Chapter 4

Margin lending, promissory notes and trustee corporations

Introduction

4.1 At their 26 March 2008 meeting, where the Council of Australian Governments (COAG) agreed to nationalise consumer credit regulation, COAG also reached in-principle agreement that the Commonwealth would assume regulatory responsibility for margin lending and trustee corporations.[1]

4.2 The Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 contains the government's proposed measures to introduce responsible lending obligations for margin lending, establish a more consistent approach to the regulation of promissory notes and debentures and require trustee companies to hold Australian Financial Services Licences.

Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009

4.3 On 3 June 2008, the Government released a green paper which canvassed 'seven critical areas of Australia's financial services'[2] including trustee corporations, margin loans and promissory notes. The green paper received 76 submissions. On 7 May 2009, after further consultation with a panel of industry and consumer groups, an exposure draft of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, plus draft regulations relating to margin lending, was released for public comment.

Interaction with the National Consumer Credit Protection Reform Package

4.4 Many of the issues addressed in the green paper are the subject of either the National Consumer Credit Protection (NCCP) reforms or this bill.

4.5 Significantly, the responsible lending obligations, which are an important part of the NCCP bill, will also be introduced into the *Corporations Act* and applied to providers of margin lending products, creating substantial cross-over between the two bills. Additionally, margin lending providers will be subject to new dispute resolution requirements, including a requirement that they be members of a registered External Dispute Resolution (EDR) scheme.

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1 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 *Explanatory Memorandum* p 3.

2 Treasury green paper, *Financial Services and Credit Reform: Improving, Simplifying and Standardising Financial Services and Credit Regulation'*, 3 June 2008 p. ii.

4.6 However, there are also some important differences between the regulation of marking lending, trustee companies and promissory notes and the regulation of consumer credit. These differences are explained in more detail later in this chapter.

Committee view

4.7 The Committee acknowledges that the responsible lending obligations which will apply to margin lending products as a result of this bill substantially reflect the obligations under the NCCP bills and that margin lending providers will have similar dispute resolution requirements. However, the Committee believes that there are other issues that must be considered in discussing the regulation of margin lending products because of their unique position as both a credit product and an investment product.

Margin Lending

4.8 The ASIC website 'Fido' defines a margin loan as follows:

> A margin loan lets you borrow money to invest in shares and other financial products, using existing investments as security. Borrowing money to invest in this way, also known as ‘gearing’, can increase the gains from an investment, but also multiply the losses. Margin loans are offered by a wide range of financial institutions and are often available online.[3]

4.9 Margin lending typically involves the investor borrowing funds (sometimes up to 80 per cent of the total value of a portfolio of listed shares, fixed interest securities and/or units in managed funds) to supplement an initial investment. Investors hope that the value of the overall portfolio will grow, increasing the equity in the portfolio. Investing using margin loans can also have taxation benefits.

4.10 However, as indicated in the ASIC definition, the risks involved with investing using funds from a margin loan can greatly exacerbate the risks associated with normal investments.

4.11 Typically, a lender will approve a margin loan for a consumer whereby the value of the loan amount cannot exceed a certain percentage of the loan's security. This is called the Loan to Value Ratio (LVR). When the value of the overall portfolio falls so that the LVR rises to greater than the level originally approved by the margin loan provider, the lender issues a 'margin call'. This requires the investor to return the ratio to below the approved level by giving the lender additional security, reducing the size of the portfolio (by selling some of the assets) or paying extra cash.

4.12 The money that investors borrow in a margin loan is generally backed by the securities or financial products owned by the investor (such as listed shares). In recent years, however, some lenders have encouraged investors to provide other assets, such as their home or investment properties as collateral.

3 http://www.fido.asic.gov.au/fido/fido.nsf/byheadline/borrowing+money+to+invest+margin+lending?openDocument (accessed 29 June 2009)

4.13 In instances where a margin lender issues a margin call and the borrower is unable to bring the LVR down below the approved level, the borrower may be exposed to the lender calling in the margin loan.

