EXPLANATORY STATEMENT

Select Legislative Instrument 2010 No. 89

Issued by the Authority of the Minister for Financial Services, Superannuation and Corporate Law

Corporations Act 2001
Corporations Amendment Regulations 2010 (No. 4)

The *Corporations Act 2001* (the Act) and the *Corporations Regulations 2001* (the Corporations Regulations) provide for the regulation of corporations, financial markets, products and services, including in relation to licensing, conduct, financial product advice and disclosure.

Subsection 1364(1) of the Act provides that the Governor-General may make regulations prescribing matters required or permitted by that Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

The Act has been amended by the *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009* (the Amending Act) for the purpose of regulating certain financial products, including margin lending facilities. A margin lending facility is defined in new section 761EA of the Act, and relates principally to the provision of credit wholly or partly to acquire one or more financial products (which is also defined in the Act).

The Act refers to two aspects of a margin lending facility: the facility itself and the variation of a facility to increase the limit of the facility. This Explanatory Statement will refer to a "margin lending facility" or a "margin loan" to describe both of those aspects.

The Regulations amend the *Corporations Regulations 2001* to make arrangements for margin lending facilities consequent to the changes made to the Act by the Amending Act.

The main provisions which are introduced by the Regulations include the following.

- A detailed methodology is provided for distinguishing between retail and wholesale clients in relation to margin loans.
- Where a financial services provider is required to provide both a Financial Services Guide and a Credit Guide to a retail consumer, they may combine the information into a single document.
- A number of matters are prescribed that lenders must take into account when conducting the unsuitability assessment.
- Specific arrangements are prescribed for situations where a credit limit breach occurs due to unilateral action by the borrower.
- It is specified that no unsuitability assessment is required for a non-recourse loan that is limited to investments in marketable securities as defined in the Act.

- There are situations where a margin lending facility may turn out to be unsuitable, in spite of the provider conducting an unsuitability assessment. A provision is made stating that in such cases no breach of the law is taken to have occurred on the part of the margin loan provider.
- The contents of periodic statements for margin lending facilities are defined.

Details of the proposed Regulations are included in the Attachment.

Public consultation on the Regulations was conducted in August and September 2009. A range of submissions were received from stakeholders resulting in a number of changes to the Regulations. The main changes include the provisions relating to credit limit breaches based on unilateral action by the borrower, as well as a number of refinements to the provisions relating to the specific matters that must be taken into account when conducting the unsuitability assessment, the carve-out from the requirement to conduct an unsuitability assessment for a non-recourse loan, and the contents of periodic statements for margin loans.

The Act does not specify any conditions that need to be satisfied before the power to make the Regulations may be exercised.

The Regulations are a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The Regulations will commence on 1 January 2011.

ATTACHMENT

DETAILS OF THE *CORPORATIONS AMENDMENT REGULATIONS 2010 (No. 4)*

Regulation 1 – Name of Regulations

Regulation 1 provides that the name of the Regulations is the *Corporations Amendment Regulations 2010 (No. 4)*.

Regulation 2 – Commencement

Regulation 2 provides that the Regulations commence on 1 January 2011.

Regulation 3 – Amendment of *Corporations Regulations 2001*

Regulation 3 provides that the *Corporations Regulations 2001* (Corporations Regulations) are amended as set out in Schedule 1 to the Regulations.

Schedule 1 – Amendments

Item [1] - Subregulation 7.1.08(4)

Section 766B of the Act defines the meaning of the term ***financial product advice***. The section identifies a number of activities that are taken not to be the provision of financial product advice, including providing an exempt document or statement to a client.

The definition of ***exempt document or statement*** in subsection 766B(9) of the Act allows regulations to be made prescribing certain documents or statements as exempt, and therefore not subject to the obligations imposed on the provision of other financial product advice.

Responsible lending requirements will be imposed on margin loan lenders, requiring them to make a written assessment of a potential client's ability to afford and service a margin loan without experiencing undue hardship. This is the assessment of unsuitability required in subsection 985E(1) of the Act. The written assessment must be provided to the client if the client requests it. It is possible that this activity could be regarded as the provision of financial product advice, which attracts a range of regulatory requirements such as the provision of a Statement of Advice (SOA). This is considered to impose an unnecessary compliance burden on businesses.

This amendment prescribes the unsuitability assessment as an exempt document or statement with the effect of ensuring that a lender does not provide financial product advice when providing an unsuitability assessment to a client.

