



ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Retail OTC derivative issuers: Financial requirements

July 2012

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals to clarify the financial requirements that apply to issuers of over-the-counter (OTC) derivatives, such as contracts for difference (CFDs) and margin foreign exchange, that are provided to retail clients.

What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses ASIC's proposals on the financial requirements that would apply to issuers of over-the-counter (OTC) derivatives, such as contracts for difference (CFDs) and margin foreign exchange, that are provided to retail clients.¹
- 2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We aim to strike an appropriate balance between:
 - (a) ensuring businesses that act as retail OTC derivative issuers have adequate financial resources to conduct their business in compliance with the *Corporations Act 2001* (Corporations Act) and in a responsible manner; and
 - (b) administering the law effectively and with minimal procedural requirements.
- 3 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:
 - (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits.

¹ In this RIS, we refer to these issuers as 'retail OTC derivative issuers'.

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A Introduction

Background

Financial requirements for retail OTC derivative issuers

- 4 The Australian financial services (AFS) licensing provisions of the *Corporations Act 2001* (Corporations Act), introduced by the *Financial Services Reform Act 2001*, commenced on 11 March 2002. Under this regime, retail OTC derivative issuers must hold an AFS licence that authorises them to deal and make a market in derivatives to retail clients.
- 5 AFS licensees are subject to the conduct obligations in Ch 7 of the Corporations Act, including obligations to:
- (a) have available adequate financial resources to provide the financial services covered by their AFS licence and to carry out supervisory arrangements (see s912A(1)(d));
 - (b) do all things necessary to ensure that the financial services covered by their AFS licence are provided efficiently, honestly and fairly (see s912A(1)(a));
 - (c) if not regulated by the Australian Prudential Regulation Authority (APRA), have adequate risk management systems (see s912A(1)(h)); and
 - (d) comply with the conditions on their AFS licence (see s912A(1)(b)), including conditions for financial requirements and the prescribed conditions under reg 7.6.04 of the Corporations Regulations 2001 (Corporations Regulations).
- 6 As part of our role as regulator of the financial services sector, we are responsible for administering the minimum financial requirements that an AFS licensee must meet. These requirements are set under s912A(1)(d) and clarified through licence conditions. The pro forma licence conditions are set out in Pro Forma 209 *Australian financial services licence conditions* (PF 209) and are further explained in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166).
- 7 The financial requirements for AFS licensees are designed to ensure that:
- (a) licensees have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act;
 - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and
 - (c) there are incentives for owners of the business to comply with the Corporations Act through risk of financial loss: see RG 166.12.

- 8 The AFS licensing regime and, by extension, PF 209 and RG 166 apply to a diverse range of business types in the financial services sector, including financial advisers, responsible entities, custodians and margin lenders.
- 9 All AFS licences, except those for licensed market and clearing participants and bodies regulated by APRA, include conditions for *base level financial requirements*. These requirements specify that the licensee must:
- (a) be solvent;
 - (b) have more assets than liabilities;
 - (c) elect one of five options to demonstrate they meet the cash needs requirement of PF 209, which include preparing a cash flow forecast for the next three months, providing an eligible undertaking or evidence of other support from an authorised deposit-taking institution (ADI), or its parent providing a cash flow forecast for the next three months (only some of the options require a three-month cash flow forecast); and
 - (d) include information on their compliance with the financial requirements in their audit report to ASIC under s989B(3), or as requested: see Section B of RG 166.
- 10 As well as the base level financial requirements, PF 209 includes *additional financial requirements*. These requirements apply to licensees that hold client money or property and/or transact with clients as principal. This includes retail OTC derivative issuers because OTC derivatives are contractual arrangements in which the issuer holds client money and the issuer and its client trade as principals.
- 11 Under these requirements, the licensee must hold at least \$50,000 in surplus liquid funds (SLF) if at any time it:
- (a) is required to hold money in a separate account under Div 2 of Pt 7.8;
 - (b) holds money or other property on trust for a client or is required to do so under reg 7.8.07(2) or otherwise; or
 - (c) has the power to dispose of a client's property under power of attorney or otherwise,
- unless the value of the money and property for all clients in total is less than \$100,000: see Section E of RG 166.
- 12 A licensee that transacts with clients as principal must hold adjusted surplus liquid funds (ASLF) of the sum of:
- (a) \$50,000; plus
 - (b) 5% of adjusted liabilities between \$1 million and \$100 million; plus
 - (c) 0.5% of adjusted liabilities for any amount of adjusted liabilities exceeding \$100 million,
- up to a maximum ASLF of \$100 million: see Section F of RG 166.

- 13 It should be noted that the amount of ASLF required increases as the issuer's liabilities expand—that is, as the issuer's business grows and takes on more clients, trading as principal, it is required to hold more ASLF, based on the variable requirements at paragraphs 12(b) and 12(c). Issuers in the start-up phase, who are yet to obtain a large number of clients, are likely to need to meet only the base requirement of \$50,000.
- 14 PF 209 and RG 166 provide information about calculating SLF and ASLF.

The retail OTC derivative sector

- 15 Retail OTC derivatives allow retail clients to gain exposure to asset classes (such as shares and currencies) without the need to purchase the underlying assets. OTC derivatives are usually leveraged products whereby, for a small upfront deposit (initial margin), the client can gain large notional exposure to the value of the underlying asset. However, derivative positions are marked to market, normally in real time, and issuers will make margin calls on client positions if the price of the underlying asset, against which the derivative is written, moves against the client.
- 16 The combination of leverage and the principal-to-principal nature of OTC derivative trading, which gives rise to counterparty default risk, means OTC derivatives are usually regarded as high-risk products for retail clients.
- 17 Retail OTC derivatives are usually traded by clients online, via platforms provided by the issuer. In most cases, clients make their own trading decisions and do not receive personal advice from either issuers or any other AFS licensee in connection with their derivative trading.
- 18 There are approximately 46 AFS licensees that are actively offering retail OTC derivatives to retail clients, as at January 2012. According to Investment Trends, there were almost 40,000 active retail OTC derivative clients, as at May 2010.² The sector has continued to grow in spite of market volatility. Our market intelligence suggests that recent growth has been in derivatives written over 'macro' asset classes, such as currencies, commodities and indices, rather than in the traditional single-stock CFDs.
- 19 While there are a number of retail OTC derivative issuers in the marketplace, market share is more concentrated, with a handful of issuers controlling well over half of the market.³ The sector can thus be seen to have a 'long tail' of smaller issuers.
- 20 Many of the smaller retail OTC derivative issuers use 'white labelling' to offer their products. This means that they rely on services provided by another

² Investment Trends, *2010 Australia CFD report*, May 2010 (Investment Trends report).

³ According to the Investment Trends report, four leading issuers control almost 65% of primary client relationships in the sector.

AFS licensee to offer retail OTC derivatives. The services offered by white label partners typically include the use of dealing platforms and information technology (IT) infrastructure, as well as access to wholesale pricing and liquidity. White label arrangements in the retail derivative sector often involve the issuer dealing on a 'back-to-back' basis, where the issuer will automatically enter into an equivalent, offsetting principal-to-principal transaction with its white label partner for every trade it executes with its end client.