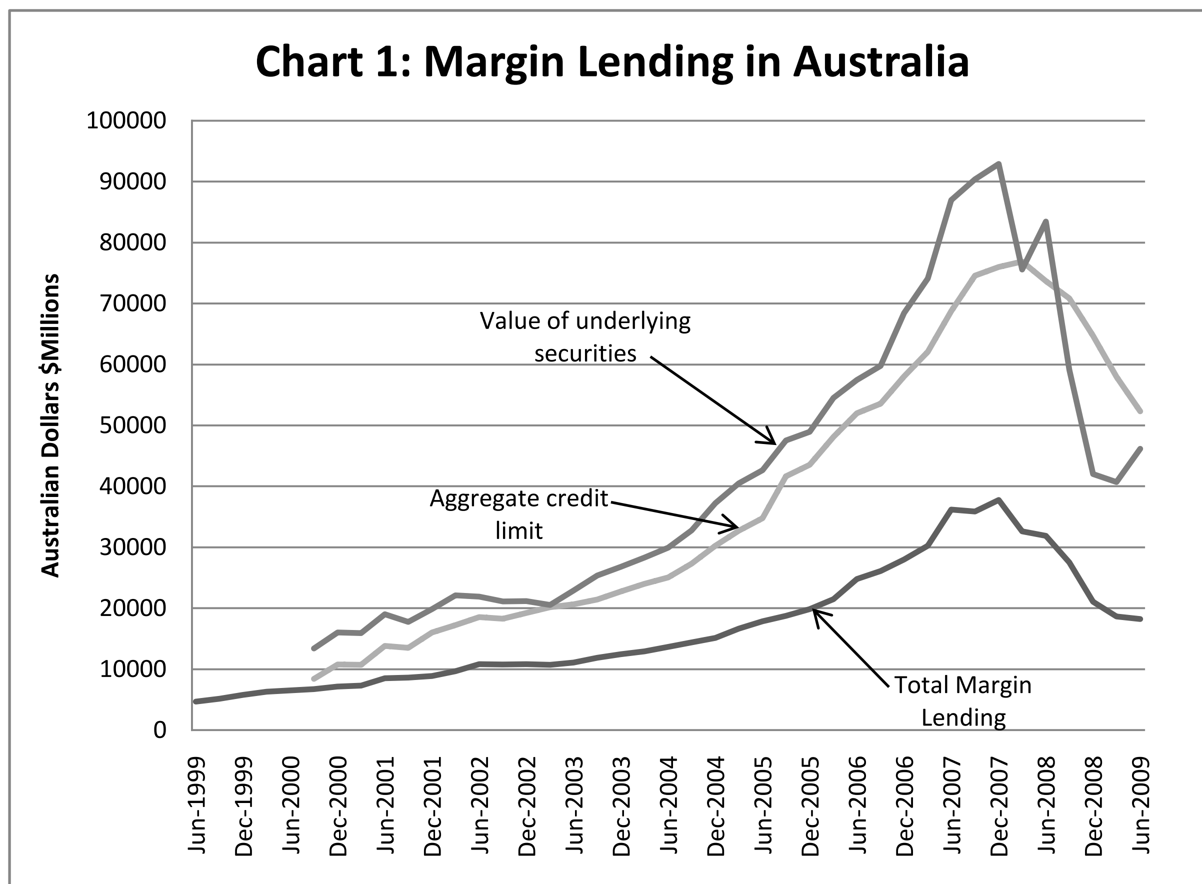
Margin Lending in Australia

4.14 In his second reading speech on 25 June 2009, The Hon. Chris Bowen MP said,

> Over the past 12 months, in the fall-out from several high-profile financial collapses, many investors lost hundreds of thousands of dollars due to margin loans. And in some cases, they even lost their family homes. While properly-geared margin lending, backed by full disclosure, does have a place in our financial services landscape, we cannot tolerate ordinary Australians being misled into grossly inappropriate margin loans that can cost a family everything they own.[4]

4.15 Chart 1 shows the substantial increase in how much investors have borrowed in margin loans since 1999. It also shows the 'aggregate credit limit', which is the sum of the lenders' approved loan limits, or the total amount lenders are willing to lend under margin loans. The value of the underlying security (the shares) is also depicted. The chart shows that, between December 2000 and December 2007, the proportion of total lending to the aggregate credit limit remained similar as the market for margin loans grew. Between December 2007 and December 2008, as the value of many stock market products fell, the total value of the securities used to back margin loans dropped below the aggregate credit limit, but not below the total borrowed. This chart shows aggregate figures. For some individual consumers, the value of the underlying securities may well have dropped close to the amount borrowed. In such instances, it is likely that a margin call would be issued (see Chart 2).

