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Dear Sir

Limited Recourse Borrowings by Superannuation Funds (Instalment Warrants)

Gadens Lawyers thanks the government for the opportunity to comment on the proposed draft *Corporations Amendment Regulation – Limited Recourse Borrowings by Superannuation Funds (Instalment Warrants).*

Gadens Lawyers Sydney office is recognised as an industry expert in the area of borrowing by superannuation funds. We advise a number of major lenders (both banks and non-banks) in relation to the making of limited recourse loans to superannuation funds wishing to purchase real property. We also regularly work with a number of the finance brokers and mortgage aggregators active in this area.

As limited recourse borrowing arrangements are most often taken up by self-managed superannuation funds (**SMSFs**), rather than other types of regulated superannuation funds, we will refer to 'SMSFs' throughout this submission, however, most of our comments are relevant to all superannuation funds that avail themselves of the limited recourse borrowing arrangements permitted by section 67A and section 67B of the *Superannuation Industry (Supervision) Act* (**SIS Act**).

As experts in the area of lending to superannuation funds, in particular SMSFs, we congratulate the government on its clear desire to remove the "rogues" from this industry. We note the government's concerns that many SMSFs may be receiving inadequate (and on occasions incorrect) 'financial product advice' about the appropriateness of acquiring a property using a limited recourse borrowing arrangement from unqualified advisers and support the government's stated desire to stamp out such situations.

However, we are concerned that the proposed amendments to the *Corporations Regulations* as currently drafted pose more questions than they answer and do not actually achieve the government's desired outcome.

This submission sets out some of the difficulties with the current drafting of the proposed regulations and provides a solution to the concerns raised by the government in the Explanatory Memorandum to the proposed regulations.

Executive Summary

1. Given the large number of regulatory changes that industry is struggling to cope with, any further change should be delayed.

2. There is a significant difference between 'instalment warrants' and 'limited recourse loans'. There are reasons to regulate 'instalment warrants' financial products but no basis to regulate 'limited recourse loans' made to superannuation funds, or the arranging of those loans by finance brokers. The regulations when implemented should be amended to make this distinction clear.

In Part 1 of this submission we consider issues with the proposed new regulations. Part 2 looks at the problems with the proposed regulations as they are currently drafted. Part 3 provides some suggested drafting to achieve the government's policy objectives.

Part 1 - Issues identified with the proposed regulations

1. What structures do the proposed regulations govern – the difference between Instalment Warrants and Limited Recourse Loans

The current drafting of the proposed regulations and Explanatory Memorandum confuses (yet appears to draw a distinction between) 'instalment warrants' and 'limited recourse loans' – both of which are made under section 67A of the SIS Act.

To understand the importance of this distinction, it is worth remembering how section 67A and 67B of the SIS Act came about.

Until September 2007, superannuation funds (including SMSFs) were not permitted to borrow money (except in very limited short term situations) as a result of the prohibition in section 67(1) of the SIS Act.

Until 12 August 1999, SMSFs 'got around the law' by the SMSF investing in 100% of the units in a 'related party unit trust' and gearing the unit trust. The effect of these structures was that the SMSF was not borrowing money – however, if the unit trust defaulted on the loan, the units in the trust owned by the SMSF became worthless.

On the 12 August 1999 the definition of an 'in-house asset' contained in the SIS Act was amended to effectively end the use of investments in geared related party unit trusts by SMSFs. As a result, between August 1999 and September 2007, SMSFs had no ability to gear their investments and as such many SMSFs were reduced to investing in shares or fixed interest cash products as they lacked the capital to invest in larger assets such as real property.

However, the placing of a prohibition in a law will drive people to 'find a way around the law'. As a result towards the end of 2006 and 2007, we started to see a new structure known as an 'instalment warrant' being used to enable SMSFs to invest in larger (more expensive assets) such as real property. The argument by persons offering these 'instalment warrants' was that a 'warrant' is not a loan and therefore, investments in these structures would not offend the prohibition on borrowing in section 67(1) of the SIS Act. Instalment warrants can be characterised as 'terms purchase agreements'.

