When is a financial product not a financial product?

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The definition of "financial product" is central to the operation of the financial services reforms in Ch 7 of the Corporations Act. In this article, the author explores the scope of that definition and critically examines recent rulings by ASIC that bills of exchange and promissory notes are not financial products for the purposes of Ch 7. He concludes that there is a strong likelihood that those rulings are not correct and outlines the consequences for industry participants if that is so. He suggests changes to the law to rectify the situation and action that ASIC and industry participants who advise on or deal in these products should be taking in the meantime to avoid a breach of the law.

INTRODUCTION

The *Financial Services Reform Act*[1] (FSRA) was enacted in 2001 to address the deficiencies identified by the Financial System Inquiry[2] (FSI) with the regulatory regime for financial products and services. The FSI had found that regime to be:

> piecemeal and varied, and … determined according to the particular industry and the product being provided. This was seen as inefficient, as giving rise to opportunities for regulatory arbitrage, and in some cases leading to regulatory overlap and confusion.[3]

In accordance with the FSI's recommendations, the FSRA inserted a new Ch 7 into the *Corporations Act*[4] introducing a single licensing regime, and a consistent and comparable disclosure regime, for all financial products.[5]

To cater for emerging products without the need to enact amending legislation, the FSRA took a flexible three-part approach to defining financial products:[6]

- a broad general definition focusing on the key functions performed by those products;[7]
- a list of specific inclusions[8] and a regulation-making power to include further products;[9] and
- a list of specific exclusions,[10] coupled with a regulation-making power to exclude further products[11] and a power for the Australian Securities and Investments Commission (ASIC) to declare products not to be financial products.[12]

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[1] *Financial Services Reform Act 2001* (Cth).

[2] *Financial System Inquiry Final Report*, March 1997 (sometimes referred to as the Wallis Report). The report is available online at: http://fsi.treasury.gov.au/content/FinalReport.asp.

[3] Explanatory Memorandum, *Financial Services Reform Bill 2001* (Cth) (FSRA Explanatory Memorandum) at [1.3]. The Explanatory Memorandum is available online at: http://scaleplus.law.gov.au/html/ems/0/2001/rtf/0642469040.rtf.

[4] Unless otherwise stated, references to Chapters, Parts, divisions, subdivisions and sections of an Act are to the *Corporations Act 2001* (Cth) (*Corporations Act*) and references to regulations are to the *Corporations Regulations 2001* (Cth) (*Corporations Regulations*), in each case as amended and in force at the date of publication of this article.

[5] FSRA Explanatory Memorandum, n 3 at [1.4].

[6] FSRA Explanatory Memorandum, n 3 at [6.36] and [6.37]. See also *Corporations Act* s 762A.

[7] *Corporations Act* s 763A(1).

[8] *Corporations Act* s 764A(1).

[9] *Corporations Act* s 764A(1)(m).

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THE GENERAL DEFINITION OF FINANCIAL PRODUCT

Section 763A(1) of the *Corporations Act* defines a financial product as a facility[13] through which, or through the acquisition of which, a person:

(a) makes a financial investment;

(b) manages financial risk; or

(c) makes non-cash payments.

If a particular facility is of a kind through which people commonly do one of these things, it is a financial product even if it is acquired by a particular person for some other purpose.[14]

A facility that is a financial product when initially acquired retains that character when it is on-sold, regardless of the intention of the person buying it.[15]

For these purposes, a person (the investor) *makes a financial investment* if:

(a) the investor gives money or money's worth (the contribution) to another person and any of the following apply:

(i) the other person uses the contribution to generate a financial return or other benefit for the investor;

(ii) the investor intends that the other person will use the contribution to generate a financial return or other benefit for the investor (even if no return or benefit is in fact generated);

(iii) the other person intends that the contribution will be used to generate a financial return or other benefit for the investor (even if no return or benefit is in fact generated); and

(b) the investor has no day-to-day control over the use of the contribution to generate the return or benefit.[16]

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[10] *Corporations Act* s 765A(1).

[11] *Corporations Act* s 765A(1)(y).

[12] *Corporations Act* s 765A(1)(z) and (2).

[13] "Facility" is defined in s 762C. It includes: (a) intangible property; (b) an arrangement or a term of an arrangement (including a term that is implied by law or that is required by law to be included); or (c) a combination of intangible property and an arrangement or term of an arrangement. Thus, a share is a "financial product" – it is intangible property, and therefore a "facility", through the acquisition of which a person "makes a financial investment" (see n 16 and accompanying text).

[14] *Corporations Act* s 763A(2).