4 The Hon. Chris Bowen MP, *House of Representatives Hansard*, 25 June 2009 p 5.



Source: Secretariat prepared from RBA Data – Margin Lending D10 – June 2009

4.16 According to the Reserve Bank, there were 199,000 margin loan client accounts in Australia in June 2009 (from a high of 206,120 in June 2008).[5] The tendency for significant downturns in the stock market to be correlated with higher numbers of margin calls is illustrated by Chart 2.

4.17 Considering the significant increase in the use of margin loans in times of economic growth and the potential for 'mum-and-dad' investors to be adversely affected by a downturn in the stock market, the lack of regulation of these products is of great concern.

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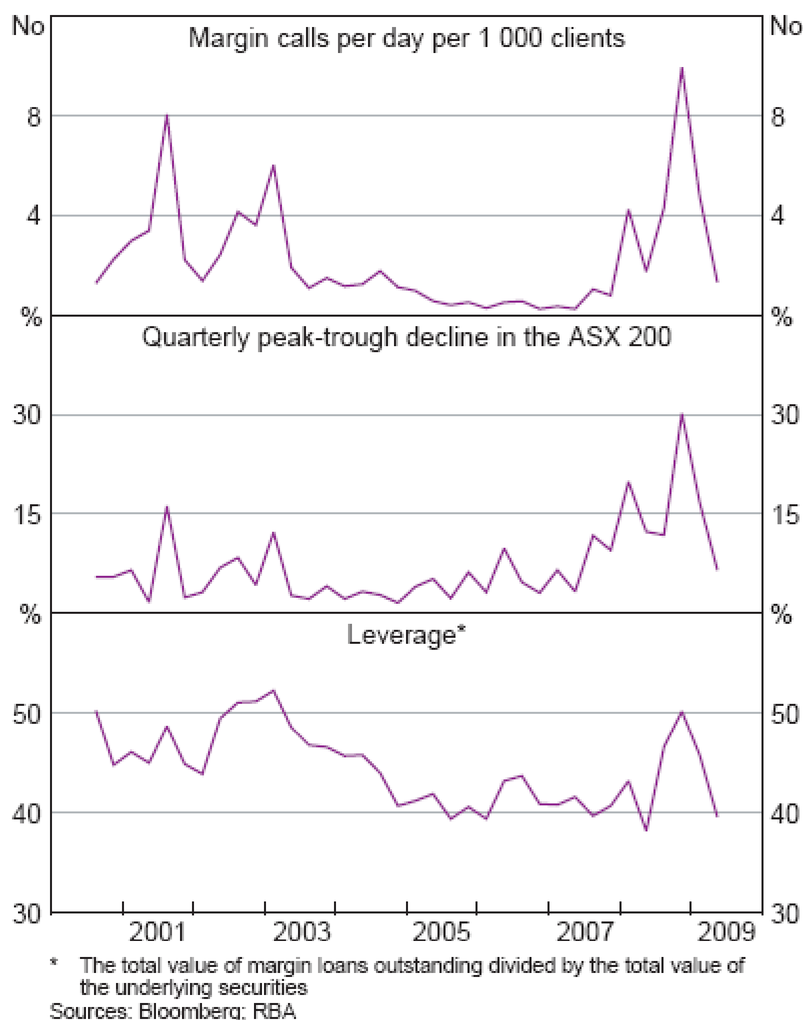
5 RBA stats D10 Margin Loans: http://www.rba.gov.au/Statistics/AlphaListing/alpha_listing_1.html (accessed 24 June 2009)

Chart 2: Margin Lending In Australia



Source: Reserve Bank of Australia – Statement on Monetary Policy August 2009

The proposed reforms

4.18 Margin lending has not been subject to any specific regulatory regime, at either the State or Commonwealth level. Treasury state:

> Margin lending facilities are not regulated as a financial product, or subject to Australian Securities and Investment Commission (ASIC) supervision relating to financial services. This is because the term 'financial product' in the relevant legislation does not cover credit products (such as margin loans) as a result of the current referral agreement with the States and Territories. Further, State and Territory legislation governing consumer credit (the Uniform Consumer Credit Code) excludes investment loans such as margin lending.[6]

6 Treasury, *Supplementary Submission 56*, p 2.

4.19 Margin loans are a contractual arrangement between the lender and the client. Primary disclosure of the terms and conditions governing the loan occurs through the lending agreement signed between the two parties. As this disclosure is not currently regulated it is not clear that investors are fully aware of the risks associated with a margin lending product.

4.20 To address inconsistencies in the regulation of margin loans, the proposed legislation includes margin loans as financial products for the purposes of Chapter 7 of the Corporations Act 2001 (which regulates the provision of financial services supplied in relation to financial products, particularly for investment purposes). This will establish an investor protection regime by ensuring that margin loan providers will be subject to the licensing, conduct and disclosure requirements in Chapter 7 as well as supervision and enforcement action by ASIC.

4.21 The margin loan regulatory regime will only apply to margin loans taken out by natural persons, including persons acting as a trustee of a trust. This means that margin loans taken out by companies, including small businesses and family companies, will not be subject to this legislation. Treasury explain that this approach avoids any potentially inappropriate outcomes for large corporate borrowers.[7]

Evidence in relation to Margin Lending

4.22 The main issues raised in relation to margin lending were the inclusion of margin loans as a financial product in the *Corporations Act*, rather than in the consumer credit legislation, the introduction of responsible lending obligations for margin lenders and the treatment of margin call notifications within the bill.

Margin Lending's inclusion in the Corporations Act

4.23 Treasury explain that the main reason for including margin lending in the Corporations Act is:

> …that it provides key protections to borrowers such as access to free dispute resolution arrangements, disclosure of important information and assurance that margin loan providers and other service providers are appropriately resourced and competent.[8]

4.24 The Securities and Derivatives Industry Association (SDIA) highlighted their concern about the impact on their members of the inclusion of margin loans as a financial product:

> Whilst understanding why the government has taken these measures in regard to margin lending, SDIA has always struggled with the categorisation of the funding facility for the purposes of financial products as a financial product itself. Our members are now faced with new

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7 Treasury, *Supplementary Submission 56*, p 5.

8 Treasury, *Supplementary Submission 56*, p 3.

> measures for disclosure and unsuitability tests which differ from other financial products.[9]

4.25 MinterEllison have argued that the proposed framework creates a significant discrepancy between how different investment products will be treated.

> The Government proposes to address other investment loans in phase two of its credit reform program. We understand that these will include loans secured by residential property mortgages to acquire investment products and securities. As these loans will relate to investment products and securities, the regulation of margin lending under the Modernisation Bill would suggest that they should be regulated under the Corporations Act. On the other hand, given they are secured by residential property, the Credit Bill would suggest that they should be regulated under that legislation. Neither result is entirely satisfactory.[10]

Licensing

4.26 The bill requires margin lenders to hold an Australian Financial Services Licence (AFSL). The Securities and Derivatives Industry Association have indicated that all their members currently hold an AFSL.[11] However, they also mention that:

> …amendments and variations to all licences will be necessary for those issuing or advising in margin lending, which will be most of our Members, and hundreds if not thousands of licensees across the industry. ASIC implemented an effective streamlining process in the lead up to re-licensing under FSR. We urge ASIC to streamline the necessary arrangements to facilitate the licence variation process during transition.[12]

4.27 In the June 2008 green paper, Treasury explain that one advantage of including margin lending in the *Corporations Act 2001* is the strength of the licensing regime and its administration by ASIC. They argue that any separate licensing regime for margin lenders would unnecessarily mirror those provisions and create regulatory overlap for businesses offering margin loans and other financial products.[13]

4.28 Treasury go on to say that inclusion of margin lending in Chapter 7 of the Corporations Act is considered to be the option which imposes the least regulatory burden on industry with respect to licensing.