In September 2007, a new section 67(4A) of the SIS Act was introduced. Section 67(4A) of the SIS Act was headed "Instalment Warrants". The 'instalment warrants' offered under section 67(4A) of the SIS Act do require '*an upfront payment to the issuer with the balance being repaid in periodic instalments*' as noted in the fourth paragraph of the Explanatory Memorandum to

these proposed regulations. A diagram of how these traditional 'instalment warrants' work is depicted at **Appendix A**.

It is relevant to note that although the early promoters of 'instalment warrants' claimed the structures were 'financial products' and therefore not 'loans', in many cases the 'instalment warrants' issued to SMSFs did not actually fall within the definition of a 'warrant' in regulation 1.0.02(1) of the *Corporations Regulations*.

Regulation 1.0.02(1) of the *Corporations Regulations* requires that a warrant be 'transferrable'. This is the major distinction between a warrant and a deliverable futures contract or other derivative. Generally speaking, the instalment warrants issued to SMSFs (both before the introduction of section 67(4A) and since that time), are not true warrants because they are not transferrable. Despite this, many of these 'warrant structures' have been issued under a Product Disclosure Statement (**PDS**) by a person with an Australian Financial Services Licence (**AFSL**).

Although some property developers and financiers adopted the traditional instalment warrant structure depicted in **Appendix A,** the mainstream banking industry was able to simplify products offered under section 67(4A) so that ordinary investors with SMSFs could arrange borrowings in accordance with the intention of the reforms.

Gadens Lawyers was a pioneer in this industry. In 2007 we worked with one of Australia's leading banks to develop the first 'SMSF lending policy' offered by a major Australian authorised deposit-taking institution (**ADI**). The policy complied with the requirements of section 67(4A) but did not involve the issuing of an 'instalment warrant'. Rather, the policy was easily explained to customers as 'a limited recourse loan to the SMSF secured by a mortgage from a bare trustee (often called a Property Trustee or Security Custodian and referred to as a '**Property Trustee**' in this submission) which must owns the legal interest in the property on trust the SMSF for the term of the loan". This structure is depicted at **Appendix B**.

Since 2007, all major Australian ADIs have adopted the structure designed by Gadens Lawyers and we continue to act for many of these lenders. Very few 'instalment warrant structures' have ever been issued by the mainstream financial services sector. Rather, most if not all participants in the mainstream financial sector offering 'limited recourse borrowing arrangements' have embraced the simpler concept of a 'limited recourse loan'.

Under a 'limited recourse loan', there is no '*up front payment to the issuer*' as described in the Explanatory Memorandum. Rather, the Property Trustee that will hold the property on trust for the SMSF for the term of the limited recourse loan, enters into a contract to purchase the property from the vendor and the SMSF pays the deposit to the vendor or the vendor's agent. The SMSF then enters into a loan with a financier to enable it to complete the purchase. The SMSF will pay on completion of the contract of purchase the difference between the balance purchase money and the loan amount.

The SMSF acquires 100% of the beneficial interest in the property from the vendor and the Property Trustee holds 100% of the legal interest in the property on trust for the SMSF throughout the term of the loan. During the term of the loan, the SMSF makes loan repayments directly to the financier and once the loan is repaid may arrange for the Property Trustee to transfer the legal interest in the property to be transferred to the SMSF.

Under the structures required by the lending policies of the mainstream financial sector, at **no** time is an 'instalment warrant' issued. The structures are a simple 'limited recourse loan'.

In July 2010 when many of the uncertainties existing under section 67(4A) of the SIS Act were clarified by the repeal of that section and the introduction of the new section 67A of the SIS Act, the heading of the old section was changed to remove a reference to 'instalment warrants' and replace it with a new reference to 'limited recourse borrowing arrangement'. Industry welcomed this change as it appeared that the government had recognised that the structures offered by the mainstream financial sector have nothing to do with 'instalment warrants'.

