AFMA

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Manager
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Dear Sir/Madam

Proposed Corporations Amendment Regulations 2012 (No.)
- Limited Recourse Borrowings by Superannuation Funds

The Australian Financial Markets Association (AFMA) represents participants in Australia's financial markets, including all of the main issuers of instalment warrants. We appreciate the consideration given by the Government to our comments on the initial draft of the proposed regulations and we welcome the opportunity to provide comments on the revised draft.

Many investors use instalment warrants as part of their investment strategy because they offer capital protection, which is highly valued in volatile markets, and can increase the value of income and contributions within a self-managed superannuation fund. It is worth recalling that 'standard' instalment warrants are based on securities and managed investment funds and, thus, are treated as a financial product under the law as it stands. Hence, there is already a range of regulatory safeguards under the Corporations Act to protect investors in these products, which have proven to be highly effective over the years.

In addition, banks provide limited recourse loans to self-managed superannuation funds for investment (eg in financial products like an interest in a registered managed investment scheme), which is also well regulated under the current law.

1. Definition of Warrant – ASX Listed Instalment Warrants

We believe that the proposed Exposure Draft - Corporations Amendment Regulations 2012 (No.) - Limited Recourse Borrowings by Superannuation Funds (Instalment Warrants), released on 13 February 2012 (**Regulation**), may have unintended consequences for the instalment warrant market.

Generally, instalment warrants are a limited recourse borrowing arrangement, which means they will generally fall within the new category of financial products in s764A(1)(m) if the proposed Regulation is made. Under the current law, instalment warrants must fall within:

- s761D(3)(c); and
- either s764A(1)(a), (b)(ii), or (ba)(ii),

of the Corporations Act in order to fall within the definition of 'warrant' in Corporations Regulation 1.0.02.

Importantly, instalment warrants are only classified as warrants if they **only** fall within either s764A(1)(a), (b)(ii), or (ba)(ii). If the Regulation is passed in its current form, instalment warrants will no longer **only** fall within s764A(1)(a), (b)(ii), or (ba)(ii) since they will also fall within s764A(1)(m) of the Corporations Act.

This appears to us to be an unintended result which has implications for the listed instalment warrant market, because for a warrant to be eligible for listing on the ASX, the warrant needs to meet the definition of warrant under ASX Operating Rule 7100. If the proposed Regulation is made in its current form then:

- An instalment warrant issuer will not be able to satisfy paragraph (b) of ASX Operating Rule 7100 because it will not be able to satisfy the definition of 'warrant' in Corporations Regulation 1.0.02; and
- New instalment warrants will only be eligible to list on the ASX where the instalment warrant issuer is able to satisfy paragraph (a) of ASX Operating Rule 7100.[1] Going forwards, this may:
    1. limit the ability of the instalment warrant products market to evolve and to be flexible in meeting the needs of investors where new product design opportunities present; and
    2. lead to confusion in the market place and in disclosure documents, where a product which looks like a warrant and is categorised a warrant under paragraph (a) of ASX Operating Rule 7100 cannot be categorised as a warrant under the Corporations Act.

The Regulation will also have similar unintended consequences for unlisted warrants, which are often structured to include leverage and an instalment warrant structure and are usually categorised as warrants under the Corporations Act. For example, under Corporations

[1] See ASX Operating Rules, Section 07 - Rule http://www.asxgroup.com.au/asx-operating-rules-guidance-notes-and-waivers.htm.

Regulation 6D.5.01, warrants that are also securities are exempted from Chapter 6D Corporations Act and the correct disclosure document for such a warrant is a product disclosure statement (PDS), not a prospectus. The effect of the Regulation is that many financial products which would currently be categorised as and regulated as warrants will no longer meet the definition of warrant under Corporations Regulation 1.0.02. As a result, where a product can no longer be categorised as a warrant under the Corporations Act due to the effect of the Regulation, we anticipate that there will be uncertainty in relation to how those products should be regulated, that investor disclosure will become more complicated and less effective and that the comparability of disclosure documents will be adversely affected.

A Proposed Solution

We think that one way to deal with the issues outlined above is to amend the definition of warrant in Corporations Regulation 1.0.02, by inserting the underlined text below:

> "**warrant** means a financial product:
>
> (a) that is:
>
> (i) a derivative under section 761D of the Act; or
>
> (ii) a financial product that would, apart from the effect of paragraph 761D(3)(c) of the Act, be a derivative for section 761D of the Act, and is excluded by that paragraph only because:
>
> (A) it is a security under paragraph (c) of the definition of security in section 761A of the Act; or
>
> (B) it is a legal or equitable right or interest mentioned in subparagraph 764A (1) (b) (ii) of the Act; or
>
> (C) it is a legal or equitable right or interest mentioned in subparagraph 764A (1) (ba) (ii) of the Act; or
>
> (D) it is a financial product which satisfies either subparagraph (A), (B), or (C) above, and it is an arrangement relating to the acquisition of an acquirable asset under section 67A or 67B of the Superannuation Industry (Supervision) Act 1993; and
>
> (b) that is transferable."