Identifying and assessing the problem

- 21 The financial requirements for AFS licensees are intended to provide clear and specific regulatory direction to licensee about how they should comply with their obligations under s912A(1)(d) of the Corporations Act.
- 22 Under s912A(1)(d), an AFS licensee must:
- unless the licensee is a body regulated by APRA—have available adequate resources (including financial, technological and human resources) to provide the financial services covered by the licence and carry out supervisory arrangements.
- 23 RG 166 provides further guidance about the policy objectives of the financial requirements for AFS licensees. RG 166.11 states that the purpose of these requirements is to ensure that:
- (a) licensees have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act (including carrying out supervisory arrangements);
 - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if a licensee's business fails; and
 - (c) there are incentives for a licensee's owners to comply through risk of financial loss.
- 24 The current financial requirements that apply to retail OTC derivative issuers, in the form of SLF and ASLF discussed above, do not meet the policy objectives of RG 166 and do not have the effect of ensuring compliance by issuers with s912A(1)(d) of the Corporations Act. This is because:
- (a) issuers may meet the minimum SLF and ASLF requirements but still not have sufficient resources to operate their business in compliance with the Corporations Act, including carrying out supervisory arrangements;
 - (b) the current resource requirements, especially the minimum requirements, do not reflect the contemporary costs of winding up an issuer's business; and
 - (c) the current financial requirements (i.e. for SLF and ASLF) are complex for licensees and difficult for ASIC to supervise.

- 25 A number of risks arise from retail OTC derivative issuers operating with insufficient financial resources, including the risk of issuer failure.
- 26 The current financial requirements, especially the minimum SLF and ASLF requirements, are also inconsistent with those of other comparable jurisdictions overseas. We are concerned that this could lead to regulatory arbitrage.

Current financial requirements may be insufficient to support and promote effective supervisory arrangements

- 27 Retail OTC derivative businesses are complicated and high risk, requiring well-developed and well-resourced supervisory arrangements and segregation of duties to handle client money, make margin calls and manage operational and market risks, among other supervisory functions. We are concerned that the financial requirements applying to retail OTC derivative issuers were not designed to, and do not, meet the objectives of RG 166 for these types of AFS licensees. This is based both on our past observation of inadequate supervisory arrangements among issuers in the sector, and our view that similar concerns are likely to arise in future, at least partly because the current financial requirements for retail OTC derivative issuers are insufficient in reflecting the complexity of their businesses.
- 28 In the course of our regulatory activities in the retail OTC derivative sector, we identified many issuers that met the current financial requirements under RG 166, yet lacked sufficient organisational capacity to operate their business in compliance with the Corporations Act and maintain appropriate supervisory arrangements.
- 29 In particular, some issuers:
- (a) did not have systems in place to account for and reconcile client money on a daily basis;
 - (b) did not properly segregate control functions;
 - (c) did not employ in-house accounting or compliance staff;
 - (d) did not lodge audited financial statements within the time allowed;
 - (e) were unable to identify and satisfy their compliance obligations; and
 - (f) were unable to respond to and address compliance breaches in a timely and comprehensive manner.
- 30 In the above cases, we took action to address the compliance breaches with the relevant issuers. (In some, more serious, cases, this included licensing action.) However, we believe that these types of compliance failure are likely to continue to arise in the marketplace as other poorly capitalised issuers enter the market.

- 31 We expect such breaches to persist because, as in the above cases, issuers only identified significant matters to ASIC in the course of its surveillance. Issuers with better developed supervisory arrangements would have been more likely to identify these breaches, report them to ASIC and rectify them without the need for intensive ASIC oversight.
- 32 In addition, we consider that the existing minimum financial requirement of only \$50,000 is too low to provide sufficient incentive to equity owners of issuers to ensure that appropriate supervisory arrangements are in place to protect their investment from losses. Providing such incentives is a policy objective of RG 166, as noted above. We believe that the risk of loss to equity owners is one reason that well-capitalised issuers are much more likely to have sufficient supervisory arrangements in place—that is, they have the incentive to implement appropriate supervisory arrangements, as well as having sufficient resources to do so.
- 33 Based on these observations, we consider that the current financial requirements in RG 166 may be insufficient to promote and support effective supervisory arrangements in the complex and high-risk business of issuing retail OTC derivatives.

Current financial requirements may be insufficient to fund an orderly wind-up of a failed issuer

- 34 We are concerned that the contemporary cost of winding up a retail OTC derivative issuer is likely to be well in excess of the minimum financial requirements.
- 35 An issuer that has inadequate resources to undertake supervisory activities is more likely to have deficiencies in the client money account, or to have maintained poor records, which would serve to complicate the process of administration and make it more likely that creditors and clients would suffer losses.

Current financial requirements are complex and difficult to supervise

- 36 Under the current ASLF requirement, a retail OTC derivative issuer must hold a particular amount of liquid funds, based on its adjusted assets and liabilities. This makes the calculation of ASLF complicated and opaque. For example, ASIC often cannot determine from an issuer's balance sheet and profit and loss statement the amount of ASLF the issuer should hold. Further information must be sought from issuers and this can result in delays in identifying and resolving problems experienced by issuers that are in financial distress.

37 In addition, the level of ASLF required is subject to accounting interpretation of assets and liabilities, such as which assets and liabilities to include on an issuer's balance sheet. We have observed several different accounting treatments of assets and liabilities to clients and counterparties, including money held in client money trust accounts. These different accounting treatments each produce a different minimum amount of financial resources that must be held by an issuer.

Costs of issuer failure due to insufficient financial resources

38 A number of risks arise from retail OTC derivative issuers operating with insufficient financial resources to operate their business effectively. One such risk is the failure of these issuers. (We note, however, that the financial requirements are not intended to prevent general issuer failure.)

39 In the past two years, we have observed the collapse of three retail OTC derivative issuers that did not have appropriate supervisory arrangements and other compliance resources. In one of these cases, the issuer was able to meet the current financial requirements, except for certain temporary breaches. In the other two cases, the issuers were not able to meet the current financial requirements.

40 In all three cases, the issuers in question did not have sufficient financial resources to maintain robust supervisory arrangements—in particular, properly resourced and effective compliance, finance and back office functions. They were therefore unable, among other things, to properly reconcile and manage deposits into and withdrawals out of their client money trust accounts (and other accounts they held with banks and counterparties), fully segregate duties, or prepare regular financial statements that accurately presented the issuer's financial position and compliance with its AFS licence conditions. This, at least in part, contributed to the failure of these issuers.

41 These examples illustrate the causal connection between an issuer's failure and its having inadequate financial resources to comply with the Corporations Act. We stress, however, that the failure of issuers in breach of the financial requirements does not demonstrate that the financial requirements are appropriate or adequate for retail OTC derivative issuers. As noted above, we have observed many under-capitalised retail OTC derivative issuers that meet the existing financial requirements but, nonetheless, have insufficient resources to undertake appropriate supervisory activities.

42 Such issuer failures, and their flow-on effects, may impose a number of costs on issuers' clients and the market more generally. These costs include:

- (a) losses to clients arising from:
 - (i) deficiencies in the client money account from having insufficiently developed record-keeping and reconciliation practices;

- (ii) an issuer's failure to operate adequate systems to manage risk, including market, operational and credit risk; and
 - (iii) issuers holding insufficient financial resources to enable an orderly winding-up of their business in insolvency; and
- (b) loss of revenue to the retail derivative sector due to the loss of investor confidence arising from the scenarios listed in paragraph (a).

43 The losses listed in paragraph 42(a) have all arisen in one or more of the three insolvency cases described in paragraphs 39–40. The loss of revenue at paragraph 42(b) is more difficult to quantify because it is impossible to tell whether a potential client would have decided to commence trading retail derivatives if the insolvencies had not occurred. However, we note the generally high, and often controversial, media profile of the sector that, in part, has prompted industry participants to form an industry body and work towards establishing a code of conduct.⁴

44 These losses may also affect an issuer's hedging counterparties and other financial services firms that act as introducing brokers to the issuer, or that 'white label' the issuer's services.⁵ It is also possible that such failures may reduce the willingness of retail clients to trade retail derivatives.

Current financial requirements are inconsistent with international peers

45 When the financial requirements for AFS licensees were introduced in 2002, the retail OTC sector was in its infancy. At that time, most derivatives were traded on exchange via brokers that were regulated as futures market participants.

