

21 September 2007

Fringe Credit Project
Fair Trading Policy Branch, Policy Division
Department of Tourism, Fair Trading and Wine Industry Development
GPO Box 3111
BRISBANE QLD 4001

By email: consumercredit@dtftwid@qld.gov.au

Dear Sirs

Submission on Consumer Credit Code Amendment Bill 2007 and Consumer Credit Amendment Regulation 2007 Consultation Package

Next Financial Limited (NFL) thanks you for the opportunity to comment on the Consultation Package.

NFL has considered the proposed amendment to remove the presumption that applies to a Business Purpose Declaration (**proposed amendment**) in section 11 of the Consumer Credit Code (**Code**).

Services provided by NFL

The services of NFL are relevant to this submission. NFL is a private investment manager specialising in equities, derivatives and hybrid securities. It provides a range of individually managed accounts offering discretionary and non discretionary trading, sophisticated lending and hedging strategies. It issues structured equity investments products in the form of unlisted instalment warrants. NFL's philosophy is to develop investment products and services that are designed to encourage investors to stay invested in the equity market over the long term.

As a result, gearing for investors is a major part of the business of NFL. The investor seeks credit for the purposes of investing in the products issued by NFL or offered by others but held through account services operated by NFL.

Proposed Amendments

The proposal would overturn the current practice of confirming that the Code does not apply by obtaining a declaration from the client (debtor) that the credit is being sought wholly or predominantly for business or investment purposes.

The proposed amendments would presume that financial products and services involve consumer credit unless enquiries are made and certain information is received. This poses difficulties and impracticalities in the context of NFL's products and services, to the detriment of its customers.

These proposed amendments put the onus on the credit provider to undertake a due diligence exercise of the client's purposes. The due diligence exercise is of little or no value in many cases involving financial products or services.

Many of the difficulties arise from the proposed amendment stating that the *only* way to prove that it is not for personal or domestic use is by undertaking the due diligence enquiries.

The issues are outlined below:

I. Financial Products

The financial products that NFL and similar organisations provide are regulated by the licensing, product disclosure statements and other provisions of the Corporations Act 2001 (Commonwealth).

For example, an instalment warrant is a structured gearing product. Instalment warrants are packaged investments, inseparably combining: investment assets, borrowing and limited recourse (that is, no further recourse to the investor). Economically and legally they need to be bundled together and are not able to be separated by the issuer or the investor.

The effect of the proposed amendments would require the issuer of the financial product, as a credit provider, to demonstrate it enquired into the purpose of the loan and obtain the required information. The net effect would be greater cost to the credit provider which would in turn have to pass those costs onto the investor.

In contrast, it would be better for the investor if the regulation reflects the nature of the packaged product, rather than focusing on regulation of individual components of the financial product.

Instalment warrants have three methods of application: cash, rollover and securityholder. Cash applicants pay cash in application for the instalment warrants. Rollover applicants lodge an existing instalment warrant in application for a new instalment warrant with the same underlying securities. Securityholder applicants lodge securities of the same kind as will be the underlying securities for the instalment warrants.

The three application methods address different needs of investors for accessing instalment warrants.

The inherent purpose of the loan bundled with the instalment warrant is mainly to acquire the underlying securities (with part of the loan to pay associated costs).

- For cash applicants, by the terms of the instalment warrants there is no choice but to have the loan proceeds used to acquire underlying securities and pay associated costs. AS a result of this, there is no benefit in requiring the product issuer also to enquire of the actual investor the purpose of the loan, let alone seek information to substantiate that.
- For rollover applicants, the loan funds are used to pay out the loan on the preceding instalment warrant, in order to get the new instalment warrant. Similarly, the purpose of that loan is clear and unavoidable.

Even if there is a small amount of cash paid to the successful rollover applicant for a new instalment warrant¹ (commonly called the “Cashback” amount), it would be impractical to make the enquiries of the rollover applicant as to the purpose of using the cashback amount. It would be unfair to some rollover applicants if they were denied the instalment warrant because the issuer could not establish to its satisfaction that the purpose of the rollover applicant in using the cashback amount was for investment or business purposes.

- For securityholder applicants, most of the loan proceeds will be paid to the successful applicant as a cashback amount. An issuer such as NFL could not offer instalment warrants if they were subject to the Code. Accordingly, under the proposed amendments, if NFL could not be satisfied of the investment or business purpose of the securityholder applicant in respect of use of loan proceeds, they would have to be denied access to the instalment warrant. This would be an unfair discriminatory outcome, despite the investment product being exactly the same for all investors - only the application method differs.
- NFL, in common with other product issuers, allows its products to be distributed through a wide network of independent dealer groups who separately advise their clients. The proposed amendments, however, place the burden on the issuer (NFL) to make the enquiries and to be satisfied of the outcome. This is impractical, because NFL does not have access to the client to make the enquiries.
- If the terms of the financial product include a provision for no further recourse against the investor (the usual feature of instalment warrants), there is no compelling case for adding to the regulatory burden when offering the product.

2. Financial service

NFL provides credit facilities to customers of its investment account services. While this credit is not inseparably bundled into a financial service product, there are similar issues.

The overwhelming majority of circumstances involve lending for immediate further investment in securities, or for related investment costs.

