## ASIC CLASS ORDER [CO 13/1411]
## EXPLANATORY STATEMENT
Prepared by the Australian Securities and Investments Commission

*Corporations Act 2001*

The Australian Securities and Investments Commission (**ASIC**) makes Class Order
[CO 13/1411] *Managed discretionary accounts: Amendment of Class Order [CO 04/194]*
under paragraphs 601QA(1)(a), 741(1)(a), 951B(1)(a), 1020F(1)(a) and 1020F(1)(c) of the
*Corporations Act 2001* (the **Act**).

Paragraph 601QA(1)(a) of the Act provides that ASIC may exempt a person from a provision
of Chapter 5C of the Act.

Paragraph 741(1)(a) of the Act provides that ASIC may exempt a person from a provision of
Chapter 6D of the Act.

Paragraph 951B(1)(a) of the Act provides that ASIC may exempt a person or a class of
persons from all or specified provisions of Part 7.7 of the Act.

Paragraph 1020F(1)(a) of the Act provides that ASIC may exempt a person or a class of
persons from all or specified provisions of Part 7.9 of the Act.

Paragraph 1020F(1)(c) of the Act provides that ASIC may declare that Part 7.9 of the Act
applies in relation to a person or a financial product, or class of persons or financial products,
as if specified provisions were omitted, modified or varied.

## 1. Background

On 3 August 1998, ASIC released Regulatory Guide 133 *Managed investments: Scheme
property arrangements* (**RG 133**) providing guidance on the minimum standards in holding
scheme property and other assets. RG 133 also applies to a managed discretionary account
service (**MDA**) in respect of a client's portfolio assets held in an MDA. An MDA is a service
under which a person (**client**) makes client contributions, an MDA operator uses those client
contributions to generate a financial return and the client's portfolio assets are managed by
the MDA operator at its discretion and not pooled with other property.

On 11 March 2004, ASIC made Class Order [CO 04/194] *Managed discretionary accounts*
which gives relief from the disclosure and managed investment provisions of the Act for
MDA operators, subject to certain conditions.

On 15 March 2004, ASIC released Regulatory Guide 179 *Managed discretionary account
services* providing guidance on how we will regulate MDA services provided to retail clients
under the Act.

In July 2012, ASIC released Report 291 *Custodial and depository services in Australia,*
which discusses our review of the Australian custodial industry, the current regulatory regime
and matters that we consider to be 'good practice'.

In July 2013, ASIC completed a review of RG 133. In implementing the policy described in
the replacement RG 133, ASIC made a number of class orders, which include [CO 13/1411].

## 2.  Purpose of this class order

The introduction of RG 133 in 1998 and its last update in 1999 were made when the managed investments regime was first introduced. Since then, the managed investments industry, as well as the MDA industry, has undertaken significant growth and evolution.

ASIC's recent surveillance work of existing major custodial providers and other regulatory activities in this industry have highlighted the need to adequately address these developments. ASIC recognises that responsible entities, licensed custody providers, operators of MDAs and Investor Directed Portfolio Services (*IDPS*) are important gatekeepers in the financial services industry. Therefore ASIC considered it important to review and update the guidance provided in RG 133.

[CO 13/1411] specifies the minimum standards that an MDA operator must meet in holding client property or arranging for client property to be held by another asset holder and minimum content requirements for the MDA operator's agreement with a custodian.

The purpose of [CO 13/1411] is to impose minimum standards on MDA operators for holding client portfolio assets to ensure that efficient operational arrangements exist and client portfolio assets are not exposed to unnecessary risks because of the way they are held. If the MDA operator has delegated the holding of a client's portfolio assets to a custodian, [CO 13/1411] requires that the MDA operator must do all things necessary to ensure compliance by the custodian with those minimum standards.

## 3.  Operation of this class order

Class Order [CO 13/1411] amends Class Order [CO 04/194] by inserting paragraphs 1.22A to 1.22S which include additional obligations applicable to MDA operators and paragraphs 2.8A to 2.8C which include additional obligations applicable to external MDA custodians.