[15] *Corporations Act* s 763A(3), which provides that a facility does not cease to be a financial product merely because it has been acquired by a person other than the person to whom it was originally issued and that person, in acquiring the product, was not making a financial investment or managing a financial risk. This particular provision is required because of the way in which making a financial investment is defined in s 763B (see n 16 and accompanying text). That definition only caters for the initial acquisition of a financial product in the primary market and does not pick up subsequent purchases of a product in the secondary market. So while in the normal sense of the expression a person who buys a financial instrument in the secondary market by way of investment would be said to be "making a financial investment", that will not be true for the purposes of Ch 7, given the particular meaning given to that phrase in s 763B.

[16] *Corporations Act* s 763B. The notes to that section give as examples of making a financial investment: (a) a person paying money to a company for the issue to the person of shares in the company (the company uses the money to generate dividends for the person and the person, as a shareholder, does not have control over the day-to-day affairs of the company); and (b) a person contributing money to acquire interests in a registered scheme from the responsible entity of the scheme (the scheme uses the money to generate financial or other benefits for the person and the person, as a member of the scheme, does not have day-to-day control over the operation of the scheme). Examples of actions that do not constitute making a financial investment are: (a) a person purchasing real property or bullion (while the property or bullion may generate a return for the person, it is not a return generated by the use of the purchase money by another person); or (b) a person giving money to a financial services licensee who is to use it to purchase shares for the person. In the latter case, the notes say that while the purchase of the shares will be a financial investment made by the person, the mere act of giving the money to the licensee will not of itself constitute making a financial investment. While the second part of this statement is correct, the first part is not necessarily correct. Technically, the purchase of shares will only involve the making of a financial investment if it takes place by way of a subscription for new shares rather than a purchase of existing shares. If it is a purchase of existing shares, that will still be an acquisition of a financial product by virtue of s 763A(2) (see n 14 and accompanying text) and, more particularly, s 763A(3) (see n 15 and accompanying text), but it will not be the making of a financial investment as defined in s 763B.

A person *manages financial risk* if they manage the financial consequences to them of particular circumstances happening or avoid or limit the financial consequences of fluctuations in, or in the value of, receipts or costs (including prices and interest rates).[17]

A person *makes non-cash payments* if they make payments, or cause payments to be made, otherwise than by the physical delivery of Australian or foreign currency in the form of notes and/or coins.[18]

SPECIFICALLY INCLUDED PRODUCTS

Section 764A(1) of the *Corporations Act* sets out a list of things that are stated to be financial products, whether or not they fall within the general definition of that term in s 763A(1). In broad terms, these include:

- securities;
- various interests in managed investment schemes;
- derivatives;
- various general insurance and life insurance products;
- superannuation interests;
- retirement savings accounts;
- deposit-taking facilities made available by an authorised deposit-taking institution (ADI);
- debentures, stocks or bonds issued or proposed to be issued by a government; and
- foreign exchange contracts that are not derivatives and do not involve a simple exchange of one currency for another that is to be settled immediately.

In the Explanatory Memorandum for the FSRA, it was emphasised that this list of specific financial products was not intended to be a "catch all list" but rather served two purposes: first, to provide examples of some of the financial products that fall within the general definition in s 763A(1) and, second, to bring the nominated products within the FSRA regime whether or not they are caught by that general definition.[19]

While most of the currently recognised categories of financial products have been dealt with specifically in s 764A(1), there are some that fall between the cracks because of definitional gaps, most particularly in the definitions of "security" and, in turn, "debenture".

For the purposes of Ch 7, "security" is defined as:

(a) a share in a body;

(b) a debenture of a body;

(c) a legal or equitable right or interest in a security covered by (a) or (b) above; or

(d) an option to acquire, by way of issue, a security covered by (a), (b) or (c) above.[20]

[17] *Corporations Act* s 763C. The notes to that section give as examples of managing a financial risk: (a) taking out insurance; and (b) hedging a liability by acquiring a futures contract or entering into a currency swap. An example of an action that does not constitute managing a financial risk is employing a security firm (while that is a way of managing the risk that thefts will happen, it is not a way of managing the financial consequences if thefts do occur).

[18] *Corporations Act* s 763D(1). The notes to that section give as examples of a facility for making non-cash payments: (a) a direct debit facility attaching to a deposit account; (b) a cheque facility; (c) a purchased payment facility such as a smart card; and (d) traveller's cheques.

[19] FSRA Explanatory Memorandum, n 3 at [6.36], [6.61] and [6.62].