¹ because, for example, the loan amount for the new instalment is greater than the outstanding loan on the preceding instalment warrant

- If the structure of the service and credit facility is by its nature *automatically* limited to using the proceeds of the credit for investment in financial products, then there is no benefit in requiring NFL to prove that it established that it is not for domestic or personal purposes by having to make enquiries of the client.
- NFL uses a wide network of dealer groups to distribute access to its accounts service. In these cases, NFL has no direct access to the dealer groups' clients, so NFL could not make direct enquiries of the client. The proposed amendments make no mention of being able to rely on the enquiries of an independent intermediary.

3. Enquiries

There are major shortcomings in the “enquiries” approach of the proposed amendment.

- First, as mentioned above, if the contractual provisions of the financial product or service force the use of proceeds for investment and associated costs, then there is no purpose to any enquiry. (The proposed amendment does not allow for this.)
- Secondly, if the nature of the loan and its general purpose does not change but there is a possibility by way of the application alternatives that the applicant will receive some portion of the loan proceeds (as a cashback amount), then:
 - (i) it would be impractical for the product issuer to make enquiries just for some of the applicants; and
 - (ii) it would be discriminatory and unfair to treat those applicants differently while the nature of the investment for all investors remains the same.
- Thirdly, the enquiries under the proposed amendment are not practical where independent intermediaries control access to the investor.
- Fourthly, the proposed amendment does not deal with the adequacy of the enquiries. Would the credit provider have to do more than rely on statements of the investor? If not, then there is no difference from the current situation of relying on a declaration from the prospective client. If the credit provider does have to do more than rely on the statement from the prospective client, to what extent must it make enquiries?
- In a situation where the prospective client is a company or a partnership, does the credit provider have to make enquiries to obtain such documents as board minutes on the proposal? or board minutes covering resolutions authorising the credit transaction and the purpose of the use of the proceeds?
- What if the prospective client refuses to provide helpful information? Would the proposed test fail to be satisfied?

The proposed reliance on enquiries by the credit provider put an artificial, subjective test on the credit provider which cannot be meaningfully satisfied because it always depends on the responses of the applicant. Rather, it should be the applicant for the credit who takes responsibility for

statements given to the credit provider, which brings it back to letting the declaration remain an acceptable method of establishing that the Code does not apply.

4. Investment Purpose

The proposed amendment does not explain the meaning of 'investment purpose', yet it is a critical feature of the proposed test.

- If the credit relationship is as described in 'financial products' above, there is no compelling policy reason to explain why the credit provider would have to obtain information that the intention of the credit was for an investment purpose when the intention is transparent.
- Does the proposed amendment require a credit provider such as NFL to establish to *its* satisfaction what the prospective investor meant by "investment" or is it what the prospective client thinks is investment that matters? This appears to force the credit provider to make a subjective assessment of the investment nature of the purpose of the client's proposed use of the loan proceeds.
- What if there was no immediate investment proposal, but a general intention to invest later, when the market is more favourable? Would the possible delay in use of funds mean the test is failed?
- What if part of the loan proceeds were to be used for investment and the remaining part is not yet undetermined or even is earmarked for domestic purposes? Does the failure to establish investment purposes for all of the loan proceeds mean the test is failed?
- What if the loan proceeds were to be lent with little or no interest to a family member to invest in property? Would the immediate use of the proceeds on uncommercial terms mean the test is failed?

The lack of clarity of the proposed amendment invites substantial uncertainty. This is fatal to the scheme, because all of the loans could later be challenged for failure to comply with the Code if the debtor later decides to challenge whether the credit provider properly established that the loan was for investment purposes.

We find the proposed test for enquiring into investment purposes to be unworkable with no discernable benefit to consumers who use the credit wholly or predominantly for financial products or financial services, but cannot establish this to the satisfaction of the credit provider under the proposed amendments.

5. Financial Regulation

Whilst credit facilities alone are not yet regulated by the corporate and securities laws, there are a number of ways in which the regulations do apply to credit facilities. For example:

- Credit facilities bundled together with other financial products or services are regulated, including in respect of disclosure and advice to clients.

- Providers of the supply of financial services are subject to specific consumer protection provisions (which can trace their origin to the Trade Practices Act (Commonwealth) consumer protection provisions). This covers key consumer protection provisions including in respect of credit facilities provided by suppliers of financial services.
- Australian financial services licenses are strictly regulated.

The combination of extensive, strict regulation of financial products and services which include credit arrangements (with some exceptions) and extensive general regulation of financial service providers, provides a comprehensive regime of legal obligations for the protection of investors and clients of financial services, even when investment-related credit facilities are involved.

The proposed amendments do not appear to recognise that. Further, the proposed amendment appears to add additional compliance burden for no additional benefit to investors and other clients of financial services.

The level of enquiries required to satisfy the Code appears to be uncertain and contrary to the recent trend of rationalising and simplifying over-burdensome financial regulation which have been seen in practice to be to the detriment of consumers.

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NFL submits that the proposed amendment is unnecessary, unworkable and overwhelmingly likely to add additional costs and delays to be borne by all investors, with little or no benefit to any of them.

NFL once again thanks you for the opportunity to forward its submission on the proposed amendment. If you have any questions in relation to this submission, please contact Brian Fowler on (02) 8198 0161.

Yours faithfully,

Brian Fowler
Director