give rise to further liabilities, contingent liabilities or other financial obligations of the licensee unless the issuer's board of directors, or other governing body, have certified in writing that, having conducted reasonable enquiries into the financial position of the licensee, there is no reason to believe that:

- (i) the licensee will not comply with section 912A (except for paragraph (1)(d) but only to the extent that paragraph is affected by this section); and
- (j) there is or will be a deficiency in any accounts maintained by the licensee for the purposes of Subdivision A of Division 2 of Part 7.8.

Where the NTA of the licensee is at any time equal to or less than 75% of the required NTA, the licensee must not enter into a transaction with any person to whom it provides financial services that could give rise to further liabilities, contingent liabilities or other financial obligations of the licensee (see subsection 912AB(10)).

These provisions oblige the board of directors, or other governing body, of an issuer that is not meeting the NTA requirement to consider the viability and solvency of the issuer before deciding to continue to take on client liabilities. In addition, where the issuer's NTA position deteriorates sufficiently, the provisions require the issuer to cease to take on new client liabilities at all.

(f) Audit opinion on financial requirements

Subsection 912AB(11) contains the requirements for the audit report issuers must lodge with ASIC. The auditor must provide an audit opinion on the matters covered at paragraph 912AB(11)(a) and provide a ‘negative assurance’ opinion, based on a review, of the matters at paragraph 912AB(11)(b).

(g) Definitions

Relevant definitions are at s912AB(13) of the Act, as amended by the Class Order. Most definitions are the same as those in RG 166. However, some definitions are specific to this Class Order.

Average revenue

This is calculated from the total revenue of the licensee over a three year period, without adjustments. Generally, the calculation uses revenue to date in the current year, a forecast of revenue for the remainder of the current year and actual revenue in the previous two years.

Eligible provider

This definition has been simplified to include only Australian ADIs and other entities approved by ASIC for this purpose.

Liquid assets

These are defined as assets that the licensee can reasonably expect to realise for their market value within 6 months. The definition also includes cash and cash equivalents.

4. Statement of Compatibility with Human Rights

This statement is prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

This class order is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* because it does not engage any of the applicable rights or freedoms.

5. Consultation

ASIC released Consultation Paper 156: *Retail OTC derivative issuers: Financial requirements* (CP 156) in 2011. In response to CP 156, ASIC received some submissions licensees who would be subject to the changes, as well as one submission from an industry body. ASIC then contacted other issuers who may be affected by the changes, to obtain information about how the changes would affect these issuers. Around half of contacted issuers (17 in total) provided the information requested.

ASIC also prepared a Regulatory Impact Statement for this Class Order, which was approved by OBPR.