46 Australia's current minimum financial requirements for retail OTC derivative issuers are much lower than the minimum financial requirements in other comparable jurisdictions overseas, such as the United Kingdom (€750,000) and Singapore (S\$1,000,000).

47 This difference in financial requirements between Australia and similar jurisdictions gives rise to the risk of regulatory arbitrage—that is, less well-resourced issuers may establish themselves in Australia while providing services to clients in Australia and overseas via online incentives.

48 We have observed significant growth in the number of issuers entering the Australian market. Some of these appear to have clients based overseas. In the 12 months to 30 June 2011, 10 new issuers entered the Australian market. In the six months to 1 January 2012, six issuers started up in

⁴ Press release, *Australian CFD providers to form industry body*, 30 March 2012, Honner Media.

⁵ White labelling is where one financial services firm offers to its clients products or services that are issued by another financial services firm, or relies on another firm's infrastructure and capabilities.

Australia. This is in a sector with a total issuer population of 46 AFS licensees. We are concerned that some of these issuers may be starting up in Australia, in preference to other jurisdictions, because of the less onerous (and insufficient) financial requirements.

- 49 We are concerned that the rate of new start-ups in the sector, combined with the ability for these issuers to obtain overseas clients relatively easily online, may affect Australia's future reputation as a well-regulated market.

Our objectives

- 50 Our proposals are aimed at ensuring businesses that act as retail OTC derivative issuers have adequate financial resources to conduct their business in compliance with the Corporations Act.
- 51 As noted above, we have developed the proposed financial requirements based on the stated objective of RG 166, while considering the most suitable approach in the context of the retail OTC derivative sector.
- 52 The proposals do *not* seek to:
- (a) prevent issuers from becoming insolvent due to cash flow problems or trading losses;
 - (b) provide compensation to clients who suffer losses, for whatever reason; or
 - (c) impose unwarranted barriers to entering the market.
- 53 Rather, the objective of the proposed requirements is to avoid the costs associated with retail OTC derivative issuers operating with insufficient financial resources.
- 54 As outlined in RG 166, in setting AFS licence conditions for financial requirements, we seek to provide certainty by setting minimum standards that are framed as clearly and simply as possible. Our proposals seek to balance the requirement to ensure that issuers have sufficiently rigorous risk management frameworks and resources to support the compliant operation of their business, against the need to avoid an unreasonable burden in maintaining particular levels of financial resources, which create unjustifiable barriers to market entry.

B Options and impact analysis

Summary of options

55 We believe there are two options to consider, in terms of resolving the problems identified:

Option 1: Clarify the financial requirements for retail OTC derivative issuers as required by the law (preferred option).

Option 2: Maintain current financial requirements (status quo).

56 We do not believe any other options exist to address the problems identified. The only other possible alternative would be to use disclosure measures to encourage retail OTC derivative issuers to improve their financial resources as envisaged by the proposed financial requirements.

57 While a disclosure-based approach would not have the same effects on competition in the marketplace as Option 1, we do not believe this would be successful in addressing the problems identified for the following reasons:

- (a) Disclosure would be impractical. The Corporations Act requires product disclosure through a Product Disclosure Statement (PDS), provided to the client at the time a product is offered, and updated periodically. As an issuer's financial position would change frequently, it is likely that any information contained in a PDS would quickly become outdated.
- (b) Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (RG 227) already requires an issuer to make available its latest audited financial statement to prospective clients to help clients consider the counterparty risk that attaches to that issuer: see RG 227.66. However, this would be insufficient to address the problem because:
 - (i) financial statements are produced at a particular point in time and may not be of assistance several months after publication; and
 - (ii) providing financial information does not require a particular standard of financial resources; it simply enables consumers to gain a general impression of an issuer's financial position and performance.
- (c) There is significant doubt about whether most clients would be able to interpret any additional financial disclosure and act on it. Given the complexity of OTC derivative trading, clients already receive large amounts of quite technical information when they open a retail OTC derivative trading account. Many clients may be unlikely to review and consider additional disclosure material. Likewise, given the nature of financial disclosure, many retail clients may not have the necessary skills to understand and act on additional financial disclosure.

Option 1: Clarify financial requirements for retail OTC derivative issuers (preferred option)

58 Under Option 1, retail OTC derivative issuers would need to meet the requirements set out in Table 1.

Table 1: Summary of financial requirements for retail OTC derivative issuers under Option 1

Requirement	Description
Cash needs requirement (12-month cash flow projection)	<p>A retail derivative issuer would need to:</p> <ul style="list-style-type: none"> • prepare, in each March, June, September and December, a projection of its cash flow over at least the next 12 months based on a reasonable estimate of revenue and expenses over this term; • have the projection approved in writing by its board of directors or other governing body, as being based on a reasonable estimate of revenue and expenses over the period; • document the calculations and assumptions used in preparing the projection, and describe in writing why the assumptions are appropriate; • update the cash flow projection if there is reason to suspect that an updated projection would show it was not meeting the financial requirements under its AFS licence; • demonstrate, based on the cash flow projection, that it will have access to enough financial resources to meet its liabilities over the projected term of at least 12 months; • demonstrate, based on the cash flow projection, that it will have in cash or cash equivalents, at all times to which the projection relates, an amount equal to or greater than the amount it is required to have in cash or cash equivalents under the net tangible assets (NTA) requirement (see below); and • make the cash flow projection available to ASIC upon request. <p>Note: This tailored cash needs requirement would supplement the other base level financial requirements for all AFS licensees to:</p> <ul style="list-style-type: none"> • be solvent at all times; • have total assets that exceed its total liabilities (or adjusted assets that exceed its adjusted liabilities); and • include information on compliance with the financial requirements in the audit report to ASIC under s989B(3) (the audit requirement).
NTA requirement	<p>A retail OTC derivative issuer would need to:</p> <ul style="list-style-type: none"> • have at all times net tangible assets (NTA) of at least the greater of: <ul style="list-style-type: none"> – \$1,000,000; or – 10% of its average revenue; • have an amount equal to 50% of the required NTA in cash or cash equivalents, (excluding any other cash or cash equivalents that are owed or payable to clients) and 50% in liquid assets; and • report its NTA position as at the end of the financial year, accompanied by detailed workings, to ASIC together with the profit and loss statement and balance sheet lodged with ASIC under s989B of the Corporations Act (Form FS70).

Requirement	Description
Reporting requirements	<p>If a retail OTC derivative issuer has:</p> <ul style="list-style-type: none"> • 110% or less of the required NTA, it must report this to ASIC and continue reporting on a monthly basis until its NTA is above 110% of the required NTA; • less than 100% of the required NTA, it must: <ul style="list-style-type: none"> – replenish the NTA to above 100% within two months of the date the deficiency arose and, failing this, disclose the deficiency to its clients; and – not enter into any transactions with any person 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 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 licence obligations; and • 75% or less of the required NTA, it must not under any circumstances enter into any transactions with any person to whom it provides financial services that could give rise to any further liabilities, contingent liabilities or other financial obligations.

Impact analysis

- 59 Under Option 1, we would seek to modify provisions in the Corporations Act to provide greater detail about the financial requirements for AFS licensees with an authorisation to make a market in derivatives to retail clients. The clarified financial requirements will ensure that a retail OTC derivative issuer has adequate financial resources and liquidity to conduct its business in compliance with the Corporations Act. We would issue a regulatory guide that reflects these requirements, to make it easier for retail OTC derivative issuers to access their comprehensive financial requirements.

