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Financial Services Risk and Regulatory Review

The Regulatory Roadmap

October – December 2013

Contents

Executive summary

In this issue of Risk and Regulatory Review the topics under discussion show that regulatory change, both at a global and domestic level continues, and is set to continue well into the future.

A International regulation: OTC Reform and FATCA

On the global front, we are seeing the first of the domestic Over-The-Counter (OTC) derivatives reforms taking effect.

As regards the U.S. Foreign Account Tax Compliance Act (FATCA), we are waiting for the Australian intergovernmental agreement (IGA) to be signed with the United States, with organisations already working towards the revised 2014 FATCA deadlines. In addition to FATCA, organisations are also having to consider the implications of what has been termed "GATCA" – the global model for multilateral automatic exchange of information proposed by the OECD – which is based on the US FATCA IGA regime.

B Domestic regulation: FOFA, Super Stream funds managers' impact, AML/CTF impacts

Locally, the Future of Financial Advice (FOFA) reforms, together with some of the Stronger Super reforms are in full effect. However, the wealth industry continues to consider how regulation can be used for competitive advantage and how to address upcoming regulatory requirements, in a cost effective and client focused way.

C Risk Management

Concurrently with all the regulatory change comes heightened expectation to drive improvements in risk management practices from both ASIC and APRA. In May 2013, APRA released consultation papers that propose to raise the bar across all APRA regulated industries by harmonising and enhancing risk management practice and requirements across authorised deposit-taking institutions (ADIs, general and life insurers), as well as Level 2[1] and Level 3[2] groups.

D Regulatory action

In this section our practitioners report on advertising practices and what it means to manage client money risk in terms of the Corporations Act and related regulatory guidance from ASIC. We conclude this edition of *Risk & Regulatory Review* with our usual ASIC and APRA updates.

In addition to the regulatory themes we discuss in this issue, in 2014 we can expect reforms to continue as implementation deadlines come online and the G20 `determines´ to `stay the course´ in implementing its global regulatory program `in a consistent manner´.

Regionally, given the agreement signed by Australia, South Korea, New Zealand and Singapore at the APEC Finance Ministers' meeting on 20 September 2013 to pilot the Asia Region Funds Passport, we can expect a greater ease of access for cross border distribution of managed fund products throughout the region.

We trust you find this edition of Risk and Regulatory Review useful and timely.

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1. A consolidated group within a single APRA-regulated industry, headed by an ADI, general insurer or authorised non-operating holding company.

2. A conglomerate group containing an APRA-regulated institution with operations across more than one APRA-regulated industry and/or including material non-APRA-regulated activities.

A

Global developments resulting in domestic regulation

OTC derivatives market reform and its impact on investment managers and institutional investors

The collapse of Lehman Brothers and the near collapse of AIG in 2008 highlighted the substantial and unknown exposures to other counterparties through Over-The-Counter derivatives. Regulators had to decide whether to bail-out these institutions without the full knowledge of the consequences of such action or inaction. As regulators never again want to be 'blindsided' about the risk positions and inter-linkages of major market participants, global scale reforms for improving the transparency, stability and integrity of the OTC derivatives market have been underway for a number of years[3].

Australian regulatory developments

Generally, OTC derivative regulatory reforms focus on three areas:

1. All OTC derivative transactions are to be reported to databases known as trade repositories (Derivatives Trade Reporting). Mandatory Derivatives Trade Reporting is being phased in, with the first phase requiring reporting by any Australian entity registered as a swap dealer with the US Commodity Futures Trading Commission (CFTC), from October 2013. Other large financial entities with OTC derivatives portfolios amounting to $50 billion or more of gross notional outstanding positions, will be required to report from April 2014. The remaining financial institutions and intermediaries, including both Australian Deposit-taking Institutions (ADIs) and Australian Financial Services Licence (AFSL) holders as well as certain foreign entities, will be required to report from October 2014. End users, for example corporates who are not ADIs or AFSL holders but who enter derivative contracts as counterparties, are not covered by the three reporting phases finalised so far, with consultation in this area anticipated[4].
2. All standardised OTC derivatives transactions are to be centrally cleared through clearing houses (Central Clearing). In this regard, the Australian regulatory framework provides for the Agencies (being the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulatory Authority and the Reserve Bank of Australia) to advise the Minister in relation to a clearing mandate, which would require clearing of specified classes of OTC derivatives in accordance with ASIC rules. The instrument classes for mandatory clearing are still under consideration
3. Where appropriate, all standardised OTC derivatives transactions are to be traded on exchanges or electronic trading platforms. Currently, the Australian regulators have not recommended any mandatory obligations for the execution of trades on organised trading venues.

Implications for Investment Managers and Institutional Investors

Investment managers and institutional investors trading in the OTC derivatives market should expect significant technological and operational challenges regarding the reforms outlined above as well as increased valuation reconciliations. A report commissioned by State Street[5] noted that most buy-side firms (including investment managers) are unprepared for the new trading mechanisms, costs and increased complexity required to adapt to an evolved OTC derivatives marketplace. Implementation challenges could also be exacerbated by the fact that jurisdictions are at differing stages of implementation.

3. See 'OTC derivatives reform – trade reporting regime' Town Hall Presentation by ASIC on 19 August 2013
4. Implementation of OTC Derivatives Reforms in Australia', Speech by Oliver Harvey delivered at Risk Australia Conference, Sydney, 13 August 2013 at page 4.
5. From Readiness to Revolution: The Implementation and Impact of Derivatives Clearing Regulatory Reform" – State Street Corporation (July 2013)

In the table that follows, we have evaluated the likely impact of certain aspects of the OTC derivatives reform agenda for investment managers and institutional investors as well as some of the potential actions that may be required:

Categories	Regulatory Objective	Impact on Investment Managers and Institutional Investors	Potential actions required
Trade Reporting	All OTC derivatives should be reported to a trade repository in order to provide regulators with a full picture of all OTC derivative positions for the entities they regulate and to enable market-wide risk monitoring.	Investment managers and institutional investors trading in interest rate, credit and equity derivatives that have been traded bilaterally or centrally through an exchange will have to be reported. **Trade Reporting** We expect transaction reporting to be outsourced to custodians, clearing brokers or the central counterparties by most investment managers and institutional investors. Without adequate automation processes internally, managers would be required to manually handle data, which could lead to increased use of spreadsheets leading to errors/ administrative burdens. **Valuation Reporting** Valuation practices will have to be enhanced to meet the two sided reporting obligations from 1 October 2014. Most investment managers and institutional investors currently rely on vendors, custodians or counterparties to provide the valuation of OTC derivatives that have been traded bilaterally for infrequent valuation data.	The OTC derivatives valuation policies, procedures, and processes will have to be reviewed to enhance the accuracy of inputs, consider market liquidity and multiple pricing sources to meet the robust valuation approach required by regulators. We noted during the 2008 crisis that changes in market liquidity can result in discrepancies in valuations for standardised OTC derivatives. OTC derivative market participants relying on others to report trades on their behalf should document procedures performed to validate compliance by those third parties (for example, require third parties to provide reporting confirmations). Robust valuation practices will improve management of collateral and margin calls and mitigate risk of disputes regarding the amount that will be posted in collateralised transactions. The accounting requirements to include adjustments to reflect counterparty credit (CVA) and own credit (DVA) charged by counterparties in uncollateralised transactions add to the complexity of derivatives valuations.

Categories	Regulatory Objective	Impact on Investment Managers and Institutional Investors	Potential actions required
Clearing and Swap Processing	All standardised OTC derivatives to be centrally cleared by well-regulated entities to reduce counterparty credit risk within the system.	Higher margin and collateral requirements for centrally cleared trades will likely challenge current liquidity risk management frameworks and allocation of capital. Existing liquidity risk scenario planning may not adequately contemplate margin risks.	Investment managers will need to consider how margin requirements will be covered on a daily basis. Clearing houses will determine the type of collateral that could be used for variation margin purposes and would typically be cash and high grade government bonds. Current liquidity management will need to be updated to ensure that adequate liquidity is available to settle on the variation margins for central clearing purposes. Investment managers should update and expand liquidity risk scenario analysis, stress testing and scenario planning in view of margin requirements.
Margin Requirements (for uncleared trades)	Derivatives which are not standardised enough to be risk managed by a CCP should be subject to adequate margin and risk reducing measures.	Similar to centrally cleared trades, additional margin requirements may strain liquidity risk management frameworks and scenario planning. It is important to note that many bespoke derivative products used to hedge specific risks will not be centrally cleared: • Cross currency swaps, commodity swaps, equity swaps and inflation swaps are examples of derivative instruments (widely used by investors to manage financial risks) are likely to remain uncleared because they do not fit the eligibility requirements of clearinghouses[6] . • Standardised derivatives that lack liquidity due to unique tenors, currency denominations, reference rates and embedded optionality may not meet the requirements for central clearing.	Investment managers should establish guidelines for acceptable types of collateral in view of counterparty credit risk. If non-cash assets are used as collateral, investment managers will need to review existing collateral management processes to understand how the collateral value is correlated with the derivative instrument. Similar to centrally cleared trades, investment managers should update and expand liquidity risk scenario analysis, stress testing and scenario planning. Further, CVA adjustments on un-collateralised derivative trades will have to be measured and incorporated in the investment strategy and risk management.

6. 'Non-cleared OTC Derivatives: Their Importance to the Global Economy – March 2013', International Swaps and Derivatives Association (2013)

Categories	Regulatory Objective	Impact on Investment Managers and Institutional Investors	Potential actions required
Mandatory trade execution on exchanges or trading platforms	Standardised derivatives should be traded on well-regulated and transparent exchanges and electronic trading venues.	Investment managers trading with US counterparties will be subjected to certain regulation, being that standardised credit default swaps and interest rate swaps below a certain threshold must trade on Swap Execution Facilities (SEFs), being trading platforms in which multiple participants can trade swaps with multiple participants, and meet CFTC pre-trade transparency requirements.	Determine preferred SEFs based on instrument type and liquidity in the market and put legal agreements in place with chosen SEFs. The existing order management platform must have the required connectivity to the platform or SEFs adopted for electronic trading.

Trading standardised derivatives on exchanges will require investment managers to consider competing markets – inter-dealer brokers (IDBs) and electronic communication networks (ECNs), that may offer the deepest liquidity for standardised derivatives to achieve best trade execution cost outcomes. The table below sets out some of the key changes to trade execution that have to be made to adapt to the new OTC derivatives market paradigm for investment managers and institutional investors that have high volumes of OTC derivative transactions.

Subhead	Impact on Trade Execution Processes
Market Liquidity	The reporting of OTC derivative transactions to trade repositories with the objective of creating greater transparency could result in lower liquidity in the OTC derivative markets. Most banks act as IDBs to provide critical pre-trade transparency and liquidity in the OTC derivative markets to end users, being investment managers and institutional investors. Bloomberg platforms, multi dealer pricing platforms, and other electronic and voice price dissemination tools are commonly used to perform pre-trade price and liquidity discovery with minimal impact on trade confidentiality. Onerous reporting requirements could result in lower market participation from brokers and thus reduce liquidity and increase fragmentation in the market.
Transaction Cost	The direct implication for transaction costs might appear to be higher spreads, higher broker commissions and difficulty in transacting in required trade size which adversely impact return on investments. However in reality, the cost incurred to transact OTC derivatives will change from paying a spread to IDBs, to a commission based fee to access platforms that have the best liquidity in the marketplace. Further, OTC derivatives reform and Basel III make risk bearing more expensive for banks and will shift the business to agency facilitation and, from transaction spread to commission based fees that can be measured for transaction cost reporting purposes.
Best Execution	Global regulatory requirements such as the European Union's Markets in Financial Instruments Directive (MiFID) require investment managers to take all reasonable steps to obtain, when executing orders, the best possible result for their clients, taking into consideration price, costs, likelihood of execution and settlement, size, and any other consideration relevant to the execution of the trade order from portfolio managers. In most bilateral OTC derivative transactions, traders exercise judgment on best execution based on experience and relationship with brokers. Investment managers are likely to be expected to demonstrate, through the attribution of implicit and explicit cost associated with trade execution. Investment managers will be expected to monitor the cost of OTC derivative transactions with the assistance of analytical tools, to demonstrate that best execution has been achieved.