[20] *Corporations Act* s 761A. Carved out from this definition is an "excluded security" (a security conferring an interest in a retirement village: *Corporations Act* s 9). The definition of "security" does not include an option to purchase an existing security unless it confers a legal or equitable right or interest in the underlying security within para (c) of that definition. An option to purchase an existing security that does not confer such a right or interest is intended to be regulated under the FSRA as a derivative rather than a security. Note that a transferable option to purchase an existing security that does confer a legal or equitable right or interest in the underlying security within para (c) will by definition be a "warrant" (*Corporations Regulations*

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"Debenture" in turn is defined as a chose in action that includes an undertaking by a body to repay as a debt money deposited with or lent to the body, excluding an undertaking:

(a) to repay money deposited with or lent to the body by a person if:
  (i) the person deposits or lends the money in the ordinary course of a business carried on by the person; and
  (ii) the body receives the money in the ordinary course of carrying on a business that neither comprises nor forms part of a business of borrowing money and providing finance;

(b) by an Australian ADI to repay money deposited with it, or lent to it, in the ordinary course of its banking business;

(c) to pay money under:
  (i) a cheque;
  (ii) an order for the payment of money; or
  (iii) a bill of exchange;

(d) to pay money under a promissory note that has a face value of at least $50,000;

(e) by a body corporate to pay money to a related body corporate; or

(f) to repay money that is prescribed by the regulations (currently nothing is prescribed).[21]

By being excluded from the definition of "debenture", the debt products mentioned in (a) to (e) above are not "securities". They may still, however, be financial products under the general definition of that term in s 763A(1), because, for example, they involve the making of a financial investment or are a facility for making non-cash payments, or if they are caught by one of the other express inclusions in s 764A(1).

Of the products excluded from the definition of "debenture", some are clearly regulated financial products for the purposes of Ch 7. ADI deposits within para (b) are regulated deposit products.[22] Cheque facilities within para (c)(i) and money orders within para (c)(ii) issued by anyone other than Australia Post are regulated non-cash payment facilities.[23]

Others are clearly not regulated financial products for the purposes of Ch 7. A deposit or loan within para (a) will almost certainly fall within the definition of "credit facility" and is therefore excluded from being a regulated financial product by s 765A(1)(h).[24] A money order within para (c)(ii) that is issued by Australia Post is likewise excluded by s 765A(1)(y) and reg 7.1.07F. An undertaking by a body corporate to pay money to a related body corporate within para (e) is similarly excluded by s 765A(1)(b).

The only products that are excluded from the definition of "debenture" and are of an indeterminate status for the purposes of Ch 7 are bills of exchange within para (c)(iii) and promissory notes within para (d). We return to analyse whether these products are financial products below.

SPECIFICALLY EXCLUDED PRODUCTS

Section 765A of the *Corporations Act* contains a diverse list of things that are stated not to be financial products, even if they fall within the general definition of that term in s 763A(1) or within the specific inclusions in s 764A(1). Relevantly, these include:

reg 1.0.02(1)) and will be regulated as if it were a derivative rather than a security, even though technically it falls within the definition of "security" (*Corporations Regulations* regs 6D.5.01 and 7.9.07A).

[21] *Corporations Act* s 9. If a chose in action that includes an undertaking by a body to pay money as a debt is offered as consideration for the acquisition of securities under an off-market takeover bid, or is issued under a compromise or arrangement under Pt 5.1 of the *Corporations Act*, the undertaking is taken to be an undertaking to repay as a debt money deposited with or lent to the body.

[22] *Corporations Act* s 764A(1)(i).

[23] *Corporations Act* ss 763A(1)(c) and 763D.

[24] See nn 26-38 and accompanying text.

- an undertaking by a body corporate to pay money to a related body corporate;[25]
- a credit facility within the meaning of the regulations;[26] and
- a facility for making non-cash payments, if payments made using the facility will all be debited to such a credit facility.[27]

At this juncture, it is worth pointing out that Parliament saw fit to include in s 765A, and therefore exclude from being a financial product, only one of the seven categories of debt products that are excluded from the definition of debenture mentioned above, namely, an undertaking by a body corporate to pay money to a related body corporate. Notably, it did not see fit to mention in s 765A bills of exchange or promissory notes.[28]

Having said that, bills of exchange and promissory notes are negotiable debt instruments that are typically used to raise finance or to defer payment obligations.[29] They therefore have a credit element that potentially attracts the exclusion for credit facilities.