> Most margin lenders and financial planners are already in possession of an Australian Financial Services License (AFSL) issued under requirements

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9 Mr David Horsfield, Managing Director and Chief Executive Officer, Securities and Derivatives Industry Association, *Proof Committee Hansard*, 24 August 2009 p 66.

10 MinterEllison, *Submission 10*, p 3.

11 Mr Douglas Clark, Securities and Derivatives Industry Association, *Proof Committee Hansard*, 24 August 2009, p 70.

12 Securities and Derivatives Industry Association, *Submission 23*, p 3.

13 Treasury, *Green Paper*, June 2008, p 32.

> specified in Chapter 7. Obtaining authorisation to issue or advise on margin loans will require a variation to an AFSL [however] this is a simpler process than requiring lenders and advisers to obtain a separate credit licence…[14]

4.29 MinterEllison have lodged an argument that a separate licensing regime should be established but concede that:

> …if the Government continues to insist that the credit licensing regime should be based upon the FSR licensing regime then credit licensing should be included within Chapter 7 of the Corporations Act.[15]

The Responsible Lending Obligations

4.30 As mentioned above, the new regulatory regime for margin lending also includes responsible lending obligations for margin loan providers.

> The main purpose is to require lenders before providing credit to make an assessment whether the product is unsuitable for the consumer. If the assessment considers that it is [unsuitable], then the loan may not be provided…
>
> While the majority of margin loans are not causing any problems for borrowers, there is evidence that in some cases borrowers have been given margin loans with features and risks that they did not fully understand.[16]

4.31 The bill includes a requirement that margin lenders do not provide a margin loan if the loan is unsuitable or the borrower cannot service the debt (or if servicing the debt would cause substantial hardship). The factors that lenders must consider are contained in the regulations.

4.32 The Securities and Derivatives Industry Association commented on whether financial advisors are in a position to make such an assessment.

> The adviser will have to address the matters set out in regulations as to whether the debt would be serviceable by the client. It would be more of a credit check like banks do: the source of funding for the equity that the client is putting in to make sure that that equity is not already encumbered and checking whether there are existing mortgages or other financing arrangements on that equity to secure the loan. These are checks that advisers do not normally make.[17]

4.33 The Financial Planning Association of Australia were less concerned about the ability of planners to assess the financial capacity of their clients. They were,

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14 Treasury, *Supplementary Submission 56*, p 4.

15 MinterEllison, *Submission 10*, p 4.

16 Treasury, *Supplementary Submission 56*, p 5.

17 Mr Douglas Clark, Securities and Derivatives Industry Association, *Proof Committee Hansard*, 24 August 2009, p 70.

however, concerned that the responsible lending obligations only apply where the financial planner was genuinely providing credit assistance. They highlighted their concern about financial planners who provide 'incidental' credit advice.

> Financial planners assist their clients with strategies to identify and achieve short- and long-term financial and lifestyle goals… A vital part of the financial planner's role is helping consumers appropriately manage debt and implement a savings plan… This is specifically not about making a recommendation about credit products; [but] they very clearly need to understand the debt and asset position of their client to be able to make suggestions about financial management.[18]

Margin Calls

4.34 Another important aspect of the bill is a provision which regulates the notification of margin calls to clients, especially where the loan has been arranged through a financial planner.

> There have been situations where it has been unclear whether it was the lender or the planner who was responsible for notifying clients when a margin call occurred. Failure to notify a client in time can result in losses for the client. The amendments require that lenders must notify clients when a margin call is made, unless clients explicitly agree to notifications being provided through their planner.[19]

4.35 The Financial Planners Association of Australia welcomed the additional safeguards contained in the legislation to ensure that arrangements to receive notifications through agents are only effected on client request.

> However, the sole notification of agents may be inappropriate in some circumstances. While the use of agents may be helpful in steady market conditions, it may be less appropriate at times of unusual market volatility, when agents may face a high volume of margin notifications, thus increasing the potential for delays in passing notifications on to clients. Where a quick response is required, it would be more appropriate for both client and agent to be informed.[20]

4.36 The Australian Financial Markets Association (AFMA), in indicating their support for a national regime to regulate margin lending, emphasised that:

> This necessarily includes procedures that support effective disclosure, proper margin call notification procedures and good lending practices.[21]

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18 Mr Deen Sanders, Financial Planning Association of Australia, *Proof Committee* Hansard, 4 August 2009 p 57.