Conclusion

In our view, the OTC derivative market reforms have formalised sound risk management practices largely adopted by large investment management firms in response to the need for a more holistic investment risk management framework. Further, the reforms provide an opportunity for investment managers to review the existing trade management cycle with a view to improving operational efficiencies and reassessing trade management strategies.

Practically, the OTC derivatives market reforms will require senior management to formulate a compliance roadmap that keeps abreast of applicable domestic regulatory developments so that the requisite business responses, such as upgrades to trading platforms, middle office risk management and legal documentation, can be achieved efficiently.

The countdown to 1 July 2014 for FATCA compliance

Additional time as a result of revised timelines should be fully utilised to ensure that Australian FIs will be FATCA compliant, exempt from FATCA or deemed compliant with FATCA by the 1 July 2014 start date and, if applicable, registered on the IRS FATCA Registration System. Even without a signed Australian IGA, there is a significant amount of guidance available to enable Australian FIs to progress FATCA implementation, while also taking into account development of "FATCA-style" exchange of information mechanisms beyond the U.S.

Setting the scene – a snapshot of FATCA and recent developments

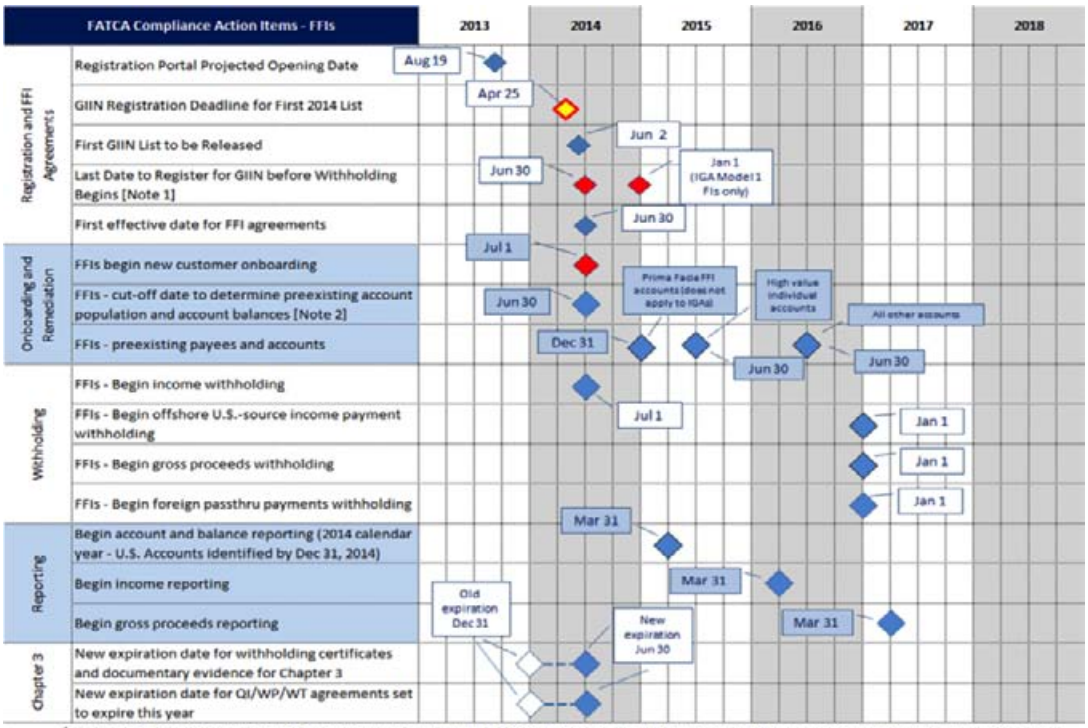
The Foreign Account Tax Compliance Act (FATCA) is a U.S. tax avoidance measure that requires foreign (non-U.S.) financial institutions (FFIs) to identify, report on and, in some circumstances, withhold on payments to account holders. It also requires certain non-U.S. entities with substantial or controlling U.S. owners to provide information about those U.S. owners. FFIs that are not excluded from FATCA and do not comply with FATCA may be subject to 30% withholding on certain payments of U.S. source income and gross proceeds of the FFI.

Final regulations and guidance for implementation of FATCA were released in January 2013 with some technical corrections issued in September 2013. Since January, FFI's have been considering the impact of the following key requirements of FATCA on their businesses, systems and processes:

- Registration of the FFI with the IRS and entry into an FFI Agreement
- Identification of new U.S. account holders through FATCA compliant onboarding procedures
- Identification of existing U.S. account holders by undertaking due diligence procedures
- Reporting of information on U.S. account holders to the IRS
- Withholding 30% of particular payments made to certain U.S. account holders.

The timeline for compliance with each of these requirements is staggered from 2014 to 2017. The IRS released Notice 2013-43 on 12 July 2013, which extended a number of FATCA compliance deadlines by six months, with the "go-live" FATCA deadline now 1 July 2014.

Revised FATCA deadlines



The revised timelines give Australian FIs additional time to implement FATCA. Australian FIs should ensure that they take full advantage of this additional time and do not delay FATCA projects until 2014. The extensions recognise that implementation of FATCA can take time for some FIs, especially where changes are required to be made to processes and systems.

An Australian intergovernmental agreement (IGA)

The Australian Treasury has been negotiating an IGA with the U.S. Treasury, based on a Model I IGA released by the U.S. Treasury. An IGA will ease certain aspects of FATCA as compared to the final regulations, such as significantly reducing the withholding requirements of FATCA, allowing greater reliance on AML/KYC procedures and information and overcoming privacy issues by requiring FIs to report to their local tax authority, rather than directly to the IRS. Entry into an IGA will require all Australian FIs to comply with the modified version of FATCA.

It is expected that the Australian IGA will be signed before the 1 July 2014 start date for FATCA (and it is hoped it will be signed before the end of 2013). If the IGA is signed by 1 July 2014, the U.S. Treasury and IRS would then treat Australia as having an IGA 'in effect'. As such, Australian FIs may then follow the IGA, even though the IGA may not have been ratified nor entered into force by enabling legislation in Australia. We understand that Australian FIs are progressing FATCA projects on the basis that the IGA will be applicable, rather than the final regulations.

A number of other countries have signed or are negotiating IGAs with the U.S. For example, the UK signed an IGA with the U.S., based on a Model 1 IGA, in September 2012 and has subsequently released regulations and guidance notes for the UK FIs. Australian FIs may find the UK guidance useful for FATCA implementation, as detailed Australian guidance is unlikely to be issued for some time following signing of an Australian IGA.

For example, a key area for Model I IGA FFIs is the requirement for account holders to provide self-certification as to their U.S. status. The UK guidance sets out guidance on self-certification for UK FIs. While many aspects are not prescribed, such as the format and wording of the self-certification, provided it confirms the account-holder's country of tax residency and whether the account-holder is a U.S. citizen, a number of examples are provided.

Broader scope on the horizon

Upon entering into an IGA, the signing country agrees to work towards the development of a common reporting and information-exchange model. The OECD released a report on 18 June 2013 on the steps needed to create a fairer and more transparent global tax system. The report referenced FATCA and IGAs in providing a framework for multilateral exchange of tax information (referred to as global FATCA or "GATCA"). The OECD has been working on this framework and consulting with OECD members as to its form and timing. The G20 have stated full support for the OECD project, with an (ambitious) timetable as follows: expected presentation of a single global standard for multilateral automatic exchange of information by February 2014, finalised technical requirements by mid-2014 and automatic exchange of information commencing by the end of 2015 among G20 members.

Australia has already agreed to join a scheme modelled on FATCA, which would require Australian banks to reveal financial information about their customers to the ATO, so it can be shared with tax authorities in a number of overseas jurisdictions (approximately 20 countries have now endorsed this approach). Recently the UK and Cayman Islands signed a FATCA-style agreement.

These global developments should be considered when implementing FATCA to ensure that changes to systems and processes are not necessarily U.S. specific, so as to minimise the need for future changes (e.g. asking an account holder to advise their tax residency, rather than simply asking if they are a U.S. tax resident or U.S. citizen).

Registration requirements for Australian FIs

On 19 August 2013, the U.S. IRS launched the FATCA Registration System and provided detailed registration guidance.

The IRS has also been releasing frequently asked questions and responses for FATCA registration. The FATCA Registration System is web-based and enables registration details to be entered, but not submitted until closer to the deadline for registration. The substantive guidance issued by the IRS will assist FIs to answer particular questions in the registration process, but may also affect strategic decisions to be made by Australian FIs for FATCA implementation.

Which Australian FIs must register?

Following signing of an Australian IGA, Australian FIs that are reporting FIs will need to register for a Global Intermediary Identification Number (GIIN) as a registered deemed compliant FFI. A reporting FI is any Australian FI or Australian branch of a foreign FI that is not exempt from FATCA or does not fall within the definition of an FFI that is treated as complying with FATCA (a deemed compliant FFI).

Even if an entity is exempt or deemed compliant and not required to register, the entity should:

- Document its analysis of whether it meets the specific requirements for the particular exemption or deemed compliant category applicable
- Detail the information relied on
- Set out the conclusions reached and identify and implement any procedures required to be put in place to ensure it continues to meet the requirements.

To minimise compliance, a fund manager or trustee may also register as a sponsoring entity for one or more sponsored investment entities (sponsored FFIs) if, amongst other things, it is authorised to act on behalf of the sponsored FFIs to fulfil the applicable registration requirements on the FATCA registration portal. The sponsoring entity is required to perform the due diligence, withholding, and reporting obligations of its sponsored FFIs. Sponsored FFIs do not need to register until 2016. Until the sponsored FFI is registered, it uses the GIIN of the sponsoring entity.

What is the deadline for registration?

The IRS has stated that registration will need to be finalised by 25 April 2014 in order for the FI to appear on the first IRS FFI list (the publicly-available list of institutions who have registered with the IRS, which will be published monthly). However, following signing of an Australian IGA, Australian FIs that do not have branches or member FFIs in non-model I IGA countries and are not qualified intermediaries will have until 1 January 2015 to register and obtain a GIIN. Other Australian FIs may, however, choose to register before 1 July 2014 so that they have a GIIN to provide to counterparties (referred to as defensive registration).

What does an Australian FI need to do prior to registration?

To enable an Australian FI to determine if it needs to register and, if so, the information required to answer the questions in the Registration System, the FI group must classify each entity in the group for FATCA purposes. The classification process involves gathering information and documenting the conclusions reached for every entity in the group. Apart from enabling registration to be undertaken, entity classification is usually part of the first phase of FATCA implementation as it will also determine the application FATCA implementation program for each entity. For example, the FATCA requirements for a reporting FI are different to the FATCA requirements for an exempt or deemed compliant entity. Further, Australian FI's that operate across multiple jurisdictions will need to consider the applicable rule set for entity classification and FATCA implementation in each jurisdiction (e.g. final regulations or particular IGA for each jurisdiction) and have a strategic plan in place to manage this complexity.

Tax, compliance and project management

Phase I impact analysis	Phase II implementation	Phase III ongoing compliance
• Define FATCA taxonomy for entities and product lines • Utilise survey tool to obtain and perform gap analysis on - Internal and external KYC/AML processes - Client data maintained - Account classification capabilities • Create a responsibility matrix to outline internal and service provider supported tasks • Conduct initial review of withholding and reporting capabilities.	• Review legal documentation for appropriate disclosures • FFI registration and development of Responsible officer certification program • Creation of internal FATCA compliance policies, procedures, and controls • Oversight and review of KYC/AML process enhancements, client account classification, and data remediation activities • Create high level requirements for initial reporting and withholding systems or process enhancements.	• Oversight and review of reporting and withholding enhancements for ongoing requirements • Ongoing internal and service provider FATCA programs to confirm compliance • Ongoing governance program and updating of initial FATCA policies and procedures to include future changes to the rules • Implement an overall quality review process.
Phase I results	**Phase II results**	**Phase III results**
• PMO and governance framework • FATCA classification of entities/products • Pre-implementation action plan with immediate and longer term action inters • Gap analysis of KYC/AML programs, account data, and reporting/ withholding.	• Development and design of process and systems enhancements to meet the requirements • Remediation of pre-existing account program • Execution of an overall implementation plan.	• Post implementation risk, controls, and oversight assessment • Future state operating model definition • Process to ensure ongoing compliance.