Against this background, we are concerned by the language in this new Explanatory Memorandum which seems to hark back to the old days and the 'instalment warrant structures'. In places, the Explanatory Memorandum seems to draw a clear distinction between these old 'instalment warrant structures' and the simpler 'limited recourse loans'. However, the difficulty is that this is not clear from the proposed wording of the draft regulations which refer simply to '*the acquisition of an acquirable asset under section 67A or 67B of the SIS Act*'.

As such, these proposed regulations as currently drafted create confusion and uncertainty rather than clarify and improve the government's stated objective of better consumer protection in this area of law. The regulations should be amended to make it clear they only apply to 'instalment warrants' as they can have no application to 'limited recourse loans'..

2. So is change really necessary – what is the law as it currently stands?

The Explanatory Memorandum to the proposed regulations makes it clear that the government is concerned that '*Superannuation funds may be receiving inappropriate advice when purchasing instalment warrants from unlicensed and unqualified advisers*'.

It appears from this sentence that the government is concerned that the current legislation may not regulate persons providing 'financial product advice' (as defined in the *Corporations Act*) in relation to 'instalment warrants'. However, the regulations as drafted have the potential to apply to 'limited recourse loans'.

'Financial product advice' is defined in section 766B of the *Corporations Act* as involving a recommendation or statement of opinion that is intended to, or is reasonably likely to influence a person to buy, sell or hold a 'financial product'. Financial product advice may be 'personal' (ie the adviser has considered one or more of the person's objectives, financial situation and needs) or 'general'.

However, it is important to distinguish between "financial product advice" in respect of these limited recourse borrowing arrangements (which focuses on whether it would be a good idea for an SMSF to borrow money to purchase property) and finance broking services (which involves assisting a client - who has already decided to borrow money – to find a loan that is suitable for their needs). It is important that these two very different activities are not confused. The proposed regulations as they currently stand fail to distinguish between these two very different activities.

When considering the law as it currently stands, it is also important to note that 'instalment warrants' were initially adopted by product providers before section 67(4A) of the SIS Act was introduced on the basis that an 'instalment warrant' was a 'financial product' as regulated by the *Corporations Act* and therefore did not offend the prohibition on SMSFs borrowing money as provided for in section 67(1) of the SIS Act.

As such, most of the issuers who have adopted an 'instalment warrant structure', have issued the warrant under a PDS and an AFSL with an authorisation allowing the issuer to 'deal in' and 'provide financial product advice' in relation to 'derivatives'. If the government is concerned

that 'instalment warrant structures' are technically not captured by the current definition of 'warrant' in regulation 1.0.02(1) of the *Corporations Regulations* (which amongst other things requires that the warrant be 'transferrable'), the drafting of the proposed regulations could include an amendment to the definition of 'warrant' so that it clear that the definition of 'warrant' includes an 'instalment warrant' issued to an SMSF.

As the major players in the financial services sector in this space do not have exposure to 'instalment warrant structures', the balance of this section focuses on 'limited recourse loans' rather than the broader question of 'limited recourse borrowing arrangements' (which may also include 'instalment warrant structures').

3. What is the difference between the role of financial advisers / accountants and finance brokers in the area of 'limited recourse loans'?

Currently, different roles are undertaken by financial advisers / accountants and finance brokers when assisting SMSFs to obtain a 'limited recourse loan'.

Many lenders rely on finance brokers to introduce borrowers to them.

Finance brokers are experts in loans and lending products. The recent introduction of the NCCP is intended to further increase the skills of finance brokers with the requirement that finance brokers obtain an Australian Credit Licence (**ACL**), give customer specified disclosure documents (consistent nationally) and undertake extensive training when providing services in respect of 'consumer credit'.

Although loans to SMSFs are only regulated by the NCCP when the trustees of the SMSF are individuals and the loan purpose is to purchase a residential investment property, most of the finance brokers assisting SMSFs with obtaining a 'limited recourse loan' are regulated by the NCCP in other aspects of their business.