Item [2] – Regulation 7.1.19A

Section 761G of the Act explains the difference between a retail client and a wholesale client to whom a financial product or a financial service is provided. Substantial relief from the requirements in the Act is provided where a financial

product or service is provided to a wholesale client. A number of tests are prescribed for making the distinction.

Paragraph 761G(7)(a) of the Act provides circumstances where financial products or services are deemed to be provided to a person as a retail client. Generally, a financial product or financial service is provided to the person as a retail client unless the price for the provision of the financial product, or the value of the financial product to which the financial service relates, equals or exceeds the amount specified in regulations as being applicable in the circumstances. The amount is specified to be $500,000 in the *Corporations Regulations 2001* (the Corporations Regulations).

In some instances it may not be immediately apparent how the price of a particular product or service is calculated, and the Act provides the necessary powers to prescribe particular calculation methodologies by regulation.

Regulation 7.1.19A explains how to determine the price for the provision of a margin lending facility, or an increase in a margin lending facility. In the case of the provision of a margin loan, the price is to be calculated based on the value of the equity provided by the client. In the case where an existing margin loan limit is increased, the price is to be calculated by adding the value of the additional equity provided to the current market value of any equity provided in the past.

Regulation 7.1.19A also specifies that for both the provision of a margin lending facility, or an increase in a margin lending facility, any equity contributed by the client that is raised by borrowings from a third party should not be taken into consideration when calculating the price of the facility.

This approach is considered to most closely reflect the policy intention with respect to the calculation used for investment products and services, where the amount invested by the client is generally equity held by the client.

Items [3] and [4] – Regulation 7.1.34

Existing regulation 7.1.34 specifies two types of situations in relation to credit which do not constitute “dealing” in a financial product. “Dealing” in a financial product is defined in section 766C of the Act. The first situation which does not constitute “dealing” is in relation to the enforcement of rights under a credit facility and the second is in relation to the disposal of a financial product that is subject to a mortgage or the transfer of the financial product to the mortgagor.

It would appear that both situations fall within conduct that a margin lender would ordinarily engage in. For example, a margin lender making a margin call on a client would arguably be enforcing rights under a credit facility, while a margin lender selling a financial product where a margin call is not met would arguably be disposing of a financial product that is subject to a mortgage. There does not appear to be any policy basis for why these situations should be excluded from constituting “dealing” conduct for margin lending facilities. Accordingly, these items ensure that such conduct in relation to margin lending facilities is not afforded the benefit of this exclusion.

Item [5] – Regulation 7.6.01AAA

Section 911A of the Act provides a licensing exemption for financial services providers if they provide their services through another entity which is licensed to provide the services. The services are limited to the issue, variation or disposal of a financial product. As applied to margin lending facilities, this exemption may result in an outcome such that the obligation to conduct an unsuitability assessment does not fall on any of the entities involved in the provision of a margin loan. The reason is that the obligation to conduct the assessment is placed on a financial services licensee that issues a margin loan to a client. Where a margin lender makes use of the exemption, the issuer of the loan would not be licensed, whereas the licensed entity would not be issuing the loan, but only arranging to issue the loan. Accordingly, neither of these parties would be required to conduct the unsuitability assessment.

This amendment ensures that the licensing exemption does not apply to margin lending facilities. This means that all entities that issue margin loans must obtain an Australian Financial Services Licence and will therefore have to conduct the unsuitability assessment when they issue a loan to a retail client.

Item [6] – Regulation 7.7.08B

Existing Section 942DA of the Act provides that under certain circumstances, a Financial Services Guide (FSG) and a Product Disclosure Statement may be combined into a single document.

Regulation 7.7.08B modifies section 942DA by allowing that under certain circumstances, a FSG and a Credit Guide may also be combined into a single document. It is specified that a person may combine these documents if they are a financial services licensee or an authorised representative of a financial services licensee and are required to give a FSG to a client under this Act, and if they also hold an Australian credit license or are a credit representative under the *National Consumer Credit Protection Act 2009* and are required to give a Credit Guide under that Act.

Regulation 7.7.08B clarifies that any information to be included in the Credit Guide that is identical to information to be included in the FSG need only be included in the combined document once.

This regulation aims to improve the efficiency of disclosure for both providers and clients by avoiding duplicating information that would otherwise need to be provided in both the Credit Guide and the FSG.

Item [7] – Regulations 7.7.09AA and 7.7.09AB

The Act provides that, whenever a licensee gives a retail client personal financial advice, the client must be given an SOA containing the advice as well as a range of other prescribed information.