By registering, an Australian FI is confirming that it is FATCA compliant. That is, it commits to having FATCA compliant onboarding in place by 1 July 2014, undertaking due diligence of pre-existing accounts within the stipulated timeframes and meeting the other requirements for FATCA. Accordingly, an Australian FI will need to have undertaken sufficient work to ensure that it will be compliant with the FATCA requirements from the relevant dates. The "must-haves" to focus on in the period leading up to 1 July 2014 are summarised in the diagram below.

To minimise cost and avoid duplication of effort, Australian FIs should leverage and connect with other change programs (e.g. updates to onboarding for other regulatory changes) and recycle existing regulatory, risk and operational infrastructure for FATCA.

If an Australian FI is not required to register, what must it do to indicate FATCA compliance?

An Australian FI that is a Non-Reporting FI will generally be required to confirm or certify its FATCA status to counterparties when requested to do so. This may be by way of completing the relevant section on the revised W-8BEN-E form, completing some other form or providing certain information or documentation to a counterparty.

The countdown …

With the launch of the FATCA IRS Registration System, the implementation of FATCA feels almost tangible. Despite delays in the release of draft and final regulations and extensions of timelines, the countdown to FATCA compliance has begun in earnest for all Australian FIs. The additional time given by the revised timelines should be fully utilised to ensure that by 1 July 2014 Australian FIs will be compliant with FATCA or will have confirmed and documented FATCA exemption or deemed compliance and if applicable, registered on the IRS FATCA Registration System. Even without a signed Australian IGA, there is a significant amount of guidance available to enable Australian FIs to make substantial progress on FATCA implementation.

1st July 2014

Entity classification
- Identify all FFIs in the expanded affiliated group
- Classify all entities for FATCA purposes, including deemed compliant entities.

New account opening process
- Required to go-live on 1 July 2014
- Obtain W-8s or other evidence from new account holders
- Cross-reference to AML and other account opening documentation requirements
- Standards of knowledge.

Financial counterparty due diligence
- Understand and agree scope of responsibility with counter parties
- Due diligence on counter parties in 2013 & 2014 to ensure timely compliance.

Compliance program initiated
- Must go-live with new account opening process
- Program designed to ensure compliance with FFI Agreement
- Monitor changes in circumstances to account holder documentation from 1 July 2014.

Withholding process (non-IGA)
- Must go-live with new account opening process
- Intermediaries must provide withholding allocation statements to withholding agents
- Some QIs may elect to perform with holding.

IRS registration
- Register by 25 April 2014 to ensure issuance of a Global Intermediary Identification Number by 30 June 2014 (and on IRS list by 2 June 2014)
- Model I IGA reporting FFIs register as deemed compliant FFIs; can register if IGA not ratified provided the jurisdiction is on IRS list of IGAs.

B

Australian specific regulatory developments

What next for Advice?

The advice industry has undergone an intensive period of change with the FOFA reforms now in full effect since 1 July 2013. However, it is no time for the industry to take a breather with the competitive landscape changing at the same time as there is an unparalleled change in clients' behaviour and their future needs.

In our 2011 paper 'The future of financial advice – Opportunities and challenges', we said that the winners from the FOFA reforms would be those with a customer focus, who make the most of their market position, and keep their strategic radar on the disruptive plays happening across the wealth management industry.

Over the past year, there is no doubt that FOFA has accelerated the move towards client centricity however there is still a way to go.

One way of upholding the principle of client centricity is through a robust advice monitoring program. With the recent regulator and industry focus on proactive monitoring, there is strong view that the 'right' monitoring and supervision arrangements for advisers will be instrumental to providing an advice provider with the desired advisor and client retention and a competitive advantage. In the words of ASIC Deputy Chairman, Peter Kell, "Monitoring and supervision are much more than audits and compliance checks. They are about proactively ensuring that advice is appropriate and clients are treated fairly."

In this article, we provide an update and summary of the changing landscape for the advice industry, and then follow with a deep dive into the changing face of effective compliance monitoring for advice quality.

Key drivers of change for the Advice Industry

- Access to information is more readily available with clients more open and willing to do their own research as well as business online. This trend will increase in importance as wealth shifts to the Gen X and Y populations
- Clients' financial awareness continues to improve post-GFC
- Growing demand for SMSFs, increasing the prevalence of "do it yourself super"
- Significant growth opportunity to provide financial advice with at least two thirds of Australians currently not receiving advice from an advisor
- Competing priorities of delivering high quality advice (backed up by a strong and continued focus by the regulator, ASIC, on the quality of advice) whilst delivering in a low cost environment to match client fee expectations.

Clients' needs are changing

Based on our research[6] and observations, we have found that clients may

- Be more willing to pay for analysis and comparison of options, rather than just for information (in fact their propensity to pay for information on single products may decrease).
- Want information on why their chosen products or strategies are suited or not suited to them
- Be less willing to pay for end-to-end comprehensive advice unless they fully understand the long term value, and more interested in obtaining an answer to a specific question – i.e. how to invest a set amount of cash or supplement low cost SMSF administration
- Want to pay smaller more frequent fees rather than large annual fees
- Want access to niche quality research, that may not be available freely online
- Expect their advisor to be relatively mobile and easily accessible e.g. email, social media, multi-channel contact as well as face-to-face meetings
- Move to self-service and 24/7 access to online data for traditional banking products consequently reducing advisor face-to-face contact opportunities
- **Will continue to seek out trusted relationships** with their advisor.

Financial advisors – the new client service model

- Financial advisors may be considered as the new 'customer service', to provide analysis on problems the client cannot solve for themselves. Their interpersonal skills, backed up by professional level qualifications will continue to grow in importance.
- Financial advisors will need to demonstrate value through providing deep insights on specific questions (e.g. more emphasis on the options considered and the value to clients)
- Collaboration will be seen as positive and necessary both within the advice network and research houses to bring expertise where required
- Pricing models will be flexible to address client needs (from comprehensive advice to single product advice)
- The use of "big data" will provide a competitive advantage to those advisors (or their licensees) who can effectively extract and utilise accurate or 'soft' information to segment their client base
- Advisors will be able to provide access to more client centric and sophisticated investment products as the Australian financial services market continues to mature
- The use of technology will become a critical element in delivering efficient services to a generation of potential clients who are not willing to pay for traditional advice. Scaled advice models and use of technology such as interactive applications and video conferencing will become critical enablers to profitable advice delivery

Financial advisors are heading into 2014 considering how to respond to these market shifts.

What next for Advice Compliance Monitoring?

There has been substantial change from an operational and regulatory compliance perspective in the area of advice quality with advisors having to better articulate their value proposition and act in the best interests of their clients. Despite financial planning groups within the industry (hereafter referred to as 'Financial Planning Groups') recognising the continuous need to enhance the supervision and monitoring of their advisors in this area, the process of improving compliance monitoring activities is often not an easy task. That said, as many of the underlying principles upon which the compliance requirements are based revolve around the best interest duty, through the design and implementation of quality advice, effective delivery of advice and a team of capable client focused advisors, compliance requirements can be better met. When these elements are in place, any pressure on compliance monitoring is reduced.

6. Back to Basics: Quality of Advice', Deloitte Risk & Regulatory Review, March 2012
'The Digital Investor', Telstra, December 2012
Recognising RDR reality: The need to challenge planning assumptions', Deloitte Touche Tohmatsu, July 2013
Dynamics of the Australian Superannuation System, The next 20 years: 2013 – 2033', Deloitte Touche Tohmatsu, September 2013

ASIC continues to scrutinise Financial Planning Groups with a continued focus on their ability to supervise and monitor advisors. In particular, ASIC recognises there is a strong correlation between an organisation's ability to identify compliance deficiencies in a timely and effective manner with an organisation's ability to prevent systemic compliance issues from occurring in the future. This is evidenced from recent media releases[7] and ASIC reports[8].

We set out below some of the common challenges experienced with compliance monitoring and our predictions on how compliance monitoring will evolve.

What is compliance monitoring?

The term compliance monitoring in this article refers to any activities that an Australian Financial Services Licensee undertakes to assess the quality of advice provided to clients by advisers, and to identify, address and respond to any compliance issues. Monitoring includes after the event reviews of advice by compliance auditors (commonly known as compliance audits) and vetting activities by compliance auditors (where advice is assessed prior to presentation of the advice to a client). More recently compliance monitoring has evolved to include other activities such as the use of data analytics and key risk indicators to identify risky advice, interviews with advisers and real time observations of the advice process.

What are the common challenges to performing effective compliance monitoring today?

Inconsistent interpretations of compliance obligations

Due to the nature of financial advice, where client personal circumstances vary significantly and the advice provided varies in complexity and scope, the boundaries (set by legislation, regulation and Licensee standards) may be interpreted differently by different stakeholders. Requirements such as the best interest duty, safe harbour requirements and the suitability of advice may well be interpreted differently by the Licensee, advisors and compliance auditors unless there is clarity of policy and terminology and effective training.

The safe harbour requirements

FOFA's safe harbour requirements

1. The provider must act in the best interests of the client in relation to the advice.
2. The provider satisfies the duty if the provider proves that the provider has done each of the following:
   - Identified the objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions
   - Identified:
     - The subject matter of the advice that has been sought by the client (whether explicitly or implicitly)
     - The objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the client's relevant circumstances)
   - Where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information
   - Assessed whether the provider has the expertise required to provide the client advice on the subject matter sought and, if not, declined to provide the advice
   - If, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product:
   - Conducted a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered as relevant to advice on that subject matter
   - Assessed the information gathered in the investigation
   - Based all judgements in advising the client on the client's relevant circumstances
   - Taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

7. For example, 13-097MR: Licensees urged to review and improve recruitment of new advisors, and other media releases such as 13-263MR 13-240MR, 13-155MR,
8. For example, ASIC Report 362 - Review of financial advice industry practice: Phase 2 and ASIC Report 251 - Review of financial advice industry practice

No clear definition of scope and/or value proposition for compliance monitoring activities
Compliance monitoring scope may often not consider key areas such as:

- Understanding the root cause of any issues identified in the advice provided.
- Assessing the cultural fit of advisors to the Licensee and to clients
- Assessing whether the implementation of the advice is matching the documented advice
- Identifying indicators of fraud

Value of monitoring activities not recognised by the advisors
Action plans which arise out of compliance monitoring are key to advisors' development. Compliance auditors may be seen by advisors as acting in the best interests of the Licensees rather than to support the advisors in meeting their compliance requirements and improving the quality of client discussions and advice for the clients.

Monitoring may not cater for advisor diversity
In Licensees with advisors with different business models, compliance monitoring may not be able to adapt to the various risks and styles of different advisors. Different advisor models may require different levels and methods of training of the advisors as well as differing compliance audit models.

Audit programs have expanded as new regulations have been issued
The focus of the compliance audit should be on the advice quality. With programs that have over the years been expanded to cover many circumstances and specific regulations, the question should always be asked "can I see the wood or the trees?"

What are the common challenges to improving compliance monitoring?

Setting a clear objective
Compliance monitoring provides various benefits to different stakeholders so it is important to set out up-front what the intended objectives are and to obtain at the start the views of management, compliance auditors and advisors to make sure those expectations are being met.

Effective project and change management
As monitoring can involve various components including the use of technology, key risk indicators, changes to processes/procedures, compliance staff capability development and advisor remuneration programs, it is important to have a clear plan of attack before designing and implementing changes.

An integrated response to effective compliance
Monitoring is part of a wider ecosystem within a Licensee's organisation. A Licensee with effective processes, systems, governance and culture will get the best value from a well-designed compliance monitoring system.

Listen to Advisors
Advisors have a clear constructive view of the benefit of an effective compliance monitoring framework. Early engagement and regular feedback is essential particularly where compliance audit results impact advisor remuneration. Where improvements are being made to compliance audit processes and impacts thereof, a clear change management plan is essential.