Cash needs requirement (12-month cash flow projection)

- 60 The current cash needs requirement for all AFS licensees in RG 166.22(c) and existing licence conditions would be replaced for retail OTC derivative issuers with a tailored requirement reflecting the cash needs requirement that will apply to responsible entities. Under the current cash needs requirement, there are five options for meeting the requirement. Only the first two options require AFS licensees, such as retail OTC derivative issuers, to maintain cash flow forecasts. There is no such requirement for AFS licensees that rely on the other three options.
- 61 The proposed cash needs requirement for retail OTC derivative issuers would require all issuers to prepare a cash flow projection and extend the minimum period over which an issuer needs to forecast its cash flow from three months to 12 months. The cash flow projection would need to be prepared on a basis similar to the current first option 1 in RG 166, which requires a business-as-usual cash flow assumption.

62 A retail OTC derivative issuer would also need to demonstrate, based on the cash flow projection, that over the term of the projection it will have:

- (a) access to sufficient resources to meet its liabilities; and
- (b) sufficient resources to comply with the cash or cash equivalents component of the NTA requirement.

63 The board of directors or other governing body of a retail OTC derivative issuer would be required to:

- (a) pass a resolution at least quarterly approving the cash flow projection; and
- (b) review and approve a revised cash flow projection when there is a material change.

64 We anticipate that the current audit requirement for all AFS licensees on an annual basis will further ensure that appropriate rigour is applied in preparing these cash flow projections.

65 Cash flow forecasting is an important tool which demonstrates that a retail OTC derivative issuer can meet anticipated expenses. Requiring a 12-month projection of cash flows addresses expected operating expenses and should, in many cases, result in a higher level of focus and governance around cash flow forecasts and cash planning than currently exists.

66 We believe that longer cash flow forecasts will assist the directors of an issuer to identify potential cash flow problems at an earlier stage, giving them the opportunity to take corrective action.

NTA requirement

67 Under Option 1, the SLF and ASLF requirements imposed on AFS licensees that hold client money or property and/or trade as principal with their client would be replaced for retail OTC derivative issuers by a tailored net tangible asset (NTA) requirement.

68 To meet the NTA requirement, a retail OTC derivative issuer would need to have NTA of at least the greater of:

- (a) \$1,000,000; or
- (b) 10% of its average revenue.

69 An issuer would need to have 50% of the required NTA in cash or cash equivalents (excluding cash in client segregated or trust accounts and any other liquid assets that correspond to amounts owed to clients) and 50% in liquid assets (NTA liquidity requirement). Issuers cannot count any assets held in respect of client liabilities or obligations towards the NTA liquidity requirement.

70 Eligible undertakings that could be included in the NTA calculation would be limited to those provided by an Australian authorised deposit taking institution (ADI), or which are otherwise approved by ASIC.

71 Additionally, a retail OTC derivative issuer would have to report its NTA position, together with detailed workings, to ASIC together with its annual submission of Form FS70 *AFS licensee profit and loss statement and balance sheet*.

Calculating NTA based on revenue

72 NTA is a measure of financial strength currently used in the financial requirements that apply to responsible entities, operators of investor directed portfolio services, providers of custodial or depository services, issuers of margin lending facilities and trustee companies providing traditional services: see Section C of RG 166.

73 Calculating the required NTA based on revenue better reflects the operating risks faced by some retail OTC derivative issuers. Revenue is the primary cash inflow used by 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.

74 This is further supported by the Basel III guidelines, which use revenue to determine a bank's capital requirements for operating risk relating to trading businesses.

Simplifying the requirements

75 We seek to simplify the financial requirements. As noted earlier, the current financial requirements that apply to retail OTC derivative issuers are complex and opaque. In comparison, the proposed requirements are clearer and less open to accounting interpretation. This should decrease compliance costs for issuers and make it easier for ASIC to verify compliance.

76 Our proposals do not have the monetary thresholds that currently apply to the SLF or ASLF requirements. This is because we believe that if an AFS licensee holds a licence that permits it to make a market in derivatives to retail clients and is entering into OTC derivatives with retail clients, those facts alone are sufficient to warrant holding the required level of NTA and additional, financial thresholds for application and unwarranted.

Reporting requirements

77 As noted above, we propose that the following reporting framework apply to issuers. If an issuer has:

- (a) 110% or less of the required NTA, it must report this to ASIC and continue reporting on a monthly basis until its NTA is above 110% of the required NTA;
- (b) less than 100% of the required NTA, it must:
 - (i) replenish the NTA to above 100% within two months of the date the deficiency arose and, failing this, make a prescribed disclosure of the deficiency available to its clients (principally by a prominent statement on its website and trading platform and/or direct communication with its clients); and
 - (ii) not enter into any transactions with any person 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 governing body has certified in writing that, having conducted reasonable inquiries into its financial position:
 - (A) except for the breach of the NTA requirement, there is no reason to believe that it may fail to meet any other of its licence conditions or obligations under s912A of the Corporations Act, including the base level financial requirements; and
 - (B) there is no evidence of a deficiency in any client account (i.e. an account maintained for the purposes of s981B of the Corporations Act); and
- (c) 75% or less of its required NTA, it must not under any circumstances enter into any transactions with any person to whom it provides financial services that could give rise to further liabilities, contingent liabilities or other financial obligations.

78 Under current licence conditions, if an issuer:

- (a) has between \$1 million and \$100 million in adjusted liabilities and the level of ASLF drops below 5.5% of adjusted liabilities; or
- (b) has more than \$100 million in adjusted liabilities and does not hold \$100 million in ASLF, when the ASLF is less than \$500,000 in excess of the amount that it is required to hold,

it must not enter into any transactions with clients that could give rise to financial obligations, until its governing body has certified in writing that, having conducted reasonable inquiry into its financial position, there is no reason to believe that it may fail to meet its licensee obligations (certification requirement).

- 79 If the certification requirement under the current licence conditions was applied in a similar way to the proposed financial requirements, issuers would be unable to use any of their NTA without triggering the requirement that they cease transacting with clients. This would contradict our objective of allowing issuers to use some of their NTA to meet unexpected expenses or losses arising from operational risk.
- 80 Requiring issuers to notify ASIC when their NTA held is 110% or less of the required NTA gives early notification to ASIC of those issuers that may be experiencing financial difficulty. Having this advance knowledge will allow us to monitor and, where appropriate, work with issuers to ensure they remain in compliance with their AFS licence conditions.
- 81 As previously stated, we intend that issuers should be able to use some of their NTA to meet unexpected expenses or losses which may arise from operational risk. Where issuers draw down on their NTA, however, we want to ensure they have an appropriate incentive to replenish those funds in a timely manner.
- 82 Accordingly, where an issuer's NTA is less than 100% of required NTA, we propose that it have two months to replenish its NTA to 100% or more of the required NTA. If it fails to do this, it must notify its clients of the deficiency by making a prescribed disclosure. This is both to give issuers an incentive to replenish their NTA in a timely fashion and to ensure that clients are informed about the issuer's compliance with the financial requirements.
- 83 The issuer also would not be permitted to enter into any transactions with clients that could give rise to further liabilities, contingent liabilities or other financial obligations until its board or governing body has certified in writing that, having conducted reasonable inquiry into its financial position, there is no reason to believe that it may fail to meet its AFS licence obligations.
- 84 We think that the floor on the amount of NTA an issuer holds should be 75% of required NTA. If an issuer draws down on NTA below this level to meet unexpected expenses or losses, the issuer would not be permitted under any circumstances to enter into any transactions with any person to whom it provides financial services that could give rise to further liabilities, contingent liabilities or other financial obligations.