For these purposes, the *Corporations Regulations* define the concept of "credit" expansively. Generally, it includes any contract, arrangement or understanding under which payment of a debt owed by a person to another person is deferred or a person incurs a deferred debt to another person.[30] Specifically, it includes issuing, indorsing or otherwise dealing in a promissory note[31] and drawing, accepting, indorsing or otherwise dealing in a negotiable instrument, including a bill of exchange.[32]

The *Corporations Regulations* further define "credit facility", relevantly, to include:[33]

(a) the provision of credit:

(i) for any period;
(ii) with or without prior agreement between the credit provider and the debtor;
(iii) whether or not both credit and debit facilities are available;
(iv) that is not a financial product mentioned in s 763A(1)(a) of the *Corporations Act*;[34]
(v) that is not a financial product mentioned in s 764A(1)(a), (b), (ba), (f), (g), (h) or (j) of the *Corporations Act*;[35] and
(vi) that is not a financial product mentioned in s 764A(1)(i) of the *Corporations Act*,[36] other than a product the whole or predominant purpose of which is, or is intended to be, the provision of credit;[37] and

[25] *Corporations Act* s 765A(1)(b).
[26] *Corporations Act* s 765A(1)(h)(i).
[27] *Corporations Act* s 765A(1)(h)(ii).
[28] Bills of exchange and promissory notes are not mentioned anywhere in the FSRA Explanatory Memorandum, apart from a minor and irrelevant reference to bank bill futures at [6.73].
[29] "The bill of exchange performs a dual function, that of giving credit to the debtor until the bill matures, and of giving the creditor immediate funds by means of its discount. Employed in this way, the bill of exchange is also a means of raising loan finance. The efficacy of such arrangements means that bills of exchange take a number of forms such as accommodation bills, which are issued primarily for the purpose of financial loan transactions and are the basis of the majority of transactions in the short-term money market, and trade bills, which continue to be used in both domestic and international trade." Per Working Group of Officials, *National Competition Policy Review of the Bills of Exchange Act 1909*, July 2003, p 10, available online at: http://www.treasury.gov.au/documents/688/PDF/Final%20Bills%20of%20Exchange%20Act%20Review.pdf.
[30] *Corporations Regulations* reg 7.1.06(3)(a).
[31] *Corporations Regulations* reg 7.1.06(3)(b)(xi).
[32] *Corporations Regulations* reg 7.1.06(3)(b)(xii).
[33] Also included within the definition of "credit facility" are loans by pawnbrokers, loans by trustees of deceased estates to beneficiaries, loans by employers to employees and related guarantees and mortgages given in respect of credit facilities: *Corporations Regulations* reg 7.1.06(1)(c) – (h).
[34] That is, one that involves the making of a financial investment (see n 16 and accompanying text).
[35] That is, a security, an interest in certain managed investment schemes, a life policy or sinking fund policy within the meaning of the *Life Insurance Act 1995* (Cth) that is not a contract of insurance, a superannuation interest, a retirement savings account, or a debenture, stock or bond issued or proposed to be issued by a government.
[36] That is, a deposit-taking facility made available by an ADI.
[37] *Corporations Regulations* reg 7.1.06(1)(a), as recently amended by the *Corporations Amendment Regulations 2003 (No 10)*, Commonwealth Statutory Rule No 368 of 2003. Prior to the adoption of the latter regulations, reg 7.1.06(1)(a)(iv) excluded the s 764A(1) products now referred to in reg 7.1.06(1)(a)(v) as well as deposit products mentioned in s 764A(1)(i),

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(b) a facility:
   (i) known as a bill facility; and
   (ii) under which a credit provider provides credit by accepting, drawing, discounting or indorsing a bill of exchange or promissory note.[38]

The effect of reg 7.1.06(1)(a)(iv) – (vi), above, is that credit facilities of the type mentioned in reg 7.1.06(1)(a)(i) – (iii) that involve the making a financial investment within the purview of s 763A(1)(a), or include products that are specifically stated to be financial products under the nominated provisions in s 764A(1), are excluded from the combined operation of s 765A(1)(h) and reg 7.1.06. They are thus still regulated as financial products even though they have credit aspects to them. However, reg 7.1.06A operates to ensure that the credit aspects of those products are excluded from regulation while the investment aspects remain appropriately regulated. This is achieved by providing that the debtor is taken to be the issuer of the financial product rather than the credit provider, and that the provision of financial product advice to the debtor or its representatives, and a dealing in the credit facility by the credit provider or its representatives, are taken not to be the provision of a financial service.[39]

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reg 7.1.06(1)(a)(v) excluded the s 763A(1)(a) investment products now referred to in reg 7.1.06(1)(a)(iv) and there was no reg 7.1.06(1)(a)(vi). The *Corporations Amendment Regulations 2003 (No 10)* adopted new reg 7.1.06(1)(a)(iv) – (vi). Deposit products were taken out of the list of specific financial products referred to in the old reg 7.1.06(1)(a)(iv) (now reg 7.1.01(1)(a)(v)) and dealt with in the new reg 7.1.06(1)(a)(vi).