Obtaining approval and support for change
The ability to deliver quality advice to clients is integral to a successful advice business. Where the compliance audit process is seen merely as a compliance requirement rather than a key business need, obtaining funding for improvements can be difficult to prioritise over other business needs or objectives. The link to strategic objectives should be clearly demonstrated in business cases.

How will compliance monitoring evolve?

Individuals performing compliance monitoring activities will take on a more advisory approach
With further investments into the capabilities of individuals performing compliance monitoring, improvements will occur in the methods by which they engage with advisors and supervisors. There will be less emphasis on compliance breach identification and more on identifying root causes and hence strengthening advisor skills and advice processes to enable compliance. New skills in analytics, psychology or information architecture will become key.

Real time focus and less emphasis on 'after the event' file reviews

There will be less reliance on 'after the event' file reviews as being the main mechanism for identifying compliance risks. Organisations will take more advantage of technology capability to include real time data analytics and key risk indicators into compliance monitoring. We expect to see other mechanisms increasing in popularity whether they be shadow shopping, advisor interviews or client surveys.

Cultural fit assessments

Licensees will focus more on the cultural fit of advisors. Although this may be performed at the advisor on-boarding stage as part of a comprehensive due diligence and induction process, information on cultural fit will be examined more often by supervisors and compliance auditors.

Increasing competency of advisors

The implementation of well-designed advice delivery processes and systems that embed preventative controls, combined with competent professional advisors, reduces the need for large quantities of after the event detective file reviews.

Conclusion

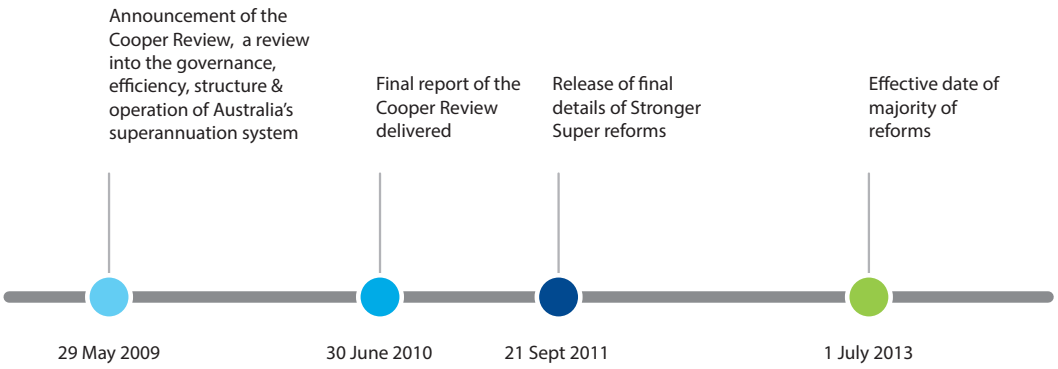
Investing in compliance monitoring is not about hedging regulatory risk. It is about proactively ensuring that advice is appropriate and clients are treated fairly. It is also increasingly about advisor retention.

Implemented properly, an efficient and effective compliance monitoring framework will add value to an advice business by facilitating an increase in the quality of advice, empowering advisors to expand their advice capabilities and discovering and addressing any compliance concerns before an impact to clients and business. The strength of the compliance monitoring framework serves as an opportunity to attract quality advisors who wish to continue to develop their technical and soft skills in a supportive environment whilst serving their clients to the best of their ability and ensuring their clients are better off as a result of seeking advice.

Riding the waves of super regulatory changes: dissecting the downstream impact on fund managers

As superannuation funds continue to enter a new world of regulation, the impacts of the reforms are starting to reverberate to related industries. The funds management industry in particular is feeling the effect of the waves of super regulatory changes.

What will these changes mean for Fund Managers? What are the challenges and opportunities that Fund Managers face? In this article we dissect the downstream impact of these super regulatory changes, as well as step back and revisit the timeline of key historical Super Regulatory Changes.



Super Regulatory Changes – what's it all about?

There are four clear sections of Stronger Super reforms:

- **MySuper:** a simple, low cost default superannuation product intended to improve the simplicity, transparency and comparability of default superannuation products
- **SuperStream:** a package of measures designed to enhance the 'back office' of superannuation. When fully implemented, these measures will improve the productivity of the superannuation system and make the system easier to use.
- **SMSFs:** reforms in this area will improve the integrity of, and increase community confidence in, the self managed superannuation funds sector
- **Governance:** measures to strengthen the integrity of the superannuation system by improving trustee and fund decisions, efficiency and effectiveness. This encompasses the release of the prudential and reporting standards for superannuation.

Downstream Impact on Fund Managers – what are the implications?

As APRA-regulated superannuation funds implement the requirements of the prudential and reporting standards, we are starting to witness a downstream impact on fund managers. Our analysis of the more significant impact on fund managers is presented in the table below.

Requirements	Impact on Fund Managers
SPS 530: Investment Governance (including SPG 530: Investment Strategy – Formulation, SPG 531: Investment Strategy – Implementation, SPG 532: Investment Risk Management and SPG 533: Valuation) A sound investment governance framework must be implemented, involving the development of articulated investment strategies and the selection, management and monitoring of investments.	Additional reporting requirements, greater need for transparency and the need for effective management of risk by service providers means fund managers may face increased costs to meet their obligations to superannuation trustee clients. Fund managers should be prepared to provide information supporting these requirements for its products, particularly on: • Investment risks • Uncertain investment outcomes such as illiquidity, tail risk and extreme correlations • Factors impacting specific asset classes such as credit spreads and yield curves • Valuation approach for each investment type, including hierarchy of valuation sources • Valuation risks that could cause material errors in unit pricing, performance reporting and financial reporting • Any compliance breaches • Performance against agreed service levels • Ability to respond to stress test results. In addition, and in alignment with their own responsibilities, Superannuation Trustees will expect fund managers to focus upon after-tax returns. This may prove challenging for fund managers without a complete picture of a client's tax situation, or in pooled funds comprising clients of differing tax positions.

SPS 220: Risk Management Trustees must have in place systems for identifying, assessing, managing, mitigating and monitoring material risks that may affect their ability to meet their obligations to beneficiaries.	Trustees will be looking for better alignment of their outsourced service providers' risk management framework and policies to their own. Fund managers can expect greater demand for assurance over the effective operation of their risk management frameworks as this will come under increased scrutiny and will be a significant focus for due diligence processes. Fund managers should revisit their current risk management framework, including procedures currently in place with regards to providing assurance over the effectiveness of this framework.
SPS 231: Outsourcing Trustees must ensure that material outsourcing arrangements are subject to appropriate due diligence, approval and ongoing monitoring and that risks are properly managed. Trustees must consult with APRA prior to implementing any outsourcing arrangements which involve offshoring	Fund managers should expect more rigour in the selection process of outsourced service providers which could include greater demand for assurance over effective operation of controls and accuracy of information provided. Fund managers should revisit their current procedures with regards to providing assurance over the effectiveness of their internal control environment and the provision of accurate data. Due diligence prior to appointment and ongoing monitoring is likely to become more rigorous. Investment management agreements may become more onerous and prescriptive. Fund managers should review their existing agreements and be prepared to re-negotiate non-compliant contracts. Offshoring aspects of operations may come into focus. Fund managers should ensure robust documentation over their own outsourced activities.
SPS 114 Operational Risk Financial Requirement (ORFR) Trustees must maintain adequate financial resources to address losses arising from operational risks within their business operations.	The investment strategy adopted for operational risk capital is likely to be composed of lower risk, highly liquid, short term instruments. Investment mandate design will need to accommodate this. There is an opportunity for products specifically aimed at the investment of ORFR reserves/capital.

Reporting Standards The Reporting Standards will facilitate APRA's task of collecting material data: • at 3 levels: the RSE Licensee, each RSE and within each RSE for sub-funds, MySuper products and Select Choice investment options; and • Expanded information about investments, including look-through of investment asset allocation and costs	Challenges faced by Trustees which have a consequential impact to fund managers are as follows: 1. System capabilities to produce data required for reporting 2. "Look through" investments reporting 3. Investment performance reporting for MySuper products and select choice investment options 4. Revised asset classes 5. MySuper and select choice investment option reporting. Fund managers should assess their ability and preparedness to provide the information required by Trustees to fulfill their requirements under the reporting standards.
Portfolio Holding Disclosure • Super funds must publish on a public section of the fund's website the fund's investment holdings on a 'look through' basis, i.e. list via the underlying investment structures and vehicles at a per fund level • Update the information half yearly every 30 June and 31 December and the information must be published within 90 days.	Fund managers should anticipate the following challenges in the provision of the information required by Trustees in their portfolio holding disclosures: • How to trace holdings through multi-layered investment structures (as regulatory examples are based on simple investment structures) • Access to non-controlled downstream service providers • Timeliness of data (proposed start date is 1 July 2014; thus for the first half year 31 December 2014, disclosure is required by 14 March 2015) • Reach to foreign investment managers • How to protect fund manager's commercially or proprietary trading information. Fund managers should assess their ability and preparedness to provide the information required by Trustees in their portfolio holding disclosures. Fund managers should consider including the evaluation of their risk management framework in the scope of their GS 007 sign-offs.

Product Dashboard • The provision of information to APRA relating to the product dashboard is one of he measures to enhance reporting obligations by RSE licensees. This is required from 31 December 2013 (hard start date) for MySuper products and 1 July 2014 for Choice products. The dashboard is required to: • Be available at all times on a publicly available section of the fund's website • Be published in the periodic statement • Have fee info updated within 14 days of end of quarter • Have other info updated within 14 days of change.	Fund managers need to be able to provide timely reporting of returns and fees and provide assistance with the level of risk, particularly in cases where a manager's product represents an entire investment option (such as on a platform). Fund managers should assess their ability and preparedness to provide the information required by Trustees in their product dashboard.

Riding the waves – what should fund managers be doing now?

Fund managers can successfully ride the waves of Super Regulatory Changes by understanding the requirements and by supporting their superannuation clients in being prepared to face these regulatory changes through responding to clients' requests in a consistent, educated and cost-effective manner.

AML/CTF impacts of SuperStream measures

As part of the broader Stronger Super reforms, the 'SuperStream' package of measures[9] aims to make the processing of everyday transactions easier, cheaper and faster. These measures impact how super funds comply with their (Anti-Money Laundering/Counter Terrorism Funding) AML/CTF obligations, and may require reconsideration of the approaches traditionally taken by super funds when performing member due diligence.

'SuperStream' - Rollover changes

The SuperStream[10] measures include changes to the rollover process and will require APRA-regulated super funds to process rollovers faster (within three working days of receiving a rollover request) and electronically. A number of funds have already commenced transitioning to the new rollover provisions.

SMSFs – prospective AML/CTF changes

The rollover of superannuation benefits from super funds to self-managed super funds (SMSFs) is not currently a designated service under the AML/CTF Act[11], and therefore do not currently attract AML/CTF obligations. However, in conjunction with the SuperStream reforms, proposed legislation[12] is seeking to capture this activity as a 'designated service', which would require super funds to comply with relevant AML/CTF obligations with respect to SMSFs, including member due diligence[13].

Member identification and verification for SMSFs

Currently, funds are exempted from carrying out member due diligence for rollovers and contributions[14], and must only undertake member due diligence at the point a member cashes out his or her benefits. With respect to SMSF's, funds will therefore need to develop new procedures for the processing of rollovers to meet 'SuperStream' requirements. These procedures will need to enable SMSFs to identify and verify members in line with member due diligence requirements and to complete these procedures within three working days of the request being received. This may present challenges to a number of super funds, where existing procedures rely on the receipt of hard-copy documentation for identification and verification; a process which typically takes much longer than three days. As such, many super funds will need to explore ways to satisfy identification and verification requirements faster.

To assist with this, the Australian Taxation Office has established a Tax File Number validation service, known as "*Super TFN Integrity Check*" (SuperTIC), to enable a fund to verify a member's identity electronically. This new TFN validation service would qualify as *electronic data*, the use of which is permissible under the current AML/CTF Rules[10] to verify member identify.