19 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, *Explanatory Memorandum*, p 14.

20 Financial Planning Association of Australia, *Submission 7*, p 4.

21 Australian Financial Markets Association, *Submission 37*, p 1.

Committee view

4.37 The Committee supports the Government's decision to include margin loans as a financial product in Chapter 7 of the *Corporations Act 2001*.

4.38 The Committee also notes that the Parliamentary Joint Committee on Corporations and Financial Services is currently conducting an inquiry into financial products and services, including the conduct of certain organisations with regard to margin lending.[22]

4.39 The Committee feels that, as most businesses who offer margin lending products already hold Australian Financial Services Licenses, the proposed licensing regime will impose less of a burden on the industry than would be imposed if an equally strong regime were established separately.

Trustee Corporations

4.40 Trustee corporations provide, among other things, 'traditional services' such as the administration of personal trust and deceased estates, including acting as a trustee of a trust, applying for probate of a will or acting as an executor of a deceased estate. Trustee companies that wish to operate in more than one jurisdiction (i.e. in different states) must comply with differing and often inconsistent authorisation and reporting requirements. This creates considerable burdens for many trustee corporations.

4.41 As explained in the Explanatory Memorandum:

> The private trustee company industry is relatively small with ten licensed private trustee companies. The majority of these trustee companies are licensed and operate in multiple jurisdictions.
>
> There are also eight public trust offices. These trustee companies have been regulated at an entity level under State and Territory regulatory regimes. As the majority of trustee companies operate in multiple jurisdictions, the need to obtain a licence in each individual State and Territory, combined with the lack of consistency in licensing requirements, creates barriers to entry and restricts competition in the marketplace.
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> In order to offer funds management services, all of the private trustee companies hold Australian financial services licences (AFSLs). As a result, they are familiar with regulation by the Australian Securities and Investments Commission (ASIC) and the requirements of an AFSL.[23]

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22 Information about the inquiry can be found at: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/index.htm (accessed 31 August 2009)

23 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 *Explanatory Memorandum* pp 33-34.

4.42 The bill introduces a requirement that both public and private trustee companies hold AFSLs.

4.43 The legislation also streamlines the dispute resolution process available to beneficiaries to enhance the protection available for trust assets. Currently, in the absence of internal dispute resolution services voluntarily provided by the trustee company, the Supreme Court is the only avenue of recourse for beneficiaries with concerns about the management of the trust or estate.

4.44 The Commonwealth is relying on its legislative power under section 51(xx) of the Constitution (which empowers the Commonwealth to make laws with respect to foreign corporations, and trading in or financial corporations formed within the limits of the Commonwealth) to make this law, rather than seeking a referral of power from the States.

Evidence in relation to Trustee Corporations

4.45 The Trustee Corporations Association of Australia (TCA), which represents all eight Public Trustees and the majority of the 10 private statutory trustee corporations, has welcomed the announcement that the Commonwealth would take over responsibility for the regulation of trustee companies. However, they highlight their concern about how the approach will work in practice with the Commonwealth:

> assum[ing] exclusive responsibility for 'entity level' regulation of traditional trustee company services, but existing State and Territory legislation, and the rules of common law and equity… continu[ing] to govern the functions and powers of trustee companies.[24]

4.46 The TCA are concerned that the bill does not introduce unnecessary duplication or hamper the objective of enabling trustee companies to carry out their activities as efficiently as possible.

Promissory Notes and Debentures

4.47 The bill amends the *Corporations Act* to create a consistent approach to the regulation of promissory notes to address issues that arose out of the collapse of the Westpoint group. Following Westpoint's collapse, the Government undertook a review of the regulatory regime for debentures, with the aim of protecting retail investors.

4.48 Westpoint group, a property developer, collapsed in January 2006 resulting in what ASIC estimates will be a total loss of $329 million for investors in the group's financial products.[25]

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24 Trustee Corporations Association of Australia, *Submission 52*, p 3.