Benefits of Option 1

Benefits of 12-month cash flow projection

- 85 Requiring all retail OTC derivative issuers to prepare quarterly cash flow projections for a 12-month period on a business-as-usual basis, and having those cash flow forecasts reviewed by auditors annually will enhance the stability of, and, potentially, investor confidence in, these issuers. It will also reduce the risk of disorderly failure for the following reasons:

- (a) To meet the requirements and obligations under both the Auditing and Assurance Standards Board (AASB) and the Corporations Act, auditors must satisfy themselves that the issuer is capable of meeting its liabilities and other obligations over the next 12 months, in a business-as-usual situation.
- (b) Cash flow forecasts signed off by directors are likely to have been prepared with care and diligence and be more accurate, providing management with a more effective decision-making tool (directors are obligated to perform their duties with care and diligence under the Corporations Act, and failing to do so may incur civil or criminal penalties).
- (c) The submissions made during our consultation phase (see Section D of this RIS) were generally supportive of the proposed requirements, although one issuer argued that 'business-as-usual' calculations would not capture all the risks attaching to retail OTC derivative issuers.
- (d) For issuers not already preparing 12-month cash flow forecasts, requiring them to prepare or extend their consideration and expectation over a period of 12 months will mean they are much better placed to detect cash shortfalls earlier, providing greater time to address emerging risks.
- (e) Where a retail OTC derivative issuer is facing failure due to sustained trading losses, the likelihood of failure should be identified by the issuer or its auditor earlier, providing an opportunity to more smoothly effect a sale or wind-down of the issuers business so as to minimise disruption and loss to clients.

Benefits of NTA requirement

More appropriate minimum requirement of \$1,000,000

- 86 As noted above, the current minimum financial requirement of \$50,000 does not reflect the resources required to operate a retail OTC derivative issuer's business adequately, in light of the inherent complexity of these businesses and the consequent need to have well-developed, resourced and effective supervisory arrangements.
- 87 Increasing the minimum financial requirement will:
- (a) better reflect the capital actually required to operate a retail OTC derivative business in compliance with the Corporations Act, which requires substantial compliance, 'back office', accounting and risk management infrastructure;
 - (b) potentially allow for a more orderly winding-up of the business if trading losses led to its insolvency
 - (c) put Australian minimum capital requirements more in line with other jurisdictions such as Singapore and the United Kingdom; and

- (d) better align the interests of retail OTC derivative issuers and their clients, and also increase issuers' incentive to comply with the Corporations Act, by increasing the amount of capital at risk.

88 Feedback from issuers was generally supportive of the proposed \$1,000,000 minimum NTA requirement: see Table 2.

Table 2: Response by retail OTC derivative issuers to proposed minimum NTA requirement of \$1,000,000

Opinion of \$1,000,000 minimum NTA	Number of issuers
Too high	3
Too low	3
The right amount	10

NTA based on 10% of revenue

89 The proposed NTA requirement, based on revenue, better reflects the operational risk of retail OTC derivative issuers for the following reasons:

- (a) As issuers grow bigger, their businesses tend to become more complex in terms of the number of systems, clients and counterparties and revenue more appropriately reflects these risks than balance sheet items.
- (b) The use of revenue as a basis for calculating the required NTA avoids the problem of differing accounting treatment of certain assets and liabilities that arise in the operation of an OTC derivative business, including:
- (i) client money held in client money accounts under s981B of the Corporations Act;
 - (ii) client money that has been paid out of client money accounts to be used as margins with hedging counterparties under s981D of the Corporations Act; and
 - (iii) the mark-to-market value of derivative positions held with clients and counterparties.
- (c) Under the 'Standardised Approach', revenue is acknowledged as the key measure of operating risk for asset management businesses within banks by the Basel III guidelines.

90 The structure of the NTA requirement is such that, as an issuer's business activity expands, so does the required NTA. This helps to ensure that the issuer continues to have adequate resources to operate its business in compliance with the Corporations Act, including maintaining adequate supervisory arrangements.

91 The NTA requirement is also simpler for licensees and ASIC to oversee than the current SLF and ASLF requirements.

92 All but one of the 16 retail OTC derivative issuers we consulted with were supportive of basing the revenue calculation on 10% of annual revenue.⁶

Benefits of NTA liquidity requirement

93 We consider the requirement to hold 50% of the NTA requirement in cash or cash equivalents, and the balance in liquid assets, will benefit investors, retail OTC derivative issuers and the retail derivative industry because issuers will have greater levels of liquid assets to manage unanticipated circumstances. They should also have more liquidity in the event of business failure due to trading losses to wind up their businesses in an orderly manner.

94 Under this requirement, a retail OTC derivative issuer would have:

- (a) cash at its disposal to address immediate unanticipated and unforeseen events, such as significant drops in revenue or increases in expenses;
- (b) access to liquid assets to respond to operational risk events, such as systems breakdowns and major compliance breaches;
- (c) access to liquid assets to address short-to-medium-term issues (e.g. a financier not being prepared to extend an existing credit or liquidity facility);
- (d) a greater opportunity to develop and implement strategies to address unanticipated short-term liquidity issues that might otherwise result in the quick demise of an issuer, even if it would be profitable over the short-term to medium-term; and
- (e) upon failure due to trading losses, more cash and liquid assets to enable an orderly winding-down of its business.

Benefits of reporting requirements

95 Unlike the current SLF and ASLF requirements, the proposed reporting requirements will allow retail OTC derivative issuers to use some of their required liquid NTA to respond to operational, compliance and other events, without breaching their AFS licence conditions or necessarily being required to stop entering into transactions with clients.

96 This will benefit issuers, their clients and the retail derivative sector generally by:

- (a) enabling issuers to make use of the liquid capital they must hold; and

⁶ For details of this consultation, see paragraphs 105–106 and Section D of this RIS.

- (b) limiting the likelihood of an issuer's businesses being disrupted by a failure to hold sufficient liquid capital after experiencing unexpected expenses.

- 97 Clients will benefit from being informed of the deterioration in an affected issuer's NTA position. This will allow clients to consider their ongoing exposure to the issuer.
- 98 We also expect that simplifying the reporting requirements, and setting them out more clearly in a regulatory guide for retail OTC derivative issuers, will improve the industry's understanding of, and compliance with, the reporting requirements. We have found, in our general compliance activities in the sector, that many issuers did not fully understand the current requirements. This would benefit ASIC by allowing us to more promptly respond to potential breaches of the capital or reporting requirements.

Benefits of reducing the risk of issuer failure due to inadequate financial resources

- 99 A number of costs would arise due to issuer failure, if the issuer had inadequate financial resources. Table 3 sets out a possible scenario where an issuer fails due to holding inadequate financial resources to operate its business effectively and in compliance with its obligations under the Corporations Act. The scenario also details where the lack of adequate financial resources exacerbates losses and costs.
- 100 The proposed financial requirements are intended to mitigate the costs which would arise in such a scenario. The third column in Table 3 lists the manner in which improved financial resources could help prevent costs arising from issuer failure due to holding inadequate financial resources.

Table 3: Possible scenario of issuer failure

Event	Cost	Effect of holding adequate financial requirements
1 Deficiency arises in client trust account that is not detected in a timely fashion.	Client money held is insufficient to meet client liabilities.	Adequate resources to carry out supervisory arrangements may lead to earlier detection of a deficiency, or prevention of a deficiency.
2 On becoming aware of this deficiency, and in the context of trading losses, directors appoint voluntary administrators.	There are costs to staff in lost employment, inconvenience and financial risk to clients, loss of value of business.	Adequate resources for strong risk management systems and to carry out supervisory arrangements may lead to earlier detection of a deficiency or trading losses before escalation to a point where the problem cannot be remedied.

Note: Financial requirements are not intended to prevent business failure.