*MDA operators*

MDA operators must comply with paragraphs 1.22B to 1.22S from 2 January 2014. If the MDA operator has an AFS licence that expressly authorises it to operate an MDA service before 2 January 2014, a transitional period applies and it must comply with the minimum standards set out in paragraphs 1.22B to 1.22R from 2 January 2015 and the content requirements for the MDA operator's agreement with a custodian set out in paragraph 1.22S from 1 November 2015.

The minimum standards in paragraphs 1.22B to 1.22R require the MDA operator to satisfy, and where it has engaged a custodian, do all things necessary to ensure that the custodian satisfies certain minimum standards in relation to holding a client's portfolio assets. The MDA operator must also do all things necessary to ensure that any sub-custodians engaged directly or indirectly by the custodian also satisfy the minimum standards applying to custodians, subject to an exception in relation to certain overseas assets.

The minimum standards in paragraphs 1.22B to 1.22R require, among other things, that the MDA operator must:

(a)     do all things necessary to ensure that, if it holds a client's portfolio assets, it holds those assets on trust for the client. If the MDA operator engages a custodian to hold the client's portfolio asset, it must ensure that all assets held by a custodian or sub-custodian are held so that the client has a beneficial interest in the assets (other than in certain circumstances where the assets are located outside of Australia);

(b)     do all things necessary to ensure that the client's portfolio assets are, as far as practicable, clearly identified and held separately from the property of the MDA operator, the holder of the assets and any other person other than the client, except where it is permissible to use omnibus accounts in respect of the property referred to in subparagraph 1.22E(b) on the conditions set out in paragraph 1.22F;

(c)     do all things necessary to ensure that it has, and any custodian and sub-custodians have, an organisational structure that supports compliance with the requirement to hold client's portfolio assets separately and must segregate custodial staff in a way that minimises any potential conflict of interests and have a documented policy to support this;

(d)     do all things necessary to ensure that custodial staff have the necessary capacity and resources to perform core administrative activities;

(e)     keep records demonstrating how it complies with its obligations to ensure that the custodian and any sub-custodians comply with the minimum standards;

(f)     have an established process to monitor and assess the custodian's performance of its obligations;

(g)     must not permit a custodian or sub-custodian to be involved in discretionary decisions concerning a deposit account, unless the MDA operator is satisfied that the custodian or sub-custodian has set out in writing and implements reasonable processes for, determining which account to use, monitoring performance by the account issuer of the issuer's obligations in relation to the account and taking action if the issuer fails to meet its obligations;

(h)     do all things necessary to ensure that it and any custodian keep records of client's portfolio assets in a way that enables the holding of the client's portfolio assets to be conveniently and properly audited by an auditor of the MDA service and any custodian or sub-custodian keeps such records in relation to any asset that the custodian or sub-custodian holds.

Paragraph 1.22S stipulates minimum content requirements for the MDA operator's agreement with a custodian. In particular:

(a)     If the MDA operator holds a beneficial interest in the client's portfolio assets on behalf of the client, it must have a written agreement with the custodian that meets the minimum content requirements subject to limited exceptions for overseas property and for a custodian that it controls.

(b)     If the MDA operator does not hold a beneficial interest in the client's portfolio assets on behalf of the client (i.e. the MDA operator arranges for the assets to be held by a

custodian on behalf of the relevant client or clients):

(i)     it must have a written agreement with the custodian that meets the relevant requirements; and

(ii)    it must do all things necessary to ensure that the custodian has a written agreement with each sub-custodian that the custodian engages to hold client's portfolio assets and the written agreement meets those requirements as if the sub-custodian were the custodian and the custodian were the MDA operator subject to limited exceptions for overseas property and for a sub-custodian that the custodian controls.

(c)     Among other things, the custody agreement must have provisions specifying rights that the MDA operator has for the ongoing review and monitoring of the custodian and any sub-custodian, specifying how instructions will be given and to the effect that the custodian must not take a security interest over client's portfolio assets unless it is permitted under the agreement and does not cover the custodian's unpaid fees. The custody agreement must specify the terms on which the custodian is authorised to engage a sub-custodian.