However, electronic data used for verification must be both reliable and independent (as deemed by the fund/reporting entity in line with its risk assessment) and comply at least with the safe harbour procedure AML/CTF Rules[15]. Under this procedure, the fund must use at least two separate data sources to verify the identity of the member (specifically, the member's name, residential address and/or date of birth) prior to processing the rollover.

9. Superannuation Data and Payment Standards 2012
10. Anti-Money Laundering and Counter-Terrorism Financing Act 2006
11. Superannuation Legislation Amendment (Reducing Illegal Early Release and Other Measures) Bill 2012. Note: This Bill has not yet been passed into law, and has lapsed, pending the resumption of Parliament under the new Government.
12. Hereinafter all references to member due diligence refers to both funds' existing obligations and the proposed rollovers to SMSFs.
13. Anti-Money Laundering and Counter-Terrorism Financing Act 2006, Section 39(6)
14. Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007 (No. 1), Part 4.2.7
15. Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007 (No. 1), Part 4.2.12 – 4.2.13

The implication of this for most funds is that, despite the ability to use the new TFN validation service for verification of identity, the process will need to be supplemented by an additional source of reliable and independent verification – either hard copy or electronic (e.g. by using an e-verification service provider).

Addressing the potential impacts

Although the proposed amending legislation has not yet passed into law, funds should consider the following to ensure they are prepared for prospective changes:

1. To verify using hard-copy documentation, funds may need to front-end the collection of the required verification documentation so that it is available when a rollover request is made (enabling the fund to comply with the 3-day timeline)

2. To verify electronically, funds will need to ensure that Part B of their AML/CTF program permits the use of electronic sources for verification. In addition, funds must consciously consider (and document) their assessment as to whether the SuperTIC and/or other e-verification service, qualifies as independent and reliable in the context of their particular program and risk assessment

3. Funds should also ensure that their AML/CTF Program and supporting procedures are updated to document changes made to accommodate the requirements.

C

Risk management

Harmonising cross-industry risk management requirements

Background

Across the financial services industry there is a heightened pressure and expectation to drive improvements in risk management practices from both ASIC and APRA.

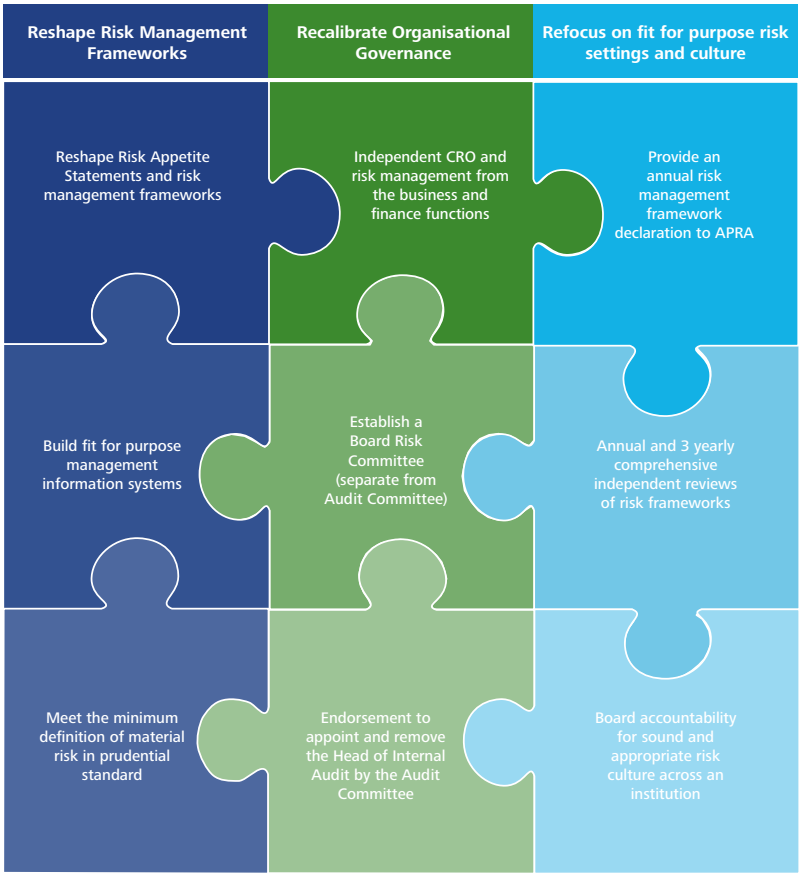
In late 2012, ASIC raised the bar in risk management practice and requirements by releasing ASIC Report 298: Assessing the adequacy of the effectiveness of the risk management systems of Responsible Entities. This was driven by a view that APRA regulated entities are generally more sophisticated in their risk management practices and there is a need to increase the use of the 'three lines of defence' model to embed risk management into strategic decision making and operational risk frameworks.

In May 2013, APRA released two consultation papers to harmonise and enhance risk management practices and requirements across authorised deposit-taking institutions, general and life insurers, as well as Level 2[16] and Level 3[17] groups.

The consultation papers that we will focus on in this article are the draft Prudential Standard CPS 220 (Risk Management) and proposed update to Prudential Standard CPS 510 (Governance). It is expected that the final standards will be issued in January 2014 and APRA has provided industry-wide transition opportunities to 1 January 2015 (effective date of compliance) with an expectation that institutions transition as soon as practicable to ensure compliance by this date.

At a glance

The following diagram summarises our view on the key impacts of the proposed CPS 220 and CPS 510 requirements and how it applies to ADIs, life and general insurers.



16. A consolidated group within a single APRA-regulated industry, headed by an ADI, general insurer or authorised non-operating holding company.

17. A conglomerate group containing an APRA-regulated institution with operations across more than one APRA-regulated industry and/or including material non-APRA-regulated activities.

The following outlines the key requirements and our perspectives on the challenges that they pose for APRA-regulated entities.

1. Reshape your risk management frameworks to meet prudential requirements in relation to documenting your risk appetite, frameworks and management information systems to manage; aligning the framework with strategic objectives and business plans; and to mitigate against material risks that may affect an organisation's ability to meet its obligations to depositors and/or policyholders

2. Recalibrate your organisational governance structure across Board, Management and people to ensure organisational capability and independence in managing risk by establishing a Board Risk Committee that is separate from the Audit Committee; have the appointment and removal of the Head of Internal Audit endorsed by the Audit Committee; and have an independent Chief Risk Officer and risk management function from business (revenue generating) and finance lines with the CRO directly reporting to the CEO and the Board Risk Committee to ensure independent assessment and management of material risks

3. Refocus your efforts acknowledging and demonstrating appropriate risk settings and culture settings across your organisation to ensure they are 'fit for purpose'. Boards must be seen to be accountable for ensuring there is a sound and robust risk culture (this is highlighted as a specific requirement). Institutions will need to provide an annual risk management declaration to APRA attesting that its risk management systems fit for purpose and meet the proposed prudential standards. Additionally, institutions must also obtain an independent assessment at least every three years from a qualified external service provider in order to attest that its risk management framework meets the requirements of the proposed proposed standards.

Reshape Risk Management Frameworks

- Fit for purpose risk management framework
- Board-approved risk appetite statement and risk management strategy
- Board-approved business plan demonstrating strategic goals
- Self-reporting of risk management deficiencies.

APRA has increased its expectation for institutions to have an integrated risk management framework that defines risk tolerances, documents policies and procedures, embeds risk management practices and connects to regulatory requirements for institutions.

Thoughtful risk appetites and fit-for-purpose risk management frameworks play a critical role in establishing and advancing an institution's strategy. An institution's risk appetite statement is the principle governing document for how the organisation views and manages risk, which ultimately drives the extent and volatility of revenues and profits. A well articulated risk appetite statement should reflect the decisions made as 'trade-offs' between risk and reward. As an institution grows, it should regularly self-assess whether the risk appetite remains appropriate to its size, business mix and complexity.

Built for purpose management information systems

- Maintain management information systems for identifying, measuring, evaluating, monitoring, reporting, and controlling risks
- Management information systems must provide Board and senior management with regular, accurate, and timely risk information and must aggregate exposures and allow for scenario analysis and stress testing.

An institution accomplishes its strategic objectives using conscious risk taking based on hard facts and timely information. We believe a management information system that is fit for purpose will be a key differentiator shared by successful institutions in the future.

Whilst effective management information systems are critical for fact-based decision making, they must also be efficient to avoid detracting focus from strategic growth. The ability to integrate stress testing and plausible scenario analysis simultaneously across various financial and non-financial risks will take greater importance in meeting APRA's expectations.

Meet the minimum definition of material risk in Prudential Standard

The definition of material risks have been expanded where a risk management framework must evaluate the connections and interdependencies of material risks that include, at a minimum:

- Credit risk
- Market and investment risk
- Liquidity risk
- Insurance risk
- Operational risk
- Risk arising from strategic objectives and business plans
- Other risks that singly or in combination with different risks, may have a material impact on an institution.

Additionally, Level 2 and 3 groups are also required to have a Board-approved liquidity management policy.

Recalibrate Organisational Governance

Independent CRO and risk management function from the business and finance functions

- CRO must be independent and have no accountabilities that may conflict with their duties (i.e. not sit within the business lines, nor be the CEO, CFO, Head of Internal Audit or appointed Actuary or sit within these executive functions)
- CRO to have direct reporting line and uninhibited access to CEO and Board Risk Committee
- Expectation that CRO acts as an effective challenger to activities and decisions that may materially affect the risk profile of an institution.

APRA requires an independent and engaged CRO and enterprise risk function (covering both risk and compliance) to ensure there is no bias or conflicts in identifying, measuring, monitoring, controlling or mitigating, and reporting on an institution's risk profile. An independent CRO must have a well-defined mandate and sufficient seniority to review and challenge an institution's risk profile levels to ensure they are consistent with its risk appetite and be able to influence the Board and senior management in how to address current and emerging risk issues. The result of these requirements may materially affect institutions that currently do not have an independent CRO function as well as those which have a CRO function, to ensure that the changes made do not pose additional conflicts in the operations.

However it also represents an opportunity to redesign a more effective organisational structure that functions efficiently.

Establish a Board Risk Committee (separate from Audit Committee)

- Establish a Board Risk Committee that provides non-executive oversight of the implementation and performance of the risk management framework
- Board Risk Committee must operate separately (with its own charter and accountabilities) from the Board Audit Committee
- Composition requirements do not prohibit the same people sitting on both committees, although each must be chaired by an independent director who each is not also the Chair of the Board; an independent director can chair both the Board Risk Committee and Board Audit Committee.

An independent Board Risk Committee should provide the Board with deeper and more transparent oversight and focus in relation to an institution's risk management framework. Notwithstanding that most larger institutions already have a separate Board Committee in place, it is important to ensure that there is a clear delineation and purpose of what the responsibilities are of the Board Risk Committee and that these do not overlap with the responsibilities of the Board Audit Committee who will continue to have responsibility for ensuring the operational effectiveness of the risk management framework.

Endorsement to appoint and remove the Head of Internal Audit by the Audit Committee

- Update the Board Audit Committee charter to reflect the responsibility of the committee to endorse the appointment and removal the Head of Internal Audit
- Reasons for the endorsement to appoint or remove the Head of Internal Audit must be discussed with APRA within 10 business days after the Board Audit Committee's endorsement.

APRA has extended the requirement of the Board Audit Committee to endorse the appointment and/or removal of the Head of Internal Audit for an institution. This extension of power ensures that management is not able to apply undue influence or elect a person to the position of the Head of Internal Audit without independent consideration of the person's credentials and a good working relationship with, and clear understanding of expectations, the Board Audit Committee.

Refocus on fit for purpose risk settings and culture

Provide an annual risk management framework declaration to APRA

- Annual declaration to APRA on the adequacy risk management as outlined in the Prudential Standard to be signed by chair of the Board and Board Risk Committee for domestic institutions and by a senior officer and two members of the Compliance Committee for foreign regulated entities
- The declaration must qualify if there are any significant breaches or material deviation from the risk management framework.

For directors or management that are signing such declarations, close oversight of a robust declaration process is a critical part of prudently discharging their oversight responsibility and providing comfort to sign-off on the declaration.