In contrast, financial advisers / accountants may not be experts in lending and are often not licensed to arrange a regulated loan.

Most major finance brokers and aggregator groups make it clear that their brokers can only assist an SMSF to find a loan. The finance broker is specifically prevented from providing the SMSF with advice about the impact of investing in a particular property using a limited recourse loan (unless that finance broker holds an AFSL).

On the other hand, most financial planning firms will not permit their financial planners to arrange a loan for an SMSF (unless that financial planner has the appropriate skills in this area and if necessary holds an ACL). Rather, the financial planner will focus on providing the SMSFs with 'financial product advice' on their investment and risk management decisions.

Finally, it is important to understand that although most lenders will accept introductions for 'limited recourse loans' from finance brokers (a credit activity), the lending policies of most major lenders require the SMSF to obtain a certificate from an 'RG146 qualified' financial planner or accountant confirming that the SMSF has received appropriate 'financial advice' from that person.

Despite the clear difference between the role undertaken by financial planners and finance brokers in respect of 'limited recourse loans', the draft regulations make no distinction between these activities. Rather, the draft regulations seem to overlook the important lending expertise brought by finance brokers to SMSF lending and give the impression that the government considers that financial planners who are not experts in lending are the only people that can have

any role to play in obtaining a 'limited recourse loan' for an SMSF. This is clearly undesirable and is likely to lead to a decrease in advisers with appropriate skills rather than the government's desire to increase consumer protection in this area.

4. What about lenders?

As noted in point 1 above, the major lenders active in offering 'limited recourse borrowing arrangements' to SMSFs have all opted to make 'limited recourse loans'. .

Since January 2008 when the first major ADI in Australia made a limited recourse loan to an SMSF, the offering has been structured as a loan and the policy has sat within the lending / credit area of the organisation.

In deciding whether or not to offer an SMSF a 'limited recourse loan', the lender has regard to its standard lending policies (as modified to cater for the SIS Act requirements). Considerations such as 'can the SMSF afford to repay the loan' and 'how will the SMSF meet its obligations under the loan' are paramount to the decision of whether or not to advance credit.

As such, these 'limited recourse loans' are more properly categorised as 'loans' (and left with the credit department) rather than 'financial products'. In fact, the proposed regulations as currently drafted run the real risk of having these arrangements moved from the very people with the skills to ensure that money is not advanced to SMSFs that cannot afford to meet their obligations under the arrangement (ie the credit department) to persons with little or no experience in credit decisions (ie investment product designers).

Further, it is important to note that no major lender in this space allows their employees or contractors (including finance brokers) to provide 'advice' to SMSFs on 'whether or not it is a good idea for them to acquire property under a limited recourse borrowing arrangement' or 'what are the obligations of the SMSF under a limited recourse borrowing arrangement' (unless the employee or finance broker is 'RG146 qualified').

Although the Explanatory Memorandum makes it clear that 'persons merely advancing credit to SMSFs' are not caught by these proposed regulations, this is not clear from the draft regulations.

5. Is it likely that the draft regulations will help the government reach its stated objectives of increased consumer protection?

You will see from 4 above, we consider the draft regulations will not help achieve the objectives if they remove the arranging and provision of credit from those best equipped to provide it. In addition, the sheer weight of regulatory change will mitigate against achieving the objectives as discussed below.

Both the changes introduced by the NCCP and the proposed FOFA Reforms will require financial planners and finance brokers to undertake considerable changes to their practices and systems. Neither of these legislative changes have had sufficient time to settle and work their way into the 'everyday, automatic processes adopted by industry'. As such it is unclear what effect these changes will have on consumer protection and confidence.

Any further legislative changes imposed on finance brokers and financial advisers / accountants run a real risk of 'missing the mark' as the impact of changes already made and proposed will not have yet had any effect.