Event	Cost	Effect of holding adequate financial requirements
3 Due to inadequate record-keeping systems, administrators find it difficult to establish client positions.	Delays arise in closing out client positions and returning money to clients.	Adequate resources to support strong record-keeping systems may facilitate that clients' positions may be ascertained promptly and closed out expeditiously.
4 Deficiency in client funds is crystallised as issuer business ceases.	Clients do not receive all their money back.	Client deficiency may have been avoided (see above).
5 Negative media coverage leads clients to exit the market.	Industry faces costs in terms of revenue and sector reputation.	There is potentially less negative coverage due to minimised deficiency and more orderly process of administration.
6 Client money is used to fund administration as issuer has insufficient assets of its own.	Clients suffer further losses and conduct may not be investigated by administrators.	Issuer has own assets to fund winding down and resources are available to investigate suspect conduct.

Costs of Option 1

Methodology for assessing costs

- 101 Based on our understanding of the retail derivative sector, there are currently about 29 active retail OTC derivative issuers to whom the proposed financial requirements would apply. (However, these issuers may also have a number of authorised representatives and introducing brokers.) There are another four issuers that would not be subject to the proposed financial requirements as they are APRA-regulated or subject to the capital rules of a licensed market.
- 102 We define retail OTC derivative issuers as AFS licensees that:
- hold an AFS licence that authorises them to make a market in derivatives to retail clients; and
 - actively offer retail OTC derivatives (such as CFDs or margin foreign exchange) to retail clients.
- 103 While we can easily identify the AFS licensees that hold the relevant authorisations, it is more difficult to identify active issuers. This is because:
- licensees are not required to use authorisations on their AFS licences, therefore these authorisations may be inactive; and
 - some licensees may use the relevant authorisations to provide services other than retail OTC derivative trading, such as providing risk management products to businesses.
- 104 Therefore, we rely on our own market intelligence, advertising and media reporting to estimate the 'active universe' of retail OTC derivative issuers. As such, it is possible that we have not identified all active issuers, especially

newer and smaller issuers. We also note that the industry changes rapidly. For example, since the period of our survey, a major issuer, MF Global Australia Limited, has exited the market due to the collapse of its parent.

105 In August 2010, after receiving four submissions to Consultation Paper 156 *Retail OTC derivative issuers: Financial requirements* (CP 156) (see Section D of this RIS), we sent letters to 29 known retail OTC derivative issuers that would be affected by the financial requirements, asking them to provide information to us, on a voluntary basis, about the impact of the proposed requirements on their business.

106 In total, 16 issuers responded. It is these responses that form the basis of our assessment of the costs of the proposed requirements. It is important to note that, while close to half of the known retail OTC derivative issuers responded, these issuers control a large majority of market share. Therefore, some aspects of the responses from these issuers, particularly those pertaining to scale, cannot simply be extrapolated to other issuers. For example, we expect that most of the issuers that did not respond would be required to have NTA under the proposed minimum amount of \$1,000,000.

Summary of costs under Option 1

107 The tables below set out some of the possible costs of Option 1.

Table 4: Summary of costs under Option 1

Stakeholder	Costs of Option 1
Investors	Issuers may pass on the costs of complying with the new financial requirements to investors.
Issuers	There may be an increase in compliance, administrative and capital costs associated with: <ul style="list-style-type: none"> • the increased opportunity costs of holding additional capital and holding liquid assets; • cash flow forecasts and auditing; • raising new capital; • restructuring and/or winding-up; and • incremental costs of collating and providing Form FS70 information.
The retail OTC derivative sector	There may be a reduction in competition in the sector due to: <ul style="list-style-type: none"> • some issuers electing to exit the market; and • the discouragement of start-ups or new entrants by the new financial requirements.
Government	There may be a minor additional cost in considering any relief application.

Table 5: Estimated additional costs in dollars under Option 1

Compliance area	Additional costs
Estimated number of issuers currently active that would be affected by the proposals	29
Estimated costs of implementing 12-month cash flow projections	\$5,000 ⁷ per issuer
Estimated additional capital that will need to be raised across the sector to comply with NTA (see paragraph 113)	\$7,800,000
Estimated administrative costs of raising additional capital to comply with NTA (see paragraph 116)	\$5,250 per issuer
Estimated costs of raising funds from unrelated investors (see paragraph 117)	\$18,000 per issuer
Estimated costs of capital per \$1,000,000 (see paragraph 119)	\$91,695
Estimated cost of capital per \$600,000 (see paragraph 119)	\$55,017
Estimated cost of meeting the NTA liquidity requirement per \$500,000 (see paragraph 123)	\$20,350

108 Table 6 sets out information about the responses of the 16 retail OTC derivative issuers who answered key questions about the cost of complying with the proposed financial requirements.

Table 6: Costs of complying with proposed financial requirements

	Median	Average	Highest	Lowest
Cost per year of compliance with 12-month cash flow proposal	\$5,000	\$12,588	\$66,000	\$0
Additional work hours per week required if implemented	1.00	2.68	24	0
Cost per year of complying with NTA proposal	\$7,500	\$222,009	\$1,390,000	\$0

Source: Responses from 16 of 29 issuers contacted by ASIC in August 2011, who provided information voluntarily about the costs and impacts of the proposed financial requirements.

Costs of 12-month cash flow projections

109 All issuers, except for one, claimed that the 12-month cash flow forecasts would take five hours per week or less to complete. While, in most cases, the reported per year cost of compliance with the requirement appeared to directly relate to the time taken to produce forecasts, this was not always the case. Three issuers reported costs to comply but no time. This included issuers who

⁷ Median of issuer responses to the relevant question in ASIC survey conducted August 2011.

reported the highest and equal second-highest costs of compliance (\$66,000 and \$40,000 respectively). While it is unclear how this apparent discrepancy arises, it may be that these issuers outsource the forecasting function and therefore do not include it in calculations of time taken.

Cost of auditing cash flow forecasts

- 110 Retail OTC derivative issuers may incur minor increases in auditing costs as a consequence of extending the cash flow period from three months to 12 months, or having an auditor annually review a new cash flow forecast. This requirement will involve auditing issuers' projections of their revenue, expenses and cash needs for the next 12 months and will most efficiently be undertaken at the same time as the current audit requirement. Based on submissions by auditing firms to our similar proposal for responsible entities, we estimate the additional auditing costs to be approximately \$2000 per issuer. However, we assume this cost has been incorporated by issuers into the overall cost estimates of forecasting.

Costs of NTA requirement

- 111 Table 7 provides information about the ability of issuers to meet the proposed NTA requirement.

Table 7: Ability of retail OTC derivative issuers to meet NTA requirement

	No. of issuers	Proportion of issuers
Deficit of proposed NTA requirement as at 29 August 2011	7	44% of all affected issuers
Issues requiring more capital that are able to raise additional funds to meet the required NTA	6	86% of affected issuers requiring more capital
Total issuers unable to raise additional funds	1	14% of affected issuers requiring more capital
Number of issuers that would consider exiting the market	4	25% of all affected issuers

- 112 Of the seven retail OTC derivative issuers that would have had a deficit of NTA as at the date of the survey, all would have been required to hold the minimum of \$1,000,000. We expect that a similar proportion of non-responding issuers (about half) do not currently hold the proposed minimum required NTA of \$1,000,000. Of the seven issuers who do not have sufficient NTA, the average shortfall was approximately \$600,000.
- 113 If we apply the \$600,000 average capital shortfall and the 44% proportion requiring more capital to the eight issuers that did not respond (rounding fractions up), we can roughly estimate the total capital shortfall: see Table 8.