The purpose of the new para (vi) was said to be to ensure "that products that provide both credit and deposit facilities (for example, a credit card facility into which deposits may be made) under a single financial product are included in the credit facility exemption, provided they satisfy the [whole or predominant purpose] test". It was also said that "where a product provides both credit and deposit facilities within a single financial product, the [whole or predominant purpose] test will determine whether or not the product falls within the credit facility exemption. However, the amendment would only provide relief in relation to an offering that constitutes a single financial product where the whole or predominant purpose of which is the provision of credit. It would not, for example, apply in relation to an offering involving two separate (albeit possibly linked) financial products, one of which is a credit facility": see the Explanatory Statement, *Corporations Amendment Regulations 2003 (No 10)*, Sch 1, item 2, available online at: http://scaleplus.law.gov.au/html/ess/0/2003/0/20031223368.htm.

One of the problems with the new reg 7.1.06(1)(a)(vi) is that it does not identify the person whose purpose is to be tested. If it is the ADI providing the deposit product, the provision works as intended. If it is the customer making the deposit, it does not. When a customer deposits money with an ADI, the whole or predominant purpose of that deposit from the customer's perspective is the provision of credit by the depositing customer to the ADI (that is why the ADI pays interest to the customer on the deposit). Accordingly, with reg 7.1.06(1)(a)(vi) drafted as it is, there is now an argument that an ADI deposit in all cases will be an unregulated credit facility under reg 7.1.06(1)(a)(vi) and s 765A(1)(h)(i) because the whole or predominant purpose of the deposit is, or is intended to be, the provision of credit by the depositing customer to the ADI.

[38] *Corporations Regulations* reg 7.1.06(1)(b). The reference in reg 7.1.06(1)(b)(ii) to promissory notes would seem to be an error. While many of the provisions in the *Bills of Exchange Act 1909* (Cth) regulating bills of exchange also apply to promissory notes (see s 95 of the *Bills of Exchange Act 1909* (Cth)), a promissory note is quite a different instrument to a bill of exchange (compare the definitions of those two terms in ss 8 and 89 of the *Bills of Exchange Act 1909* (Cth)). Hence, one would not normally regard a facility where the underlying instrument is a promissory note rather than a bill of exchange as a "bill facility", as referred to in reg 7.1.06(1)(b)(i). Further, while one can discount or indorse a promissory note, one does not accept or draw a promissory note, as referred to in reg 7.1.06(1)(b)(ii) (see s 95(2) and (3)(b) of the *Bills of Exchange Act 1909* (Cth)).

[39] *Corporations Regulations* reg 7.1.06A(2) and (3). See also *Corporations Act* s 762B, which is headed "What if a financial product is part of a broader facility?" and provides that if a financial product is a component of a facility that also has other components, Ch 7 of the *Corporations Act* only applies in relation to the facility to the extent it consists of the component that is the financial product. A note to s 762B mentions that, for example, Pt 7.9 will not require disclosures to be made in relation to those other components.

The FSRA Explanatory Memorandum, n 3, at [6.38], gave as an example of how s 762B might operate a banking product involving dual credit and debit facilities. It said that Ch 7 would only apply to the debit aspects of the facility and not the credit aspects.

It could be argued that s 762B also applies to a single facility between two parties that is wholly an investment facility (and therefore a financial product) from the perspective of one of them and wholly a credit facility (and therefore not a financial product) from the perspective of the other, so as to regulate the former but not the latter (that is to say, that the investment and credit aspects of the facility are separate "components" for the purposes of s 762B). On that argument, regs 7.1.06(1)(a)(iv) – (vi) and 7.1.06A would not have been necessary. Having regard to the heading and note to s 762B and the exposition of its intended effect in the FSRA Explanatory Memorandum, that argument perhaps pushes the meaning of "component" and the boundaries of s 762B too far.