It is also important to note that industry is already struggling to keep up with the myriad of changes to legislation in the financial services sector and that additional changes are likely to

actually result in a contraction of the industry as the cost of compliance outweighs the benefits of doing business. As such, Australian consumers may actually find it more difficult to obtain appropriate professional advice on either their lending requirements or their investment and risk management strategies.

Further, regulations such as the proposed regulations may result in significant numbers of people currently making these 'limited recourse loans' available to SMSFs actually reducing their product offering or in some cases leaving this part of the industry altogether.

With strict caps on contributions imposed on SMSFs, the removal of the ability for SMSFs to create wealth by appropriate gearing is likely to result in more people relying on government pensions in old age or people being forced to remain in the workforce for longer (resulting in higher unemployment for younger people) as investments in superannuation fail to generate the income required by members in their retirement.

We encourage the government to refrain from making further changes to the financial services laws at least until industry has had the opportunity to observe the results of the changes that have already been made or that are close to implementation.

Against the general issues explored above, we now turn to the specific problems with the drafting of the proposed regulations as currently drafted and offer some potential solutions to assist the government to reach its desired objectives.

Part 2 - What are the problems with the draft regulations as they currently stand?

The proposed regulations as currently drafted do not meet the government's desired objectives as stated the Attachment to the Explanatory Memorandum.

(a) Regulation 7.1.04J

Regulation 7.1.04J declares that a limited recourse borrowing arrangement as defined in sections 67A and 67B of the SIS Act is a financial product.

(b) Regulation 7.1.04H

Regulation 7.1.04H refers to the fact that 'an arrangement relating to the acquisition of an acquirable asset under section 67A or section 67B of the SIS Act is issued when:

(i) a person enters into a legal relationship that sets up the arrangement; and

(ii) each person to the arrangement is an issuer of the product'.

At law, the persons that 'enter into a legal relationship that sets up an arrangement relating to an acquisition of an acquirable asset under section 67A or 67B of the SIS Act' are the persons that sign the contract for sale to acquire the asset - that is the vendor and purchaser. It seems unlikely that the intent is that the vendor wishing to sell a property to an SMSF is intended to first obtain an AFSL.

Financial advisers generally do not get involved in advising on the 'legal relationship that *sets up* the arrangement to acquire a property under section 67A or section 67B of the SIS Act' (ie the signing of the contract for sale) and neither do finance brokers.

In any case, even if it were possible to argue that these people were somehow caught by the current drafting of the regulations, it would make little sense if both these people were required to prepare a PDS (as required by issuers of most financial products).

A further problem arises with the proposal that '*each party to the arrangement is an issuer of the product*'. Under this drafting, if finance brokers and financial advisers were to continue to offer these arrangements despite the need for a PDS and an AFSL, the result would be that an SMSF could be given several different PDSs (one from each 'issuer' in the arrangement) for one acquisition.

From a commercial perspective, regulation 7.1.04H as currently drafted is unworkable and may lead to persons ceasing to offer these products altogether – or limiting the options available to SMSFs by prescribing the lender and service provider that must be used.

(c) Regulation 7.1.06(2A)

The Attachment to the Explanatory Memorandum to the draft regulations states that a new sub-regulation 7.1.06(2A) in the Principal Regulations would '*prevent persons that merely provide credit as part of a limited recourse borrowing arrangement from being caught by the new requirements.*' Unfortunately, regulation 7.1.06(2A) does not actually contain such a provision.

Further, the Attachment to the Explanatory Memorandum states that '*a limited recourse borrowing arrangement under subdivision 67(4A) of the SIS Act is not a 'credit facility' under the Principal Act*'. We assume that the reference to 'section 67(4A) is a typographical error as this section has been repealed. In any case, the draft regulation 7.1.06(2A) itself appears to refer to the current sections 67A and 67B of the SIS Act.

It is difficult to understand what the purpose of this sentence is. One suggestion is that the government is trying to make a distinction between 'instalment warrant structures' and 'limited recourse loans', however, this is not clear.