Table 8: Extrapolation of capital required to meet the NTA requirement

	Additional capital required
Issuers with a deficit of required NTA ⁸	7
Estimated proportion of non-responding affected issuers requiring more capital ⁹	4
Average amount of shortfall ¹⁰	\$600,000
Estimated total amount of capital that will need to be raised by retail OTC derivative sector to comply with NTA	\$7,800,000

Cost of raising capital

- 114 Based on our issuer survey, larger issuers will not be required to raise additional capital to meet the NTA requirement. However, many smaller, under-capitalised issuers will need to raise additional capital to comply. Of the issuers who responded stating they would need to raise additional capital:
- (a) one stated that it would be unable to do so (however, this issuer was in the process of exiting the industry anyway);
 - (b) three stated that they would raise capital from their parent company;
 - (c) two stated that they would raise funds from existing shareholders; and
 - (d) one did not specify how it would raise the funds.
- 115 Based on their responses, the larger retail OTC derivative issuers will not need to source additional capital externally; thus the administrative costs associated with sourcing additional capital are expected to be minimal. However, the directors may need to meet and give consideration to the additional capital required.
- 116 As an example of the possible administrative costs associated with sourcing additional capital, there will be a total cost of \$5250 per entity if the relocation of internal funding requires:
- (a) one week's time of an analyst (assuming a salary of \$75,000 per year) at a cost of \$1500 per entity; and
 - (b) one hour's time of directors at a cost of \$3750 (as previously estimated).
- 117 Of the smaller issuers, who have stated they may need to source additional capital, the main sources cited were related entities or existing shareholders. However, it is possible that other retail OTC derivative issuers that did not

⁸ Taken from responses to our survey of August 2011.

⁹ Based on an extrapolation of the proportion of responding issuers requiring more capital to meet the NTA requirement compared to those issuers that did not respond to our survey of August 2011.

¹⁰ Taken from responses to our survey of August 2011.

respond to our survey may need to obtain funds from unrelated investors. As an example, internal administrative costs of sourcing these funds would be \$18,000 if:

- (a) a chief executive officer paid \$200,000 per year spent two weeks marketing, at a cost of \$7500;
- (b) an employee (assuming analyst salary of \$75,000 per year) spent two weeks preparing due diligence, at a cost of \$3000; and
- (c) three independent directors spent two hours considering the proposal, at a cost of \$7500.

118 These costs will vary depending on the availability of equity capital in the market and the viability of the issuer's business. It should be noted that, in light of recent collapses in the retail OTC derivative sector, it may be difficult for some smaller issuers to raise capital from third-party investors.

119 The overall cost of capital will also depend on the particular issuer's cost of equity capital. While we cannot determine what this will be for issuers, we have used the average return of the S&P ASX 200 Financials ex-REITS¹¹ Accumulation Index from 2001–07 as a broad proxy for this. Table 9 sets out the annual cost of an issuer's equity capital on this basis.

Table 9: Retail OTC derivative issuer cost of capital based on S&P ASX 200 Financials ex-REITs Accumulation Index

Average return on index 2001–07	Annual cost of equity capital per \$1,000,000	Annual cost of \$600,000 of equity capital (average of that required by surveyed issuers)
9.17%	\$91,695	\$55,017

120 Issuers may incur minor costs associated with calculating average gross revenue as part of calculating the required NTA. Issuers will be required to provide a forward estimate of these for the next 12 months.

121 Most issuers, in their survey responses, did not provide an estimate of the costs of complying with the NTA requirement. The only issuer that did focused on the requirement to hold 50% of NTA in cash, which is discussed below.

Cost of NTA liquidity requirement

122 Only one issuer appeared to consider the impact on its returns on equity of being required to 'ring fence' 5% of annual revenue in relatively low-yielding cash assets. However, we expect this cost to be high across the industry. While some surveyed issuers appeared to have sufficient cash or

¹¹ This is a stock index maintained by Standard and Poor's. The term 'REIT' stands for 'real estate investment trusts'.

cash equivalents to meet the requirement at the time of the survey, they may still bear the cost of being required to retain funds in low-yielding cash accounts.

- 123 In Table 10, we attempt to quantify the opportunity cost of an issuer retaining funds as cash or cash equivalents, rather than being able to use those funds in its business. As in our proposals for financial requirements for responsible entities, we have used the average cash rate from the Reserve Bank of Australia (RBA) as a proxy for the returns of the cash investments in which issuers will need to retain the cash NTA, and the average return of the S&P ASX 200 Financials ex-REITS Accumulation Index from 2001–07 as a proxy for the issuer’s cost of capital.
- 124 Index returns from 2001–07 have been used because, due to the market dislocation and losses in that index since 2007 caused by the global financial crisis, it would not be a realistic reflection of the expected returns for owners of retail OTC derivative issuers. (However, it may reflect the actual returns of equity holders in financial services firms generally.)
- 125 We also make the general observation that it is very difficult to determine what equity owners of retail OTC derivative issuers would regard as a reasonable expected return on equity. The costs in Table 10 should therefore be seen as a guide only.

Table 10: Opportunity cost of retail OTC derivative issuers meeting the NTA liquidity requirement

RBA cash rate (10-year average) ¹²	S&P ASX 200 Financials ex-REITS Accumulation Index (average annual return 2001–07)	Annual opportunity cost of holding \$500,000 in cash or equivalents under the liquid NTA requirement
5.1%	9.17%	\$20,350

Costs to ASIC under Option 1

- 126 We do not believe that Option 1 will impose additional costs on ASIC. We already conduct surveillance activities in the retail OTC sectors, which may be targeted based on our assessment of risks, or may be commenced in response to breaches or complaints. These compliance activities often include considering issuers’ compliance with the financial requirements under their AFS licence and reviewing submitted with their profit and loss statement under s989B of the Corporations Act.

¹² RBA 10-year average cash rate 2001–11.

127 Because of the complexity of the current financial requirements, and because there is no requirement for licensees to regularly report their ASLF position, we incur costs in collecting and reviewing financial information to assess licensees' compliance with the financial requirements.

128 We do not expect to conduct more frequent surveillances under Option 1. On the contrary, we expect the increased simplicity of the proposed requirements, and the more detailed reporting requirements will actually make it easier for us to monitor and assess the compliance of issuers with the financial requirements.

Effects on competition of Option 1

129 Only one issuer reported that it would be unable to raise funds to meet the NTA requirement. (This issuer was in the process of exiting the market at the time, due in part to ongoing regulatory action by ASIC.) However, four issuers stated that they would consider exiting the market due to the imposition of the financial requirements.

130 The respondents to CP 156 generally expected the proposals to have limited impacts on competition. (One exception was the issuer that identified the cost of maintaining funds as liquid NTA, who argued this was especially burdensome in its case.)

131 Respondents noted, however, that the requirement for \$1 million minimum NTA could act as a barrier to entry, and that the proposed financial requirements may prompt some sector consolidation. Respondents argued that this would have both positive and negative impacts. For example, it was suggested that consumers may benefit from choosing between a smaller number of better-capitalised issuers. In general, respondents argued that, given the perceived leniency of the requirements, effects on competition would be limited.

132 We are unsure whether issuers' apparent failure to consider the opportunity costs of meeting the NTA liquidity requirement (mentioned above) would have affected their assessment of the impact on competition of the proposed financial requirements.

Summary of analysis

133 We consider on balance that the potential enhancement of investor and financial consumer confidence in the retail derivative sector flowing from issuers being more stable as a consequence of being required to prepare longer and more accurate 12-month cash flow forecasts outweighs any additional costs to issuers for the preparation of the cash flow forecasts.

- 134 The benefits to investors, responsible entities, the retail derivative sector and Government that arise from the new method of calculating the NTA requirement include:
- (a) enhancing issuer compliance with the Corporations Act;
 - (b) better aligning the interests of issuers with clients;
 - (c) enhancing the alignment of the NTA requirement with operational risk;
 - (d) improving incentives for retail OTC derivatives to comply with their Corporations Act obligations through risk of loss;
 - (e) reducing the risk of disorderly retail OTC derivatives failure; and
 - (f) providing a larger pool of capital to fund the orderly winding up of an issuer if that issuer failed due to trading losses.
- 135 These benefits outweigh any additional costs to issuers and investors incurred in complying with the requirements and the disadvantage of the potential loss of a small number of undercapitalised and less stable issuers from the market place.
- 136 The requirement to hold 50% of the required NTA in cash or cash equivalents and the balance in liquid assets will ensure retail OTC derivative issuers will be more liquid and capable of managing unanticipated circumstances. This benefit outweighs the additional costs of being required to hold this amount of NTA in cash or liquid assets.