Regulations 7.1.06(1)(a)(iv) – (v) and 7.1.06A were first introduced by the *Corporations Amendment Regulations 2002 (No 3)*.[40] The Explanatory Statement for those regulations stated:

> Regulation 7.1.06 previously had the effect that no credit facility (as defined in that regulation) was a financial product. However, there are a number of investment products which are either mentioned in section 764A or fall within the definition of financial product through paragraph 763A(1)(a) that could also be within the definition of credit facility. These include debentures and basic deposit products. Although these products are facilities for making a financial investment, they are potentially also credit facilities. For example, a debenture is a facility for making an investment from the perspective of the person acquiring the debenture but from the issuer's point of view they are basically a form of credit. Therefore, these facilities may not currently be financial products within the meaning of the Act.
>
> The amendment to regulation 7.1.06 provides that where a financial product is one of a number of the specific inclusions in section 764A or is an investment product as defined in paragraph 763A(1)(a) then it is not a credit facility and, thus, not exempt from the definition of a financial product. *This qualification to the definition of a credit facility would only apply to the general part of the definition of credit facility in paragraph 7.1.06(1)(a), the specific inclusions mentioned in the other paragraphs of that subregulation would continue to be credit facilities in all cases*.[41]
> (emphasis added)

Hence it would seem that these provisions were specifically not intended to apply to bill facilities of the type mentioned in reg 7.1.06(1)(b).

THE INTERACTION OF THE THREE LIMBS

The specific exclusions in s 765A(1) take precedence over the other two limbs of the definition of financial product.[42] Consequently, if something is excluded from being a financial product under that section (for example, because it is a credit facility), it cannot be a financial product even if it is expressly mentioned in s 764A(1) or otherwise falls within the general definition of financial product in s 763A(1).

The general definition of financial product in s 763A(1) is supplemented by, and subordinate to, the list of specific inclusions in s 764A(1).[43] It also operates subject to the provisions dealing with incidental products in s 763E.[44] This latter section applies to products where they are an incidental component of a facility that also has other components, or where they are a facility that is incidental to another facility, where the facility or that other facility (as the case may be) does not have as its main purpose the making of a financial investment, managing a financial risk or making non-cash payments. The effect of the section is to deem the incidental product not to be a financial product under ss 763A – 763D.[45]

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[40] *Corporations Amendment Regulations 2002 (No 3)*, Commonwealth Statutory Rule No 41 of 2002, Sch 1, cll 10 and 11. They were subsequently modified by the *Corporations Amendment Regulations 2003 (No 10)*, Commonwealth Statutory Rule No 368 of 2003, Sch 1, cll 2 – 4: see n 37.

[41] Explanatory Statement, *Corporations Amendment Regulations 2002 (No 3)*, Item 1 (in the attachment under the heading "Treatment of certain financial products which are also credit facilities – amendment to regulation 7.1.06 and regulation 7.1.06A"), available online at: http://scaleplus.law.gov.au/html/ess/0/2002/0/20020307041.htm.

[42] The inclusions in s 764A(1) are expressed to operate subject to subdiv D (s 765A) and the exclusions in s 765A(1) are expressed to operate despite anything in subdivs B or C (ss 763A – 763D and s 764A respectively). See also *Corporations Act* s 762A(3).

[43] *Corporations Act* s 762A(2). See also n 19 and accompanying text.

[44] See the concluding words to ss 763A(1) and 763E(1).

[45] Paragraph 6.46 of the FSRA Explanatory Memorandum, n 3, stated that s 763E was intended to ensure that the general definition of financial product in s 763A(1) did not pick up a range of consumer transactions that have an element, but not the primary purpose, of doing one of the three things mentioned in that definition. It noted, for example, that the definition of managing a financial risk could potentially cover warranty periods or guarantees in contracts for the sale of goods, or card registration services with the incidental benefit that the consumer will not be liable of any unauthorised use of a credit card between the time the service is notified of the loss and the time the service notifies the issuing bank. Similarly, a security bond arrangement by a telecommunications provider providing for the payment of interest could potentially be a facility for making a financial investment.

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The word "incidental" can, of course, have a number of meanings. It can mean "naturally attaching to", "occurring as something casual or of secondary importance" or "following upon as a subordinate circumstance".[46] In this setting, it probably means "happening in fortuitous or subordinate conjunction".[47]

The carve-out for incidental products in s 763E only applies to the general definition of financial product. It too is subordinate to s 764A(1).[48] Thus, if a product comes within the list of things specifically stated to be financial products in s 764A(1), it will be a financial product even if it is incidental to another facility that is not a financial product.[49]

BILLS OF EXCHANGE

On 20 November 2003, ASIC published a frequently asked question (FAQ) on its website regarding the status of bills of exchange as financial products under the *Corporations Act*. Perhaps emboldened by the italicised words in the passage from the Explanatory Statement for the *Corporations Amendment Regulations 2002 (No 3)* quoted above,[50] ASIC pronounced:

> We consider that a bill of exchange, including a bank bill, issued on ordinary commercial terms, is generally not a financial product for the purposes of the *Corporations Act* …
>
> Generally, we take the view that a bill of exchange falls within the exclusion for credit facilities: reg 7.1.06(a) [*sic*].[51] A credit facility is not a financial product for the purposes of the *Corporations Act* …[52]

At first blush, this seems a surprising outcome. Given the tripartite approach Parliament took to defining financial products, if it had intended bills of exchange to be wholly excluded from Ch 7, you would have expected it to include them in the list of products specifically stated not to be financial products under s 765A, rather than leave it to a chance construction of the exclusion for credit facilities to achieve that result.