Subsection 947B(2) of the Act sets out the required content of an SOA. Paragraph 947B(2)(g) provides that the SOA must include any other statements or information required by the regulations.

This item inserts regulation 7.7.09AA, which recognises a number of prescribed matters that are considered to contain particular risks to margin loan borrowers, and which should therefore be carefully considered by lenders and advisers before providing or recommending a margin loan.

The regulation would address the issues by requiring that the lenders must include in the SOA information about the following matters:

- whether a client has taken out a loan to fund the equity contribution made by the borrower for the margin lending facility. If so, the SOA must also disclose whether the security for the loan includes the borrower's primary residential property;
- whether there is a guarantor for the margin lending facility. If there is a guarantor, and if the financial services licensee has the necessary information, it must include a statement as to whether the guarantor has been appropriately informed of the risks involved with providing the guarantee for the facility; and
- information about all other debt held by the borrower. For example, this would include, among other types of debt, any home loans, investment loans, car loans, personal loans, study loans or credit card debt.

Furthermore, regulation 7.7.09AA would prescribe that ASIC may specify in a legislative instrument any other matter that it considers to be relevant for the purpose of establishing whether a margin lending facility, or a margin lending facility with an increased limit, is unsuitable for the client, and which must be included in an SOA covering a margin loan.

The Act does not explicitly provide ASIC with the power to make legislative instruments, other than instruments that are exemptions or modifications. The instruments that ASIC may need to be able to make for regulation 7.7.09AA would be neither exemptions nor modifications. This item also inserts regulation 7.7.09AB, which is a technical regulation that modifies the relevant provisions in the Act to expressly allow the regulations to provide ASIC with the power to make the kinds of legislative instruments that may be required.

Item [8] – Regulation 7.7.09BA

This item contains the same requirements as Amendment [7] above, where advice in relation to a margin loan is provided by an authorised representative of a financial services licensee (and not by the licensee itself).

Item [9] – Regulation 7.8.06A

Division 3 of Part 7.8 of the Act and related existing regulation 7.8.07 set out provisions for the conduct and requirements of financial services licensees when dealing with non-monetary property of clients. These requirements and conduct obligations are not relevant or appropriate for standard margin lending facilities, which usually involve the borrower providing property as security for the facility.

Therefore, regulation 7.8.06A provides an exemption for standard margin lending facilities from Division 3 of Part 7.8 of the Act.

Item [10] – Regulations 7.8.08A, 7.8.08B, 7.8.09, 7.8.09A, 7.8.10 and 7.8.10A

Regulation 7.8.08A

There are concerns that a margin loan borrower, without informing the lender in advance, may purchase shares or other financial products and gives instructions to settle the trade through the margin lending facility such that a breach of the credit limit would result if the trade was settled by the lender.

The following problem has been identified:

- recognising that the borrower might make multiple additional contributions of equity within a three-month period before an unsuitability assessment for the initial credit limit increase had been carried out.

Regulation 7.8.08A would fix this problem by providing that:

- the margin lender may settle the trade, subject to the requirement to conduct the unsuitability assessment within a certain period of time after the trade is settled;
  - where the increase is no more than five per cent of the credit limit, lenders will be allowed to conduct the unsuitability assessment up to 90 days after the limit increase occurs;
- whenever a credit limit increase occurs in the manner described, an unsuitability assessment must be conducted and the assessment must conclude that the facility is not unsuitable for the client after the limit increase, before another such increase could occur; and
- if the sum total of several contributions made within the one day is no more than five per cent of the credit limit, they are taken to be one increase for the purposes of this proposed amendment.

The regulation would also require that if the unsuitability assessment concludes that the limit increase is unsuitable, the lender must reduce the outstanding loan amount back to the level that was originally assessed as not unsuitable. This adjustment must be carried out within 90 days.

Regulation 7.8.08B

This regulation creates an exemption from the requirement that funders make an unsuitability assessment in circumstances where the borrowed funds form a non-recourse loan invested in marketable securities, a beneficial interest in marketable securities or a combination of marketable securities and cash. If a margin lending facility is a non-recourse loan in its entirety, including all interest, fees and charges relating to the facility, and if the client has not taken out a loan to fund the equity for the facility, the facility is taken not to be unsuitable.

A non-recourse loan is a loan where the rights of the lender against the client for default on the loan, or on the sum of the loan, fees, charges, and interest related to the loan, are limited to rights relating to the original asset or replacement asset.