We note that we have consulted with the ASX and they agree that amending the definition of "warrant" to ensure that instalment warrants are not unintentionally excluded from the definition under the Corporations Regulations would avoid confusion amongst issuers and investors of listed products.

We would be happy to discuss with any alternative solutions that you may wish to consider.

2. Limited Recourse Borrowing Arrangements

Multiple Parties to an Arrangement

Member firms who issue limited recourse loans relevant for the purpose of the Regulation have raised a concern that, in some instances, multiple issuers may be required to issue a PDS for the same limited recourse loan arrangement. The Regulation should be refined as necessary to avoid the outcomes described below.

Paragraph (2)(b) of Regulation 7.1.04H means that each party to a relevant arrangement for the purpose of this Regulation is an issuer of the product. This would have the effect that each party to a limited recourse borrowing arrangement would be deemed to be an "issuer" of the product and this would have adverse effects for issuers and borrowers for which there is no compensating public benefit.

For example, member firms have raised a concern where limited recourse borrowing arrangements involve a bank lending to a superannuation fund that wishes to invest in a financial product, such as an interest in a registered managed investment scheme. In this form of arrangement:

- The issuer of the financial product issues a PDS in relation to the financial product;
- The same PDS also describes the limited recourse borrowing arrangement of the bank to allow investors to invest in the financial product and the security trust arrangement whereby the security trustee mortgages the financial product in favour of the bank as security for the loan; and
- The bank and the security trustee would consent to be named in the PDS (s1013K of the Corporations Act).

It should be noted that the bank and the security trustee would be liable for loss or damage caused by their statements in the PDS under s1022B(2) and s1022B(3) of the Corporations Act.

The Regulation would require the bank and the security trustee, as issuers, to each issue a PDS. Members have expressed concern that the multiple issue of PDSs from multiple issuers for the arrangement described above would actually complicate disclosure to retail investors, to their disadvantage, and would be disproportionately burdensome compared to the status quo. There is no public benefit from this outcome but it would increase costs for the investor and the 'issuers'.

Furthermore, although the issuer, bank and security trustee may be entitled to rely on Class Order [CO 03/1092] to prepare joint PDSs, each of the issuer, bank and security trustee would need to assume full responsibility of the whole PDS and not for that portion of the PDS which relates to their respective financial product. This would be undesirable as it would expose each of the issuer, bank and security trustee to liability for each other's financial product.

To further complicate the issue, other potential difficulties involving multiple issuers are:

- Subregulation 7.1.04H(2) states that a limited recourse borrowing arrangement is "issued" when a person enters into a legal relationship that sets up the arrangement. We note that the intended application of this deeming provision is unclear where an arrangement involves more than two parties.
- Subregulation 7.1.04J(2) takes custodial and depository services outside of the scope of the Regulation in order to avoid unintended consequences. However, concern has been expressed to us that this subregulation does not capture dealing services of the type provided by a trustee in acquiring a financial product on behalf of the client. In the absence of this coverage, the exclusion would be imperfect and the potential for multiple issuers under the Regulation would remain. As this activity is adequately regulated, the scope of the subregulation should be extended to include such dealing services.

Credit Facilities

Subregulation 7.1.06(2A) provides that a limited recourse borrowing under subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) is not a "credit facility" under the Corporations Act. The Explanatory Memorandum states that this Regulation should prevent someone who "*merely provides credit as part of a limited recourse borrowing arrangement from being caught by the new requirements*". However, the effect of the Regulation does not seem to give this outcome, as a mere lender would still be at risk of being treated as the issuer of a financial product. The Regulation should be reviewed to ensure that it is consistent with its intent.

3. Concluding Comments

It is proposed that the Regulations should commence three months after they are registered. This would provide an insufficient adjustment period given the potential licensing and disclosure requirements that may have to be addressed once the final regulations are made. The appropriate time period determined in consultation with industry after the final form the Regulations are otherwise decided.

Thank you for the opportunity to make this submission. If you have any questions that you would like us to follow-up, then please contact me and I would be pleased to assist.

Yours sincerely

David Lynch
Head of Policy & Markets