ASIC qualified its pronouncement above by adding:

> However, some bills of exchange may still be a financial product under the *Corporations Act* if, for example, they are interests in a managed investment scheme or *form part of a facility for making a financial investment*.[53]
>
> (emphasis added)

The highlighted text in this quotation does not withstand close legal analysis. As mentioned above, the general definition of financial product in s 763A(1), which captures products pursuant to which a person makes a financial investment, is subject to the exclusions in s 765A. Hence, if a bill of exchange is an excluded credit facility under s 765A(1)(h), as ASIC says it generally will be, it cannot be a financial product under ss 763A(1)(a) and 763B, whether or not it forms part of a facility for making a financial investment.

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[46] *The New Shorter Oxford English Dictionary* (4th ed, Clarendon Press, 1993).

[47] *DPP v United Telecasters Sydney Ltd* (1990) 168 CLR 594 at 612; 91 ALR 1, per Toohey and McHugh JJ (albeit in a different context).

[48] See the concluding words to s 763E(1).

[49] Hence, products such as consumer credit insurance offered as part of a credit facility, and superannuation offered as part of a contract of employment, are still financial products even though they are incidental to things that are not financial products (credit facilities and contracts of employment respectively): FSRA Explanatory Memorandum n 3 at [6.47].

[50] See n 41 and accompanying text.

[51] The reference here to "reg 7.1.06(a)" presumably should be to reg 7.1.06(1) (the definition of "credit facility"), or more specifically to reg 7.1.06(1)(b) (the particular exclusion for "bill facilities"). It is possible that ASIC may have meant to refer to reg 7.1.06(1)(a) – if it was of the view that bills of exchange fall within the general carve-out for credit facilities in that regulation rather than within the specific carve-out for bill facilities in reg 7.1.06(1)(b) (see nn 33-39 and accompanying text) – but if that was its view, then its conclusion that bills of exchange are excluded credit facilities pays insufficient heed to reg 7.1.06(1)(a)(iv) (see n 34 and the text accompanying n 83).

[52] ASIC, Frequently Asked Questions about FSR QFS 132, *Is a bill of exchange a financial product?*, 20 November 2003: http://www.asic.gov.au/asic/asic.nsf/ASIC+FSR+FAQ+DisplayW?ReadForm&unid=51C788323D373F77CA256DE20012538B.

[53] ASIC, n 52.

Perhaps what ASIC meant to say here is that a bill of exchange might be a component of a larger facility that has as other components the making a financial investment and the fact that the bill of exchange itself might be an excluded credit facility would not prevent the investment components of the larger facility from being regulated as a financial product.[54]

Identifying the relevant facility or facilities

One of the real difficulties that the general definition of financial product poses is determining where a particular "facility"[55] begins and ends and, if there is more than one facility involved, how they relate to each other.

The *Corporations Act* contemplates that a financial product, which must be a facility in its own right,[56] may be a component part of a broader facility with other components and that the broader facility may or may not constitute a financial product.[57] It also contemplates that a financial product may be a separate but related facility to another facility and that the other facility may or may not constitute a distinct financial product.[58]

As some facilities are regulated by Ch 7 (financial products) and other facilities are not (credit facilities), where you draw the boundaries around and between those facilities will obviously affect the regulatory outcome. To illustrate the point with an extreme example, consider a typical project financing transaction. This may involve:

- a commitment by the financiers to subscribe for, or underwrite the issue of, shares in the project vehicle (regulated securities);
- a commitment by the financiers to provide credit to the project vehicle pursuant to a bill acceptance and discount facility (an unregulated credit facility);
- the provision by the financiers of day-to-day banking facilities to the project vehicle, including deposit accounts (regulated deposit products) and cheque accounts (regulated non-cash payment facilities);
- the provision of hedging facilities by the financiers to the project vehicle (regulated derivatives); and
- a requirement on the part of the financiers as part of the security arrangements that the project vehicle enter into various insurance policies to protect its assets or cashflows (regulated insurance products).