Option 2: Maintain current financial requirements (status quo)

- 137 Under Option 2, the current financial requirements in RG 166 would continue to apply to retail OTC derivative issuers. This would mean that:
- (a) only retail OTC derivative issuers who select the first two options for meeting the cash needs requirement would need to prepare cash flow forecasts, and then only for three months;
 - (b) the minimum capital requirement, as ASLF, would remain at \$50,000;
 - (c) the financial requirements would be based on ASLF, which is subject to different accounting interpretations; and
 - (d) there would be no NTA liquidity requirement.

Benefits of Option 2

- 138 The benefit of continuing to apply the current financial requirements is that retail OTC derivative issuers and investors will avoid any additional costs associated with the clarified financial requirements under Option 1.

Costs of Option 2

- 139 We estimate a number of potential costs would be incurred by retail OTC derivative issuers, investors, the retail derivative sector and Government if the current financial requirements continue to apply. There may be a loss of investor confidence in the sector flowing from issuers:
- (a) not having sufficient liquid assets to enable anticipated and unexpected events to be addressed;
 - (b) having insufficient capital at risk to have appropriate incentives to succeed;
 - (c) having minimum financial requirements significantly below regional financial service centre peers; and
 - (d) the complexity of the current financial requirements and continued difficulty of oversight.
- 140 Reduced levels of compliance with the Corporations Act may result where retail OTC derivative issuers have insufficient capital to fund the orderly winding up of their business if it fails.
- 141 Another potential cost is the loss of confidence in the Government by local and international investors because of failure to address the problems identified with the current financial requirements.
- 142 Finally, there may be increased costs to Government in addressing the consequences of retail OTC derivative issuer failure, including licensing action, court proceedings and addressing investor complaints.

Summary of analysis

- 143 We consider the costs of Option 2 outweigh the benefits.

C Consultation

- 144 On 9 May 2011, we released CP 156, with the consultation period ending on 4 July 2011. We received four submissions on the proposals in CP 156.
- 145 Respondents were generally supportive of the proposals. However, there were some other relevant comments made by respondents, as follows:
- (a) Some respondents thought that the proposals should go further, including having a higher minimum NTA requirement.
 - (b) Concern was raised about how the proposals may affect issuers differently depending on their corporate structure.
 - (c) There was a fairly consistent view that the proposals would not substantially increase barriers to entry or lead to consolidation and thus, would not greatly affect competition.
 - (d) There were differing views about whether the proposals would achieve their stated objectives, with some respondents stating that the proposals were too lenient or that business-as-usual cash-flow forecasting did not cover off on all material risks.
- 146 To build on the information obtained in the consultation process, in August 2011, we sent a questionnaire to issuers that would be affected by the proposals. We invited these issuers to voluntarily complete the questionnaire, which asked for information about the financial impact of complying with the proposed requirements.
- 147 These responses form the basis of our assessment of the costs of implementing Option 1.

D Conclusions and recommended option

- 148 There is significant uncertainty surrounding the quantitative whole-of-industry costs and benefits of the options proposed in this paper. However, we recommend Option 1 because, on the qualitative evidence available, it addresses the identified problems and achieves our objectives.
- 149 We consider Option 1 achieves our objectives for the following reasons:
- (a) This option will ensure that retail OTC derivative issuers have more financial resources and are better able to operate their business in compliance with the Corporations Act, including carrying out supervisory activities, by requiring:
 - (i) more robust cash flow forecasting;
 - (ii) greater amounts of capital and liquidity; and
 - (iii) capital levels better reflecting operational risk.
 - (b) It aligns the interests of retail OTC derivative issuers and their clients by imposing a minimum NTA requirement so that retail OTC derivative issuers are entities of clear financial substance with sufficient capital at risk to provide their owners and directors with incentives to successfully manage the risks that arise in their business.
 - (c) It ensures that Australia provides comparable investor protection to other leading financial services centres and comparable regulatory regimes by imposing a minimum NTA requirement that is better aligned with operational risk to enhance investor confidence in Australia's reputation as an attractive financial services centre.
 - (d) It provides increased levels of assurance that, if a retail OTC derivative issuer does fail due to trading losses, there will be more money available for the orderly winding up of its business.
- 150 We conclude that the benefits of Option 1 on balance outweigh the costs of this option as follows:
- (a) The safeguarding of investor confidence in the retail derivative sector by encouraging issuers' stability through the requirement that issuers prepare longer and more accurate 12-month cash flow forecasts outweighs any additional costs to issuers and investors associated with preparation of the cash flow forecasts.
 - (b) on the basis of the information presently available, the qualitative benefits to investors, issuers, the retail derivative sector and Government of the NTA requirement potentially outweigh any additional costs to issuers and investors incurred in complying with this requirement. These benefits include:

- (i) enhancing retail OTC derivative issuers' compliance with the Corporations Act, including enhanced support for effective supervisory activities;
 - (ii) better aligning the interests of issuers with their clients;
 - (iii) better aligning the financial requirements with operational risk;
 - (iv) reducing the risk of retail OTC derivative issuer failure by both increasing the required amount and liquidity of capital, as well as requiring more detailed cash flow projections; and
 - (v) providing a larger pool of capital to fund the orderly winding up of an issuer due to trading losses.
- (c) The benefits to investors, retail OTC derivative issuers and the retail derivative sector of issuers being more liquid and capable of managing unanticipated circumstances, which will result from the requirement to hold 50% of the required NTA in cash or cash equivalents and the balance in liquid assets, outweigh the additional costs to responsible entities of this requirement

151 On this basis, ASIC recommends Option 1.

E Implementation and review

Implementation

- 152 We propose to use our power to modify the law to implement the proposed financial requirement for all retail OTC derivative issuers. We did not formally consult on this method of implementation as it had not been settled at that time.
- 153 We typically use our modification power to grant relief. However, we have used it to impose requirements on short selling and credit legislation. Exercising our modification power through a class order is an efficient way to implement the proposed requirements. A class order is a disallowable instrument and is reviewable by the Senate. This means that the Senate could disallow the proposal if it objected to it. Implementation will occur by around 31 January 2012, with the new requirements commencing in stages from 31 January 2013.
- 154 The other method of we considered was varying the individual licence conditions of each retail OTC derivative issuer. However, this method is inefficient because each issuer could request a hearing on the varying of their licence conditions. It could be a significant drain on ASIC's resources if all 29 active issuers (and potentially many others who have the relevant authorisations but are not currently offering retail OTC derivatives) sought a hearing.
- 155 We would, on a case-by-case basis, consider granting relief to a retail OTC derivative issuer from the proposed financial requirements where the issuer is prudentially regulated overseas.
- 156 We would set out the proposed requirements and provide guidance to issuers in a stand-alone regulatory guide. This would prevent RG 166, which contains general guidance on financial requirements for all AFS licensees, from becoming cluttered and unwieldy and ensure the requirements have an appropriate profile within the retail OTC derivative sector.

Review

- 157 We will continue to monitor compliance by retail OTC derivative issuers with the financial requirements through breach reporting by issuers and their auditors and when conducting individual surveillances.
- 158 We propose to monitor and review the effectiveness of the proposed requirements within three years of their application and may subsequently make alternative proposals to enhance their effectiveness as required.