25 For more information on ASIC's response to the Westpoint collapse, see: https://westpoint.asic.gov.au/ (accessed 31 August 2009)

4.49 One of the main issues arising from the Westpoint case was the inconsistent regulation of promissory notes and debentures. Treasury explain:

> Promissory notes, a form of debenture and debt instrument, are used by the issuer to raise funds from retail investors. In return, retail investors receive interest on their investment. However, the current regulation of a promissory note differs depending on its value: promissory notes valued at less than $50,000 are generally regulated as debentures; at $50,000 or over, generally as financial products. This difference derives from distinctions between retail and wholesale investors incorporated in early 1980s legislation which is now considered to be anachronistic.[26]

4.50 Westpoint issued promissory notes with a face value of at least $50,000 in an attempt to obfuscate having the debt treated as promissory notes by ASIC and therefore having ASIC's jurisdiction over their compliance monitoring challenged. Because of the uncertainty, ASIC attempted to come to an agreement with Westpoint about the treatment of this debt. In a Senate Estimates hearing on 25 May 2006, ASIC gave the following evidence:

> There was an express exclusion [in the Corporations Act] for promissory notes over $50,000 from the definition of 'debentures'; that was the problem. We looked at what could be done given that that is what the situation appeared to be, that these were not covered by the legislation that we are tasked to regulate. We developed an argument that we thought had some merit and we thought we needed to raise directly with Westpoint to persuade them that what they were doing, which purported to rely upon the exclusion, did not in fact do so…
>
> It would be fair to say there was a lot of toing-and-froing between ASIC and Westpoint and in particular their lawyers, Freehills—they might say 'toing-and-froing'; we might say 'cat and mousing'—over this issue. We eventually realised by the end of 2003 that we were being stalled, we were being given the run around, and we delivered an ultimatum to Westpoint to either comply with the argument that we had put forward about the Corporations Act or we would take court action. We ended up taking court action to force Westpoint to comply with the Corporations Act, based on a very difficult technical argument that in part relied upon an interpretation of the Bills of Exchange Act rather than the Corporations Act. Nonetheless, we had to fight for our jurisdiction and that is what we did.[27]

4.51 The court finally determined that the issue took the form of an interest in a managed investment scheme (rather than a debenture that had to comply with the relevant debenture provision in the Corporations Act).

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26 Treasury, *Supplementary Submission 56*, p 13.

27 Mr Mark Steward, Deputy Executive Director, Enforcement, ASIC, *Committee Hansard* 25 May 2006 p. 89.

The Proposed Reforms

4.52 The amendments proposed in this legislation seeks to improve regulatory certainty and clarify the law by amending the definition of debentures so that promissory notes valued at above $50,000 fall into the definition and therefore are subject to the same regulatory regime.

4.53 The amendments also provide for the establishment of a register of debenture trustees who will provide a level of investor protection for debenture holders. Only certain entities are permitted to undertake this role, as set out in Chapter 2L of the Corporations Act. Trustees' duties include those set out in the Corporations Act, as well as those in ASIC's guidelines on debentures. The guidelines emphasise the need for trustees to monitor the financial position and performance of the debenture issuer.

4.54 The amendments also aim to enhance transparency by providing for public access to the list of trustees, who are required under law to represent the interests of investors and undertake important responsibilities on their behalf.

Evidence in relation to Debentures and Promissory Notes

4.55 Treasury have indicated that, during the Government's consultation process with regards to this bill, there was broad support for this amendment as it would clarify the operation of the legislation and provide consistency.[28]

> In June 2009 the Government released for consultation the Green Paper… Twenty submissions were received in relation to debentures. While four possible reforms were canvassed, after discussions with ASIC regarding its forthcoming review of debentures, it was decided to proceed initially with only the promissory notes amendment…

Conclusion

4.56 The Committee welcomes the Financial Services Modernisation reforms contained in this bill.

Recommendation 12

The Committee recommends that the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 be passed.

Senator Annette Hurley
Chair

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28 Treasury, *Supplementary Submission 56*, pg 13.