As stated in point 5 above, all major lenders offering 'limited recourse borrowing arrangements' have structured these arrangements as 'limited recourse loans'. As such the arrangements are considered by people with appropriate lending skills and where appropriate under the responsible lending policies developed by these lenders for the NCCP.

To remove what are effectively 'credit decisions' from trained credit analysts and place them in the hands of people with 'investment skills' is a backwards step that is likely to diminish consumer protection as these arrangements may no longer be considered by people with the appropriate skills in this area.

(d) Regulation 7.6.01AB

This regulation proposes that a person covered by these amendments will be required to hold an AFSL with an authorisation that:

(i) would cover the person if the service provided was provided in relation to a security; or

(ii) would cover the person if the service provided was provided in relation to a derivative;

It appears that this approach has been adopted to enable persons with existing AFSLs to offer these 'limited recourse borrowing arrangements' without the need to vary their AFSL.

However, it is important to note that most financial advisers do not have an AFSL authorising them to 'deal by issuing' and most finance brokers do not hold an AFSL (although most will hold an ACL). Therefore, given the huge compliance costs currently facing industry participants as a result of the vast amounts of new legislation affecting them, there is a significant risk that many persons with significant skills in arranging 'limited recourse loans' or 'providing financial product advice' on 'limited recourse borrowing arrangements' will decide to exit this area rather than face even more compliance costs.

Part 3 - A possible solution

As noted above, it seems clear that the government's desired outcome from the proposed regulations is to ensure that:

(a) superannuation funds are receiving proper advice about their investment decisions;

(b) superannuation funds continue to have access to brokers with appropriate lending skills; and

(c) superannuation funds continue to have the opportunity to build wealth through properly structured geared arrangements.

As such:

(a) regulation 7.1.04H must be deleted (as the concept of 'issue' is irrelevant with a limited recourse borrowing arrangement);

(b) regulation 7.1.04J (renamed as regulation 7.1.04H) must be amended to only regulate persons providing advice about the appropriateness of a limited recourse borrowing arrangement and provide a carve out for persons who 'merely arrange or provide credit as part of a limited recourse borrowing arrangement';

(c) regulation 7.1.06(2A) must be deleted as there seems to be no reason to exclude 'limited recourse loans' from the definition of 'credit'; and

(d) regulation 7.6.01AB must be amended to make it clear that the relevant 'financial service' is the provision of 'financial product advice'.

Our proposed simplified drafting designed to achieve the government's objectives is set out in **Appendix C**.

Conclusion

Gadens Lawyers would be pleased to assist the government to achieve its stated policy objectives in this area. Please contact Vicki Grey on 02 9931 4753 or vgrey@nsw.gadens.com.au if we can assist further.