Annual and 3 yearly comprehensive independent reviews of risk management framework

- Annual internal and/or external audit on the compliance with, and effectiveness of, its risk management framework with the results reported to the Board Audit Committee
- Comprehensive independent review with the results reported to the Board Risk Committee at least every three years taking into consideration the size, business mix and complexity and considering whether:
  - The framework is implemented and effective
  - It remains appropriate and aligned to current business plan
  - It is consistent with Board approved RAS
  - It is supported by adequate resources
  - The RMS accurately documents the key elements of risk management framework to facilitate the strategy for managing the risk profile.

APRA requires all institutions undertake regular independent reviews of their risk management frameworks. The review process has been expanded across all APRA-regulated entities to include a three year comprehensive independent review that currently applies to insurance institutions.

Board accountability for sound and appropriate risk culture across an institution

- Boards have explicit accountability to ensure that sound and appropriate risk culture is implemented across the institution
- Risk management systems must outline the approach to ensure all employees have awareness of the risk management framework and for instilling appropriate risk culture.

APRA is increasing the attention it gives to both risk governance and risk culture, and in the process further developing its thinking and supervisory practices. This is a reflection of the realisation that increasingly, the heart of control failures are often issues in the corporate culture and people, rather than the implementation of poorly designed risk management processes. It is important that Boards set the "tone at the top" to ensure that a sound risk management culture is embedded.

Next steps

The proposed standards poses varying challenges for APRA regulated entities, depending on the industry, complexity and maturity of each institution. For example, the requirements to have an independent CRO and risk function will be a new operating model for most non-ADI insurance businesses where the risk function may currently sit within Finance or Operations. This requirement will lead to a redesign of risk functions and may drive a war to attract and / or retain experienced CRO talent.

Another example is the challenge of designing an appropriate and effective Board Risk Committee governance structure. Institutions that currently have a combined Audit and Risk Committee may be considering retaining the same membership composition across both the Risk and Audit committees but with separate charters and minutes. The challenge for these institutions is to ensure that the design and intent of both committees are clear particularly for management with regard to accountabilities, escalation, reporting and decision making roles in discharging their duties.

Those impacted by the proposed standards should have commenced or completed a gap analysis on their existing practices in order to determine their ability to meet the requirements. Based on the gaps identified, a plan should be designed to address these gaps over the course of the next 12 months leading up to 1 January 2015. Institutions should allow time for pre-implementation checks to ensure that the changes addresses the intent of the requirements and to ensure sufficient time has been allocated to implement requirements such as enhancements to technology and management information systems (this can take an extended period of time to sufficiently implement). It is important to develop a transition plan with evidence of ongoing checks and enhancements so that institutions have a documented road map to execute against in their transition towards ensuring compliance and in meeting APRA's expectations.

D

Regulatory action

Regulator themes around advertising practices

ASIC is ramping up its monitoring of financial services and credit advertising to enforce the importance of the way companies inform consumers or promote their products and services.

ASIC Regulatory Guide 234: 'Advertising financial products and services (including credit): Good practice guidance' (RG234) outlines guidance for financial services organisations to comply with their legal obligations to avoid false or misleading statements and misleading or deceptive conduct. In the past few months alone, ASIC has entered into an enforceable undertaking and issued a number of media releases indicating that organisations have changed their various advertising practices.

What are some of the ASIC themes

The themes that have emerged around advertising requirements from the recent ASIC activity can be clustered as shown in the diagram:

Many of these requirements are discussed in the RG234 which was published by ASIC to:

- Help promoters comply with their legal obligations to not make false or misleading statements or engage in misleading or deceptive conduct
- Ensure that promoters give clear, accurate and balanced messages when promoting financial products, financial advice services, credit products and credit services.

In terms of the above themes, RG234 contains sections dealing with:

- Fees and costs
- Warnings, disclaimers, qualifications and fine print
- Interest rates and comparison rates
- Product comparisons and suitability
- Scoping of credit assistance
- Use of certain terms and phrases in advertisements.

What should financial services and credit firms be doing

- Ensure the product due diligence approval process for advertising materials includes review by the Legal and Compliance teams and relevant product committees
- Train in-house advertising and marketing teams on the requirements
- Consider how to manage outsourced service providers that provide communications services;
- Evaluate and assess controls around advertising requirements
- Conduct periodic health-checks on adherence to advertising requirements.

Managing client money risk

The large scale global corporate collapses from 2008 onwards have been the catalyst for regulators in many jurisdictions tightening client money rules and embarking on enforcement action. Domestically, ASIC has similarly increased its focus on client money handling practices, with continuing enforcement activity.

What is client money risk?

Failure to manage client money in accordance with client money rules results in client money risk. This is the risk that if a corporate collapses, money that does not belong to the failed institution (i.e. client money) is co-mingled with that of the failed institution. Clients then join the pool of concurrent creditors in the insolvent estate and will suffer significant losses. Given these consequences, even prior to the global financial crisis, most jurisdictions had rules that were intended to ensure the protection of client money.

The Australian client money rules are complex and find different application depending on what business activity is being undertaken. The Corporations Act, 2001 contains the primary legislative client money requirements whereas the market integrity rules for the trading of financial products on the Australian Securities Exchange contain requirements that are distinctive to those traded financial products. So as by way of example, the client money rules when dealing with insurance products differ in many respects to those rules that cover on-exchange derivatives trading. The complexity of the rule set for client money is further exacerbated when institutions operate in multiple jurisdictions where there are differing client money rules and / or certain activities are supported on a regional basis.

How should client money risk be evaluated?

In order to manage client money risk, organisations should be assessing and evaluating client money handling practices in terms of both their domestic and international operations. In this regard, these are some of the questions that could be asked when reviewing whether client money risk is being adequately dealt with:

- Are there controls in place to identify client money? In this regard, it should be noted that client money (as defined in the rules) may not always be obvious. For example, premium refunds from insurers that are paid to intermediaries for onward payment to clients would be client money whereas fees or commissions that may be due to the organisation are not client money
- How is client money kept separate? Compliance with client money rules can often become more challenging when the client money account is held with the Australian ADI that is performing the business activity that gives rise to client money rules having to be complied with
- What designations and contractual arrangements are in place around the client money account?
- Do the client contractual arrangements and disclosures comply with client money rules?
- How has client money risk been managed across multiple jurisdictions?

- Are the personnel handling client money complying with the operations manual?
- Are the client money risk controls that are in place effective?

Why should client money handling practices be reviewed?

While regulatory impetus and the attendant complexities associated with client money risk are certainly the main drivers behind organisations embarking on client money reviews, many organisations have also chosen to do so because the handling of client money is core to investor confidence in their organisation. The global economy remains volatile and any non-compliance with client money rules could reduce consumer and / or investor confidence in the organisation resulting in reputational damage, loss of clients, regulatory sanction and ultimately financial loss.

ASIC Update

Advice

ASIC consults on proposed enhancements to training standards and a replacement to the Training Register

On 24 June 2013, ASIC released *Consultation Paper 212 Licensing: Training of financial product advisers – Updates to RG 146* (CP 212) which outlines proposed enhancements to the training standards for people who provide financial product advice.

CP 212 proposes to retain the current training standards in RG 146 as 'base level' standards, and to introduce two further regimes of training. These are proposed to come into effect in 2015 and 2019. CP 212 proposes increases in the:

- Generic knowledge requirements
- Specialist knowledge requirements for financial planning, securities and superannuation
- Skill requirements for personal advice
- Educational level requirements.

ASIC has also outlined proposed changes to the ASIC Training Register. *Consultation Paper 215 Assessment and approval of training courses for financial product advisers: Update to RG 146,* released on 19 August 2013, proposes that approved training courses will no longer need to be listed on the ASIC Training Register. Instead, it is proposed that authorised assessors will assess training courses to determine if they meet the training standards in RG 146.

ASIC update on financial advice stakeholder engagement

ASIC has recently completed two significant engagement programs with AFS licensees who advise retail clients. These programs are part of ASIC's gatekeeper monitoring to ensure gatekeepers are adequately informed and resourced for the functions they undertake.

Review of financial advice industry practices: Phase 2

On 31 July 2013, ASIC released *Report 362 Review of financial advice industry practice: Phase 2* which summarises the findings of their recent review of the business and risk practices of the top 21 to 50 AFS licensees that provide personal financial advice. This follows on from ASIC's 2011 review of the 20 largest financial advisers. The report highlights that:

- Licensees are focused on risk management and compliance, though different AFS licensees identified different key risks
- Licensees employ different methods to manage risks, and some deploy significantly more resources than others to risk management
- Proactive licensee monitoring should be instrumental in detecting incidents and breaches
- Advisers should not rely on risk profiling tools without also considering if the outcomes are appropriate for their clients' circumstances.

New licensee visits

ASIC also concluded visits to 24 financial advice AFS licensees who have only recently obtained their AFS licence. ASIC asked licensees questions about their business model, advice processes and approach to risk and compliance with the aim to help them to understand their AFS licence obligations.

In the coming year, ASIC will be undertaking further visits to other newly licensed financial advice businesses, and to around 60 established AFS licensees to discuss implementation of the FOFA reforms. ASIC will use the information gathered to target future financial advice surveillance and to inform their policy work.

ASIC to boost record-keeping obligations

On 31 July 2013, ASIC released Consultation *Paper 214 – Updated record-keeping obligations for AFS licensees* for industry review and comment. ASIC is proposing to update the current record keeping obligations for AFS licensees to refer to the new conduct obligations in Part 7.7A of the *Corporations Act 2001 (Cth)*. The record keeping obligations arise when giving personal advice to retail clients and also for general advice to retail clients in connection with the conflicted remuneration provisions. ASIC is proposing that licensees retain records of certain matters for at least seven years after the date on which the advice was provided. Some of the matters that licensees need to keep records of are:

- The information relied upon to give advice
- Why the advice was considered appropriate
- Ongoing fee arrangements
- Records demonstrating why the licensee formed the view that a benefit was not conflicted remuneration.

ASIC is also proposing similar record keeping provisions for Trustees of regulated superannuation funds. Namely, ASIC is planning to modify the law so that when these Trustees provide personal advice to members of the fund, they must retain a record of certain matters for at least seven years after the date of which the advice was provided. Among other things, Trustees will need to keep records of the advice and a note to identify whether the cost of the advices is allowed to be charged to a member or members other than the recipient and, if so, on what basis. These requirements would also apply to AFS licensees acting under an arrangement with a trustee to provide advice to members and the advice is charged for collectively. Submissions in response to CP 214 are due by 23 October 2013.

ASIC consults on the quality of SMSF advice

On 16 September 2013, ASIC released proposed guidance in *Consultation Paper 216 Advice on self-managed superannuation funds: Specific disclosure requirements and SMSF costs* (CP 216) with the aim of improving the quality of advice given to investors as part of its continuing focus on the SMSF sector.

ASIC's recent review of the sector found there was significant room for improvement in the quality of advice received by clients. In particular, ASIC found that there is a need to improve the disclosure of information that may influence a decision to establish or switch to an SMSF.

CP 216 contains ASIC's proposals to impose specific disclosure obligations on advisers, including the need to:

- Warn clients that SMSFs do not have access to the compensation arrangements under the *Superannuation Industry (Supervision) Act 1993* in the event of theft or fraud
- Explain other matters that may influence the client's decision to set up an SMSF.

CP 216 also looks at the appropriate level of resources consumers should have before setting up an SMSF.

AFSL

ASIC releases information sheet about applying for a limited AFS licence

On 14 June 2013, ASIC released an information sheet to assist those intending to apply for a limited AFS licence. *Information Sheet 179 Applying for a limited AFS licence* outlines what information needs to be submitted in support of a limited AFS licence application, and gives information about which ASIC guidance will be most relevant for those seeking a limited AFS licence.

The limited AFS licence replaces the existing "accountants exemption" which allows accountants who are members of CPA Australia, the Institute of Chartered Accountants Australia or the Institute of Public Accountants to provide advice on the establishment, structuring, valuation and operation of an SMSF. As part of the FOFA reforms, this exemption will cease to apply on 1 July 2016.