This regulation ensures that providers are not able to recommend investments in sophisticated financial products without conducting an unsuitability test. The

exemption from conducting an unsuitability assessment is restricted to instances where the client invests wholly in marketable securities, a beneficial interest in marketable securities, or a combination of marketable securities and cash. This is a risk management measure which ensures that retail investors cannot invest in complex products within a margin lending facility without an assessment of unsuitability being conducted.

Regulation 7.8.09

Subsection 985G(1)(c) of the Act states that certain matters may be prescribed by the regulations to be taken into account when making an assessment of unsuitability as required in section 985E.

Regulation 7.8.09 identifies a number of matters that must be taken into account when conducting the unsuitability assessment. These are matters that are considered to constitute key risks for the borrower and which may lead to harmful consequences if they are not properly understood and managed in the course of providing the margin lending facility.

Experience shows that problems can occur where clients have taken out a second loan to finance their equity contribution for the margin loan, in particular where they have used their homes to secure this second loan. This creates a scenario known as 'double gearing' which may in some situations lead to the risk of clients losing their homes, if they are unable to service their loans following a margin call. The regulation therefore prescribes 'double gearing' situations as a matter that must be considered by lenders in assessing the possible unsuitability of the proposed loan for the client.

The provider of a margin lending facility must also consider the amount of other debt incurred by the client. This will include, among other types of debt, any home loans, investment loans, car loans, personal loans, study loans or credit card debt.

In cases where there is a provision of a guarantee by a third party for a margin lending facility, reasonable inquiries must be made about whether the third party has been appropriately warned about the risks to which it is being exposed to by guaranteeing the facility. Finally, the regulation also allows ASIC to prescribe other matters which must be taken into consideration for the unsuitability assessment in a legislative instrument.

Regulation 7.8.09A

Similar to regulation 7.7.09AB in Amendment [7] above, regulation 7.8.09A is a technical amendment that modifies the Act to provide ASIC with the necessary power to make the legislative instruments that may be required for regulation 7.8.09.

Regulation 7.8.10

Subsection 985H(2)(b) of the Act provides that the regulations may prescribe particular situations in which the issuer of a margin lending facility must assess a margin loan as unsuitable for the client.

Regulation 7.8.10 prescribes such a situation. A loan must be assessed as unsuitable where the client is unable to be contacted by usual means of communication on an

ongoing basis, and has not appointed an agent to act on their behalf, as this situation would mean that margin calls may not be able to be notified to the client.

Regulation 7.8.10A

Subsection 985K(4) of the Act provides that regulations may prescribe particular situations in which a margin lending facility is taken not to be unsuitable for a retail client. Regulation 7.8.10A prescribes two such situations.

Under subregulation 7.8.10A(1), the first case would be where a margin lending facility becomes unsuitable, in spite of the best efforts of the provider in conducting the unsuitability assessment. In such a situation it would be unreasonable to penalise the lender on the grounds of having provided an unsuitable margin lending facility. In such cases, no breach of the law is taken to have occurred on the part of the margin loan provider, provided the original unsuitability assessment was conducted in accordance with the relevant provisions in the Act.

Under subregulation 7.8.10A(2) the second case would be where a provider has been exempted if the margin lending facility is a non-recourse loan, as set out in detail in under new regulation 7.8.08B

Item [11] – Regulations 7.9.30A and 7.9.30B

Section 1017D of the Act provides that periodic statements must be provided to holders of certain financial products, and sets out minimum information that must be included in a statement. Subsection 1017D(5) of the Act sets out the content of a periodic statement, while paragraph 1017D(5)(g) provides that a statement must also include details prescribed by the regulations.

Regulations 7.9.30A and 7.9.30B are contained in Subdivision 5.4A of Division 5 of Part 7.9 of Chapter 7 of the Corporations Regulations.

Regulation 7.9.30A applies the Subdivision to a margin lending facility. It also specifies that requirements in paragraphs 1017D(5)(a) to (f) of the Act do not apply for margin lending facilities, as these requirements were designed for investment rather than credit products, and are not necessarily applicable or relevant for margin lending facilities.

Regulation 7.9.30B prescribes information particular to margin lending facilities, to replace the information in paragraphs 1017D(5)(a) to (f). The prescribed information includes key matters such as:

- the outstanding loan amount;
- the current interest rate;
- an itemised list of the security provided for the loan together with the valuation applied to each item;
- the loan to security ratios, as these determine when a margin call may be issued; and
- a summary of all transactions that occurred during the reporting period.