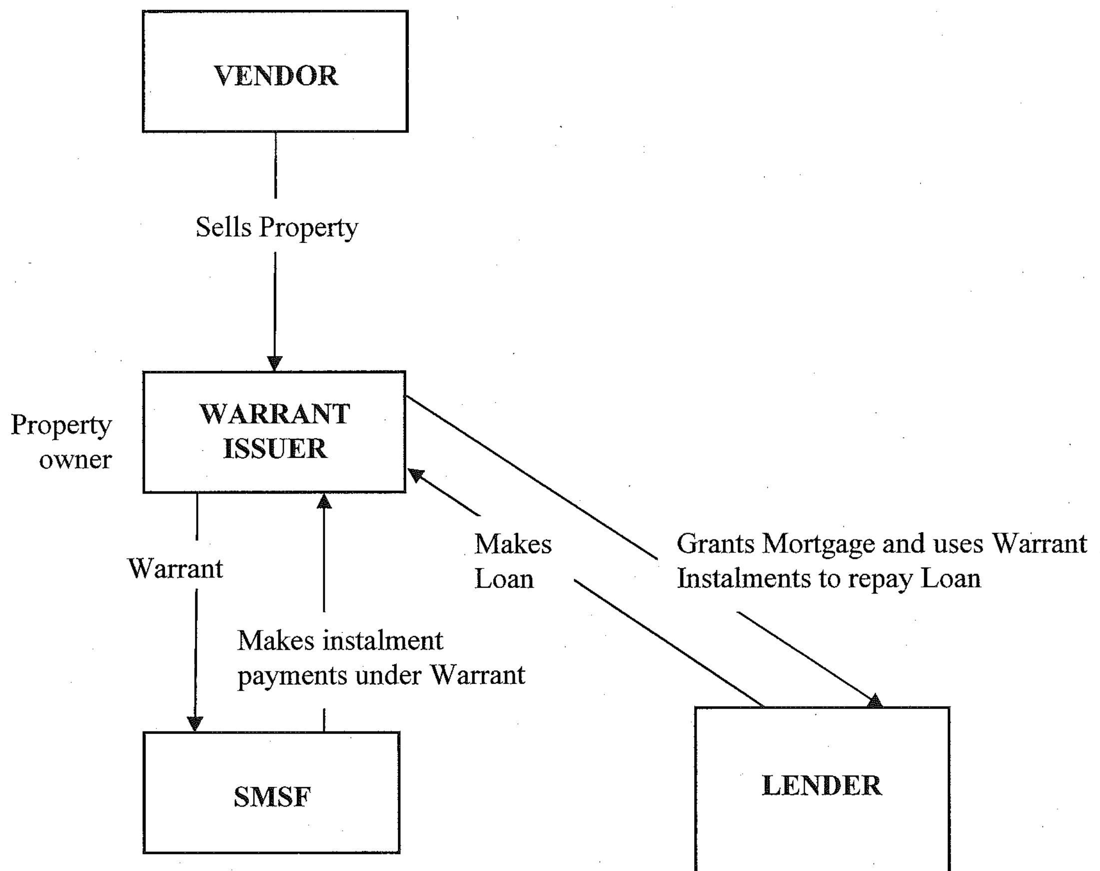
Yours sincerely

Vicki Grey
for **GADENS LAWYERS**

Appendix A – A typical instalment warrant structure

- A Lender may make a loan to the Warrant Issuer (although this is not necessary)
- The Warrant Issuer purchases the property and issues a warrant to the SMSF setting out the terms on which the Warrant Issuer holds the property for the SMSF. Amongst other things, the Warrant makes it clear that the Warrant Issuer's recourse against the SMSF for non payment of an instalment is limited to the property.
- The SMSF makes instalments as described in the Warrant to the Warrant Issuer.
- The Lender has **no** recourse to the SMSF (there is no contractual relationship between the Lender and the SMSF). The Lender's recourse to the Warrant Issuer may be limited to the property, although this is not necessary.
- Once all instalments required under the Warrant have been paid by the SMSF, the SMSF may direct the Warrant Issuer to transfer the property to the SMSF.