New ASIC guidance for platforms a boost for investors

ASIC has moved to require investment platform operators to explain how they choose the different products on offer to investors through their platforms. Further requirements include ensuring they have adequate resources to conduct their financial services businesses, having appropriate corporate structures and compliance arrangements, having additional policies such as voting policies and policies when consumers do not opt in to continuing to receive advice, and improved disclosure through a consumer warning acknowledgment.

Investors will also have access to a product issuer's internal dispute resolution system when they have concerns about investments made through platforms and product issuers agree to do so. The revised guidance is contained in *Regulatory Guide 148 Platforms that are managed investment schemes.*

The revised requirements apply from 1 July 2013 to AFS licensees that are licensed to operate a platform from that date. Existing operators have until 1 July 2014 to comply with the requirements or can opt in earlier by providing a written notification to ASIC, together with notification on their website.

ASIC releases new information sheets on dispute resolution and misconduct

On 18 July 2013, ASIC released information in the form of four information sheets about its approach to disputes with financial services and credit providers, unpaid debts, external dispute resolution and misconduct within companies under external administration.

The four newly released information sheets cover:

- Disputes about unpaid debts: Small proprietary companies (INFO 173)
- Disputes with financial services or credit providers (INFO 174)
- Misconduct within company under external administration (INFO 175)
- External dispute resolution: What to do if you are unhappy with a scheme decision (INFO 176)

ASIC weighs every report against four criteria:

- What is the extent of harm or loss?
- What are the benefits of pursuing the misconduct?
- How do other issues, like the type and seriousness of the misconduct and the evidence available, affect the matter?
- Is there an alternative course of action?

Credit

ASIC releases updated guidance to assist credit industry

On 29 May 2013, ASIC released updated regulatory guidance in *Regulatory Guide 203 Do I need an Australian credit licence?* (RG 203) to help individuals and entities in the credit industry decide whether they engage in credit activities and whether they need an Australian credit licence.

RG 203 has been updated to:

- Reflect the current form of the National Consumer Credit Protection Act 2009 (National Credit Act) and *National Consumer Credit Protection Regulations 2010*, and remove information that is no longer relevant since the end of the transitional registration regime
- Provide additional guidance about, and examples to illustrate, the different types of credit activities
- Provide additional information about licence exemptions, including examples to illustrate the scope of some of the exemptions that are more commonly relied on.

ASIC has also made structural changes to RG 203, clarifying the three main things individuals and entities should consider when deciding whether they need an Australian credit licence:

- Whether the provision of credit or consumer lease is regulated under the National Credit Code. If it is not, the licensing requirements in the National Credit Act will not apply. A number of exclusions are outlined in the guide
- If it is regulated under the National Credit Code, whether the entity engages in one or more of the specified types of activities in relation to that provision of credit or consumer lease

- If engaging in credit activities, whether one or more of the licence exemptions apply. All of the current exemptions are outlined in the guide.

These changes have been made to clarify the guidance included in RG 203, rather than make substantive changes to ASIC's approach to administering the credit licensing regime.

ASIC review of debt consolidation sector

On 18 July 2013, ASIC released Report 358 *Review of credit assistance providers' responsible lending conduct relating to debt consolidation* (REP 358). The review of debt consolidation providers has found that Australian credit licensees that provide these services are at risk of not complying with their responsible lending obligations, particularly in relation to record-keeping practices and rolling existing loans, credit cards and other debts into new loans with longer terms (often 30 years) which are secured over the family home.

ASIC will continue to monitor this sector closely to ensure that debt reduction strategies proposed by providers are meeting consumer requirements and objectives, and are affordable both in the short and long term.

ASIC releases guidance on use of reverse mortgage calculator

On 2 September 2013, ASIC released *Information Sheet 185: Using ASIC's reverse mortgage calculator* (INFO 185) to assist industry use of ASIC's MoneySmart reverse mortgage calculator. The calculator was created for industry to meet new obligations under the *National Consumer Credit Protection Act 2009* (National Credit Act).

Under the National Credit Act, credit licensees are required to use the calculator to make and show prospective reverse mortgage borrowers a range of projections that relate to the value of their home and the debt they may face over time. Credit licensees must also provide consumers with a printed copy of the projections.

INFO 185 provides:

- Practical guidance for credit licensees on how to use the calculator to meet their legal obligations, including the projection of different scenarios
- Information about how the calculator may be used to meet existing responsible lending obligations under the National Credit Act.

ASIC also updated Regulatory Guide 209 Responsible lending conduct (RG 209) to take into account new responsible lending obligations that apply to reverse mortgages, including:

- The requirement for licensees to make reasonable inquiries about a consumer's requirements and objectives in meeting possible future needs
- Presumptions of unsuitability where the loan-to-value ratio exceeds set thresholds based on age
- How the requirement to make and show equity projections can be used to meet existing responsible lending obligations to consider requirements and objectives.

Custodians

New financial requirements for custodians

On 28 June 2013, ASIC released the updated *Regulatory Guide 166 Licensing: Financial requirements* (RG 166) in a bid to strengthen the financial requirements for custodial and depository service (custody) providers. The new rules also apply to asset holders for registered schemes or investor directed portfolio services. The new financial requirements have applied from 1 July 2013 for new licensees. For existing licensees, there will be a one year transition period and compliance will be required from 1 July 2014.

Under the changes, custodians (not including incidental providers) and asset holders will be required to hold net tangible assets (NTA) amounting to the greater of:

- $10 million; or
- 10% of average revenue.

Providers who meet the definition of 'incidental provider' will be required to hold NTA amounting to the greater of:

- $150,000; or
- 10% of average revenue.

All custody providers and asset holders will be subject to new requirements regarding the preparation of cash flow projections and liquidity.

Funds

ASIC grants relief for periodic statements for quoted and listed managed funds and to facilitate quotation of ETFs on the AQUA market

On 17 October 2013, ASIC has released Report 373 Response to submissions on CP 196 (REP 373), finalising ASIC's approach to relief for periodic statements and facilitating quotation of exchange traded funds (ETFs) on the AQUA market.

REP 397 highlights that issuers of interests in registered schemes were generally supportive of ASIC's proposals. ASIC has granted relief to issuers of AQUA quoted and listed managed investment schemes to help them overcome practical difficulties in preparing periodic statements for the scheme members. ASIC has also granted relief to facilitate the quotation of ETFs on the AQUA market. This relief eliminates the need for issuers to apply for individual relief in most circumstances for each new ETF they quote on the AQUA market.

ASIC releases updated guidance on constitutions of registered managed investment schemes

On 5 June 2013, ASIC released revised guidance in an updated version of *Regulatory Guide 134 Managed investments: Constitutions* (RG 134) to assist operators of registered managed investment schemes (schemes) and their advisers understand ASIC's views on the content requirements of constitutions for schemes. ASIC is providing the managed investments industry until 1 October 2013 to comply with the new requirements. For schemes registered before 1 October 2013, ASIC will not require responsible entities to amend their constitutions to comply with the revised guidance.

The aim of the updated policy guidance is to provide clarity to operators of schemes and their advisers by specifically outlining ASIC's view on the constitutional content requirements, and how ASIC will apply these requirements in deciding whether to register a scheme.

ASIC and European Union authorities cooperate on alternative investment funds

ASIC has entered into 29 supervisory cooperation arrangements with European Union (EU) securities regulators, agreeing to help each other supervise fund managers operating across borders. The bilateral memorandums of understanding (MOUs), signed by ASIC on 12 July 2013, have been applicable from 22 July 2013.

The cooperation allows Australian fund managers to manage and market Alternative Investment Funds (AIFs) in the EU under the rules of the Alternative Investment Fund Managers Directive (AIFMD). An AIF includes hedge funds, private equity funds and real estate funds, among others.

Hedge funds no systemic risk to financial system

On 10 September 2013, ASIC released Report 370: The *Australian hedge funds sector and systemic risk* (REP 370). The key points from REP 370 are as follows:

- The Hedge funds that ASIC identified, manage only a small share of Australia's $2.1 trillion managed funds industry with more than half of these holding less than $50 million each
- The survey indicates Australian hedge funds do not currently appear to pose a systemic risk to the Australian financial system
- Listed equities represent surveyed hedge fund managers' greatest asset exposure, with 32% of this being in Australian-listed shares.

Surveyed qualifying hedge funds also use low leverage and appear to have adequate liquidity to meet obligations.

The survey was representative of the state of the Australian hedge fund industry as a whole, with the assets of the 12 surveyed qualifying hedge funds representing approximately 42% of the assets held by single-strategy hedge funds in Australia.

ASIC releases further guidance on hedge fund disclosure

On 3 October 2013, ASIC refined the definition of a hedge fund to ensure its disclosure requirements are appropriately targeted at those funds that pose more complex risks to investors.

Following extensive consultation with industry, Class Order [CO 13/1128] Amendment of Class Order [CO 12/749] and an updated *Regulatory Guide 240 Hedge funds: Improving disclosure* (RG 240), make changes to the characteristics that prompt a registered managed investment scheme to be classified as a hedge fund.

This class order will assist industry by expanding some of the existing carve-outs and providing greater clarity about the operation of some of the characteristics in the definition. An anti-avoidance clause has been inserted to ensure that responsible entities do not structure schemes with the sole or dominant purpose of avoiding those schemes being characterised as hedge funds.

ASIC's disclosure requirements for hedge funds commence from 1 February 2014.

Markets

OTC derivatives reform - ASIC implements reporting regime.

On 11 July 2013, ASIC released the new OTC derivatives reform webpage – including the ASIC Derivative Transaction Rules (Reporting) 2013, ASIC Derivative Trade Repository Rules 2013, *Regulatory Guide 249 Derivative trade repositories*, and explanatory statements and FAQ material.

The package of rules and guidance follows consultations launched in March 2013, and constitutes the final rules around OTC derivatives trade reporting obligations of financial institutions and the regulation of derivative trade repositories in Australia. The rules for derivative trade repositories cover issues such as application requirements and conditions, the manner in which they must provide their services, and ASIC's approach to regulation of overseas-based repositories.

On 29 August 2013, ASIC released *Regulatory Guide 251 Derivative transaction reporting* (RG 251). The reporting rules in RG 251 establish which entities will need to report to trade repositories, what information will need to be reported, and when the reporting obligation will start for different classes of reporting entities and different instrument types.

The Australian reforms have been designed to ensure, as far as possible, consistency with international requirements as well as to maximise the prospects of substituted compliance or sufficient equivalence judgments being reached by foreign regulators.

End users of OTC derivatives (i.e. those that are not financial institutions or intermediaries) will not be covered by the reporting regime, and ASIC will consult on their reporting obligations later this year.

ASIC makes rules on dark liquidity, high-frequency trading

On 12 August 2013, ASIC released its market integrity rules on dark liquidity and high-frequency trading. ASIC has also released guidance on the rules which clarify ASIC's expectations of market operators and participants. The final rules follow extensive internal analysis and consultation with industry and are aimed to improve the transparency and integrity of crossing systems and strengthen the requirements for market participants to deter market manipulation.

The rulings require new disclosure and confidential requirements for trading participants, a duty to report any suspicious activity directly to ASIC, a standardised ticker size that does not discriminate against participants, and new regulations on the commission structure. The rules will come into force in stages over nine months.

ASIC guidance on rules for ASX 24

On 21 August 2013, ASIC released Regulatory Guide 250 *Guidance on ASIC market integrity rules for risk management and other requirements: ASX 24 market* (RG 250). RG 250 provides guidance on the market integrity rules for the Australian Securities Exchange Limited derivatives market (ASX 24) that were registered in May 2013, and which cover risk management, supervisory policies and procedures, and foreign participants. RG 250 also provides guidance on the rules that cover disclosure about clearing arrangements and obligations on participants to give priority to the client's instructions where there is a conflict between the client's interests and the participant's interests.

Additionally, the guidance explains a waiver granted by ASIC to principal traders (i.e. market participants who trade only on their behalf) in respect of certain risk management obligations. These include those circumstances where the principal trader accesses the market as client of another market participant, as the order and position limits are set by that market participant.

