ASIC CLASS ORDER [CO 10/1034]

EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (***ASIC***) makes ASIC Class Order [CO 10/1034] under subsection 761EA(9) of the *Corporations Act 2001* (the ***Act***).

Subsection 761EA(9) of the Act allows ASIC to declare that a particular kind of facility is not a margin lending facility.

1. Background

In January 2010, Parliament amended the Act, through the *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009*, to include a margin lending facility as a type of financial product. Margin lending facilities are also known as "margin loans". The amendments also inserted a number of additional obligations on margin lenders, over and above the existing Chapter 7 obligations on financial services providers.

The primary additional obligations imposed on margin lenders are found in Division 4A of Part 7.8 of the Act and require that:

(a) A margin lender must ensure that the margin loan is suitable for the client, and, in particular, ensure that the client can service the margin loan by paying margin calls when due;

(b) A margin lender must notify the client of margin calls in a way specified by the Act or must notify the client's agent (for example, the client's advisor), where the client has arranged for the client's agent to notify the client.

Generally, the new provisions commence operation on 1 January 2011.

In early 2010, the Australian Financial Markets Association (***AFMA***) raised with ASIC, on behalf of its instalment warrant issuer members, its concern that some

instalment warrants traded on the financial market operated by ASX Limited (***ASX***), in particular, some "resetting" or "rolling" instalment warrants and some "barrier-feature" instalment warrants, may technically be caught by the definition of "margin lending facility" in the Act. AFMA was concerned that issuers might not be able to comply with the additional margin lending obligations, particularly where an investor is buying an instalment warrant on the secondary trading market where timing is critical. AFMA requested that ASIC declare that ASX-traded instalment warrants are not margin lending facilities.

Some resetting, rolling and barrier-feature ASX-traded instalment warrants might be caught by the definition of "margin lending facility" because they satisfy the elements of the definition of "standard margin lending facility" in subsection 761EA(2) of the Act, that is, where:

(a) credit is provided by the issuer to the client;

(b) the credit is used to acquire one or more marketable securities;

(c) the credit is secured by property;

(d) that secured property is the marketable security acquired; and

(e) if the loan-to-value (***LVR***) ratio rises to a specified level, the client must, or the issuer may, take action to reduce the LVR, for example, by reducing the credit amount through repaying some of the credit or through selling the underlying marketable security.

While most instalment warrants are likely to satisfy paragraphs (a) to (d) of the definition, some "resetting", "rolling" or "barrier event" instalment warrants will also satisfy paragraph (e) due to their LVR-based trigger feature and so will be a standard margin lending facility.

2. Purpose of the class order

The purpose of the class order is to exempt certain types of instalment warrants from the additional obligations imposed on margin lenders, in particular, in Division 4A of Part 7.8 of the Act. This will ensure that issuers of ASX-traded instalment warrants will be able to continue issuing ASX-traded instalment warrants to investors, including investors buying in the time-critical secondary trading market, without having to comply with the new additional obligations on margin lenders.

The instalment warrants covered by the declaration will remain otherwise regulated as a financial product under Chapter 7 of the Act.

ASIC decided to grant relief for the following reasons. Firstly, issuers would be unlikely to be able to comply with the additional margin lending obligations, particularly where an investor is buying an instalment warrant on the secondary trading market where timing is critical. Secondly, Parliament's main focus in enacting the new margin lending provisions was to regulate traditional margin loans, rather than ASX-traded instalment warrants. Thirdly, ASX-traded instalment warrants are non-recourse and thus investors' liability is limited. Finally, ASX-traded instalment warrants already receive some consumer protection under the *ASIC Market Integrity Rules (ASX Market)* and the *ASX Operating Rules*.

3. Operation of the class order

The class order declares that an instalment warrant (as defined in the class order) that is traded on the financial market operated by ASX, that is issued by a financial services licensee and that is a standard margin lending facility, is not a margin lending facility.

The class order defines an instalment warrant as a financial product where the issuer provides credit to a client to buy one or more marketable securities, which the issuer then holds on trust for the client until the client repays the credit, at which time the client then receives full, legal ownership of the marketable security. The definition also requires that the provision of credit is non-recourse so that, if the client “walks away” from the product without repaying the credit, the issuer cannot claim against the client’s other assets.

The definition of “instalment warrant” is limited to a financial product that is a security or an interest in a managed investment product. This means that, notwithstanding the declaration that the product is not a margin lending facility, the product will remain regulated by Chapter 7 of the Act as a security or an interest in a managed investment product.

4. Consultation

Before making this class order, ASIC consulted extensively with AFMA and those of its members that issue ASX-traded instalment warrants.