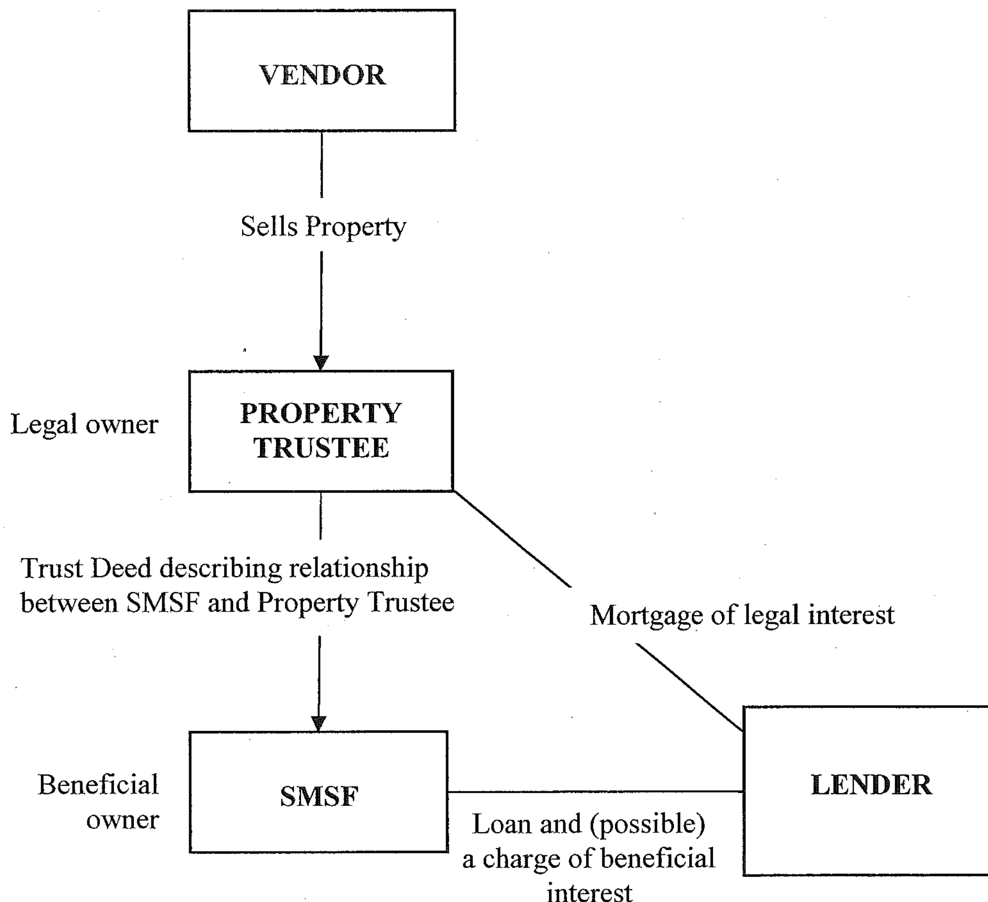
The structure is represented diagrammatically below.



Appendix B – A typical limited recourse loan (as adopted by the major lenders in Australia)

- The Property Trustee purchases the property at the direction of the SMSF and becomes the legal owner.
- The SMSF is the beneficial owner of the property.
- The lender lends to the SMSF. Lender has no recourse against the assets of the SMSF other than the security property.
- The SMSF makes payments under the loan directly to the lender.
- The lender may require a guarantee and possibly collateral security from members of the SMSF. Collateral security cannot be taken from the SMSF itself.
- Loan funds must only be used for the purchase of a property and there can be no redraws or further advances.
- Once the loan is fully repaid, the SMSF may direct the Property Trustee to transfer the legal interest in the property to the SMSF.

The structure is represented diagrammatically below.



Appendix C – Proposed new drafting of the regulations

Proposed new Regulation 7.1.04J – Specific things that are financial products – limited recourse borrowing arrangements

(1) For paragraph 764A(1)(m) of the Act, a person who provides financial product advice about the acquisition of an acquirable asset under section 67A or section 67B of the *Superannuation Industry (Supervision) Act 1993* is declared to be a financial service given in relation to a financial product.

(2) However, the following are not declared to be a financial product:

(a) a custodial or depository service (within the meaning given by section 766E of the Act);

(b) a custodial or depository service not covered by paragraph (a);

(c) an administrative service provided in relation to a custodial or depository service or arrangement;

(d) a person who merely provides credit to enable a person to acquire an asset under section 67A or section 67B of the *Superannuation Industry (Supervision) Act 1993; and*

(e) a person who merely arranges for a person to obtain credit to acquire an asset under section 67A or section 67B of the *Superannuation Industry (Supervision) Act 1993.*

Proposed new Regulation 7.6.01AB – Persons taken to hold financial services licenses covering limited recourse borrowing arrangements

For subsection 911A(7) of the Act, a person who provides financial product advice about the acquisition of an acquirable asset under section 67A or section 67B of the *Superannuation Industry (Supervision) Act 1993* must hold a financial services licence authorising them to provide personal financial product advice in relation to:

(a) a security; or

(b) a derivative.