Products

ASIC releases follow-up term deposit report

On 4 July 2013, ASIC released *Report 353: Further review of term deposits* (REP 353), which highlights improved industry practice and better outcomes for investors in relation to the automatic rollover of term deposits.

REP 353 found that the eight ADIs reviewed have generally implemented ASIC's recommendations to improve disclosure. All eight now disclose the risk of dual pricing in terms and conditions documents and in at least one mode of investor communications. All eight also disclose the existence of grace periods in pre-maturity and/or post-maturity letters, and most also tell investors the actual or indicative interest rate that will apply to their new term deposit before it rolls over.

ASIC will continue to monitor the term deposit market to encourage further improvements to disclosure, including by ADIs which did not participate in ASIC's review.

ASIC continues crackdown on hybrids

On 20 August 2013, ASIC released Report 365 *Hybrid securities* (REP 365) which discusses recent offers of hybrids in Australia.

ASIC have noted an improvement in the disclosure of the risks of hybrids and will now focus on possible misleading conduct in the sale of hybrids. This includes:

- Inappropriate labelling of hybrids and unwarranted comparison of hybrids to different, less risky products
- Promoting the potential higher returns of hybrids and the brand name or reputation of the issuer without balancing that with the risks of the product.

ASIC is planning to explore whether new strategies can be developed to help investors check their understanding of hybrids before investing in them.

Financial reports of stapled entities

On 11 October 2013, ASIC released a consultation paper on financial reporting by stapled securities issuers.

A stapled security is one issued by an entity whose securities are required to be traded together with the securities of another entity. Consultation paper CP 217 Presentation of financial statements by stapled entities (CP 217) seeks feedback on proposals for presenting combined financial information covering these stapled entities.

Stapled entities may be unable to present combined financial statements covering entities in a stapled group under the new Australian Accounting Standard AASB 10 Consolidated Financial Statements which applies for reporting periods beginning on or after 1 January 2013.

ASIC is seeking feedback on proposals to:

- Provide class order relief to allow stapled entities to present combined financial statements
- Require such statements to be audited or reviewed
- State that combined financial statements are necessary to meet the true and fair view requirement
- Not relieve stapled entities from presenting the financial statements required by accounting standards, and
- Continue to allow the financial statements of all stapled group entities to be presented together in a single financial report.

Submissions closed 30 November 2013.

APRA Update

Harmonising cross-indusry risk management requirements (See article on Page 28).

On 9 May 2013, APRA released for consultation *Prudential Standard CPS 220 Risk Management* (CPS 220), a proposed cross-industry prudential standard to harmonise, consolidate and enhance its risk management requirements. In addition, APRA proposed changes to *Prudential Standard CPS 510 Governance (*CPS 510) regarding enhanced governance requirements. These proposed enhancements to existing prudential requirements reflect and make more explicit APRA's heightened expectations in these areas.

APRA proposes to respond to submissions and finalise the prudential standards by 1 January 2014 (to provide certainty to all affected entities and groups) but the standards will not be fully effective until 1 January 2015. However, affected entities and groups will be expected to develop and introduce implementation plans to ensure that they are able to meet all requirements by 1 January 2015. APRA will monitor the progress of these implementation plans.

The existing industry-specific risk management requirements and CPS 510 will continue to apply to all ADIs, general insurers, life companies and Level 2 Heads over this transition period. APRA expects to finalise and release CPS 220 and the revised CPS 510 by the end of 2013. In addition, APRA expects to release a prudential practice guide on risk management within the same period.

APRA releases final guidance on managing data risk

On 2 September 2013, APRA released in final form its prudential practice guide on the management of data risk for all APRA-regulated institutions.

Prudential Practice Guide CPG 235 Managing Data Risk (CPG 235) is a cross-industry guide applicable to all ADIs, general and life insurance companies and superannuation funds regulated by APRA. The guide is designed to assist these institutions in appropriately managing their data risk and is targeted at those areas where APRA has identified weaknesses through its supervisory activities.

The management of data risk is crucial for APRA-regulated institutions because it can affect their ability to meet financial and other obligations to beneficiaries. The risks associated with the use of data, including data application, retention, storage and security, have become more significant with increasing automation and the criticality of data to decision-making.

CPG 235 provides guidance on each of these areas as part of an overall framework for managing data risk. The guidance is intended to be used by Boards and senior management of APRA-regulated institutions, as well as risk and technical specialists and others with an interest in this topic.

APRA releases letter to RFCs on Banking Exemption Order 96

On 23 September 2013, APRA released a letter to registered financial corporations (RFCs) advising of its decision to defer until 1 January the commencement of any changes to the Banking Exemption Order 96. This follows on from a discussion paper released by ASIC on 19 April 2013 which set out proposed changes to the operation of the Banking Exemption Order 96. The changes include the conditions that RFCs must meet in order to obtain exemption from authorisation under the *Banking Act 1959*.

APRA releases draft reporting standards for the supervision of conglomerate groups

On 26 September 2013, APRA released for consultation proposed reporting standards relating to the capital adequacy of conglomerate groups. Conglomerate groups, referred to as Level 3 groups, are groups comprising APRA regulated institutions that perform material activities across more than one APRA-regulated industry and/or in one or more non-APRA-regulated industry.

The consultation package released includes a discussion paper and two reporting standards together with associated reporting forms and instructions. The proposed Level 3 data collections will assist APRA to ensure that Level 3 groups are capitalised in accordance with the proposed capital adequacy prudential standards that were released for consultation in May 2013. The capital adequacy framework encompasses all material risks to a Level 3 group's APRA beneficiaries, including risks emanating from non-APRA-regulated institutions in the group.

Submissions on the proposed reporting standards are due by 31 October 2013, and Level 3 groups will be required to comply with the standards under the Level 3 framework by 1 January 2015. Collection of data is proposed to commence with the first reporting period ending after 1 January 2015.

APRA expects to publish the final Level 3 prudential standards in the last quarter of 2013 and intends to release final reporting standards, forms and instructions during the first quarter of 2014.

ADIs

APRA releases final prudential standard for Financial Claims Scheme (FCS)

On 24 June 2013, APRA released a response paper on the FCS for locally incorporated ADIs, as well as the final version of *Prudential Standard APS 910 Financial Claims Scheme* (APS 910).

The response paper addresses submissions received in relation to APRA's November 2012 consultation package on the FCS.

Under APS 910, ADIs are required to be operationally ready to meet payment, reporting and communications requirements should they be declared under the FCS. There are also requirements under APS 910 for ADIs to be able to produce a 'single customer view' for each account holder to facilitate fast payment under the FCS.

The payment, reporting and communications requirements under APS 910 have been effective from 1 July 2013 and ADIs have 12 months to comply with the new requirements. The commencement date for existing FCS requirements relating to the single customer view remains 1 January 2014.

APRA may grant an extended transition period on application by an ADI. Lodgements of such applications are expected three months prior to the relevant compliance date to allow sufficient time for APRA to consider and approve an extension.

APRA releases final package on disclosure of composition of capital and remuneration

On 26 June 2013, APRA released a response paper and a final *Prudential Standard APS 330 Public Disclosure* relating to Pillar 3 disclosures on the composition of capital and on remuneration by ADIs in Australia.

These disclosure requirements form part of APRA's implementation of the Basel III capital reforms released by the Basel Committee on Banking Supervision in December 2010. They are intended to improve market discipline and the transparency of regulatory capital and remuneration. The prudential standard was released in draft form in April this year. As part of these measures, ADIs will be required to disclose:

- Additional information on their capital adequacy
- Full details of the terms and conditions of each regulatory capital instrument
- A reconciliation between their regulatory capital and financial statements.

These disclosure requirements will, among other things, inform the market of the composition of ADIs' regulatory capital in a standard form that will allow market participants to compare the capital of banking institutions within and across jurisdictions. In addition, ADIs will be required to disclose qualitative and quantitative information about their remuneration practices and aggregate remuneration data for senior managers and material risk-takers. The disclosure requirements commenced for the first reporting period on or after 30 June 2013.

Implementation of the Basel III liquidity framework in Australia

OOn 8 August 2013, APRA released a note for ADIs providing further detail on its approach to the implementation of the Basel III liquidity framework under *Prudential Standard APS 210 Liquidity* and, in particular, on the operation of the committed liquidity facility (CLF).

In December 2010, the Basel Committee on Banking Supervision released a series of measures designed to strengthen liquidity buffers to promote a more resilient global banking system. APRA has been consulting on the implementation of the main elements of the Basel III liquidity reforms in Australia. The reforms introduce a global liquidity standard called the liquidity coverage ratio (LCR) that requires banking institutions to hold sufficient high-quality liquid assets (HQLA) to withstand a minimum of 30 days severe liquidity stress.

Due to the relatively short supply of Australian dollar HQLA, the Reserve Bank of Australia will allow 'scenario analysis' ADIs to establish a secured CLF sufficient in size to cover any shortfall between the ADI's holdings of HQLA and the requirement to hold such assets under the LCR. APRA is undertaking a trial exercise with all scenario analysis ADIs in 2013. APRA will release further details on the CLF process once it has completed this exercise

General Insurers

APRA releases consultation package on a reinsurance counterparty data collection for general insurers

On 28 June 2013, APRA released for consultation a discussion paper outlining its proposal to collect reinsurance counterparty data from general insurers and Level 2 insurance groups. The discussion paper is accompanied by four draft reporting forms and instructions.

The discussion paper proposes the collection of specific data items to assess the impact of a downgrade in a reinsurer's credit rating on a general insurer's prescribed capital amount coverage, based on current reinsurance recoverables. The proposal also requires general insurers to undertake a forward-looking reinsurance exposure analysis in order to assess the impact of the failure of a material reinsurer on the prescribed capital amount coverage. This proposal was previously released for consultation in June 2012 as part of APRA's review of capital standards for insurers and takes into account feedback from that consultation, where appropriate.

Comments on the proposals in the discussion paper and the draft reporting forms and instructions were due by 14 August 2013. A response paper with a final package of reporting standards and an amended prudential standard are due to be released by APRA in late 2013. The first reporting forms will be due to APRA with the annual returns submitted by insurers that have a financial year-end of 31 December 2013.

Superannuation

APRA releases final reporting requirements for superannuation

On 6 June 2013, APRA released a letter to industry and final versions of 32 reporting standards, reporting forms and instructions for APRA-regulated superannuation funds.

APRA's reporting requirements implement the transparency and accountability recommendations from the Government's Stronger Super reforms, and the superannuation reporting proposals on which APRA had previously consulted in 2009. The new requirements also support the implementation of prudential standards, MySuper products and SuperStream. These revisions will be the first changes to the reporting requirements for superannuation since 2004.

The release of this package follows the release of 'proposed final' versions of 35 reporting standards, reporting forms and instructions on 28 March 2013. The requirements in 22 of the final reporting standards took effect from 1 July 2013, with the remaining 10 taking effect from 1 July 2014. The first publication using the new data will be published in late 2013.

Final reporting standards for superannuation

On 6 September 2013, APRA released final *Reporting Standard SRS 702.0 Investment Performance* (SRS 702.0) as part of a set of three reporting standards for superannuation. SRS 702.0 collects information about the investment performance of each non-lifecycle MySuper product and each lifecycle strategy stage of a lifecycle MySuper product.

On 23 September 2013, APRA released a letter to RSE licensees setting out an extended submission timeframe for the first reporting period due to the short period between the release date of final SRS 702.0 and the first due date for submission. The due date for all RSE licensees required to report information under SRS 702.0 for the first quarterly lodgement is 11 November 2013.

APRA releases draft prudential practice guide for superannuation

On 20 September 2013, APRA released the draft *Prudential Practice Guide SPG 310 Audit and Related Matters* (SPG 310) for consultation. SPG 310 represents the final draft prudential practice guide from APRA's review of superannuation-related guidance material to support the implementation of prudential standards and changes to the *Superannuation Industry (Supervision) Act 1993* and SIS Regulations.

SPG 310 aims to assist an RSE licensee in complying with APRA's requirements in relation to the audit for an RSE licensee's business operations under *Prudential Standard SPS 310 Audit and Related Matters*, and more generally, to outline prudent practices in relation to audit arrangements.

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