(d)     The MDA operator must ensure that the custody agreement has reasonable liability provisions and if appropriate contains reasonable indemnity provisions in relation to losses caused to the MDA operator or the relevant client by the custodian's acts and omissions that relate to that agreement.

(e)     The custody agreement must require the custodian to certify to the MDA operator in writing at least every 13 months that the custodian believes on reasonable grounds that the custodian and each sub-custodian has met the terms of the agreement and certain minimum custodial standards that apply in relation to the custodian and sub-custodian, other than as disclosed in writing to the MDA operator or that the custodian reasonably believes are trivial. The custody agreement must also provide the MDA operator with a right to terminate in certain specified circumstances including in circumstances that involve the MDA operator having reasonable grounds for believing that the custodian or a sub-custodian has not complied with or is unlikely to comply with these minimum standards.

*External MDA custodians*

Existing paragraphs 2.8, 2.9 and 2.10 of [CO 04/194] will not apply from 2 January 2014 or, if the MDA operator is authorised to act as such before 2 January 2014, then paragraphs 2.8, 2.9 and 2.10 will cease to apply from 2 January 2015.

New paragraphs 2.8B and 2.8C are inserted into [CO 04/194]. These apply once existing paragraphs 2.8 to 2.10 cease to apply and require that an external MDA custodian must do all things necessary to ensure that, broadly:

(a)     a client's portfolio assets other than when held under Division 2 or 4 of Part 7.8 are held on trust, subject to some exemptions; and

(b)    in the case of a deposit taking facility of the client, the facility is an account that complies with section 981B of the Act; and

(c)    a client's portfolio assets held by the external MDA custodian or any other person are held in a way so that the client has a beneficial interest in the client's portfolio assets.

These requirements do not apply in relation to certain overseas assets.

## 4. Consultation

On 20 December 2012, ASIC released Consultation Paper 197 *Holding scheme property and other assets* (**CP 197**) seeking feedback on our proposals to update our guidance for responsible entities of registered managed investment schemes on holding scheme property and other assets. These proposals were also relevant for licensed custody providers, MDA operators, and IDPS operators. The consultation period closed on 28 February 2013.

ASIC received 8 non-confidential responses to the proposals in CP 197 from industry bodies, financial services providers and an academic. CP 197 can be found on ASIC's website.

The Office of Best Practice Regulation has approved the attached Regulation Impact Statement for regulation to implement the policy in the replacement of RG 133.

# Statement of Compatibility with Human Rights

*Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011*

**ASIC Class Order [CO 13/1411]**

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*.

**Overview of the class order**

The class order relates to Managed Discretionary Accounts (**MDA**) being a service under which a person (**client**) makes client contributions, the MDA operator uses those client contributions to generate a financial return and the client's assets held through the MDA (**client's portfolio assets**) are managed by the MDA operator at its discretion and not pooled with other property.

The general purpose of the class order is to strengthen the regulation of a financial services licensee authorised to operate an MDA, and any custodian it engages, to ensure that a client's portfolio assets is not exposed to unnecessary risks by the way it is held or dealt with by the licensee or its custodian.

Developed in consultation with industry, the class order specifies the minimum standards a licensed MDA operator must satisfy in holding client assets or arranging for those assets to be held by a custodian.

Key aspects of these standards are:

(a) The MDA operator must do all things necessary to ensure that all of a client's portfolio assets held by it or by a custodian it engages is ultimately held on trust for the relevant client and are held separately from any other property, subject to certain limited exceptions.

(b) The MDA operator must have, or do all things necessary to ensure that any custodian or sub-custodian has, an organisational structure that supports compliance with the requirement for a client's portfolio assets to be held separately.

(c) The MDA operator must do all things necessary to segregate custodial staff from non-custodial staff, in a way that minimises the potential for conflict.

(d) The MDA operator must have, or do all things necessary to ensure that the MDA operator and any custodian or sub-custodians has, the knowledge and skills necessary to perform their duties.

The class order also establishes minimum requirements that apply to agreements between MDA operators and custodians and between custodians and sub-custodians.

**Human rights implications**

This class order does not engage any of the applicable rights or freedoms.

**Conclusion**

This class order is compatible with human rights as it does not raise any human rights issues.