Is this one big credit facility (albeit with different components) that is wholly excluded from regulation under s 765A(1)(h) or a number of separate but related facilities, the regulatory ramifications of which have to be independently determined? A common sense construction giving effect to the intended reach of the FSRA would obviously dictate the latter answer. The position, however, may not always be so clear cut and a bill facility is perhaps a prime example.

It is typically the case that the person who buys a bill of exchange as an investment is quite divorced from the actual provision of finance to the drawer of the bill of exchange:

> The most usual form of a bill of exchange drawn under a bill facility from a bank is a bill:
>
> - drawn by the customer on the bank;
> - made payable to the customer or at the order of the customer; and

[54] See *Corporations Act* s 762B and n 39. If this is in fact what ASIC meant, then it is supportive of the construction suggested below that a typical bill acceptance and discount facility involves two facilities: (1) a credit facility under which the bank provides credit to its customer by accepting and discounting bills drawn by the customer; and (2) an investment facility under which the bank sells those bills to customers wishing to invest in that type of debt instrument. See n 60 and the accompanying text, particularly the three full paragraphs preceding that note.

[55] See n 13 and accompanying text.

[56] *Corporations Act* s 763A(1) defines a financial product as a *facility* through which, or through the acquisition of which, a person does one of the three things mentioned in that section.

[57] See *Corporations Act* ss 762B and 763E(1)(a)(i).

[58] See *Corporations Act* s 763E(1)(a)(ii). See also the passage quoted from the Explanatory Statement for the *Corporations Amendment Regulations 2003 (No 10)*, n 37, referring to "two separate (albeit possibly linked) financial products, one of which is a credit facility" (although, of course, a credit facility is not a financial product for these purposes).

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> - endorsed by the customer (as payee) in blank to enable the bill to be sold to third parties …
>
> In the usual case, a bank providing a bill facility undertakes not only to accept the bill, but also to purchase or procure the discounting of the accepted bill and to pay the customer a predetermined price for the bill – either by reference to the bank's own bill rate or the BBSW rate, plus a margin. The bank may then sell the bill or it may retain the bill in its portfolio. The predetermined amount paid to the customer is not affected by how the bank subsequently deals with the bill. If the bank sells the bill in the interbank market, then (other things being equal) it will sell it at a lower rate of discount and therefore for a larger amount than the amount it pays to its customer. By doing this, the bank will achieve a return on its investment.[59]

There are at least two views available as to what constitutes the relevant "facility" in this typical case. The first is that the facility is the totality of the arrangement between the person being provided with credit under the bill facility (the drawer of the bill), the bank initially providing that credit, and the person (if any) to whom the bank subsequently sells the bill to liquefy its commitment under the facility. On this view, the acceptance of the bill by the bank and its subsequent sale to the first investor who buys it would all be part and parcel of the provision of credit to the drawer of the bill and the overall facility would therefore be an excluded credit facility and not a financial product.

The other, and it is submitted overwhelmingly better, view is that there are in fact two facilities. The first is unquestionably a credit facility – the bill facility under which the bank provides credit to its customer by accepting and discounting bills drawn by the customer. The second is a quite different facility – an investment facility under which the bank sells those bills to customers wishing to invest in that type of debt instrument.

This second view is consistent with the way in which the market for bills of exchange operates in practice. As noted in the quotation above, banks may choose to retain bills of exchange in their portfolio rather than sell them to customers. If they sell them to customers, the amount they raise from the sale is quite likely to be different from the amount of finance provided to the drawer of the bills under the relevant bill facility. This indicates that the sale of a bill by a bank in the typical case mentioned above is, in form and substance, a quite separate transaction to the provision of finance by the bank to the drawer of the bill.

This second view is also consistent with the language of reg 7.1.06(1)(b)(ii), which on its face only applies to a facility under which "*a credit provider provides credit* by accepting, drawing, discounting or indorsing a bill of exchange". A person who buys a bill of exchange from a bank in the typical case mentioned above is no more providing credit to the drawer of the bill than a person who buys a share from an underwriter is providing capital to the company which first issued the share to the underwriter in an underwriting shortfall.

In fact it seems fairly clear that, for the purposes of Ch 7, a bill of exchange issued under a typical bill acceptance and discount facility (or for that matter any other type of bill facility) is a separate "facility"[60] in its own right. The bill acceptance and discount facility is a contractual arrangement, and therefore a facility, between the bank and the relevant customer setting out the terms and conditions governing the provision of credit. A bill of exchange issued under such a facility is intangible property (a negotiable debt instrument), and therefore also a facility, that gives rise to obligations in favour of the holder quite apart from the facility documentation under which it is issued. The second of the two facilities described above – the "investment facility" under which a bank sells bills of exchange to customers wishing to invest in that type of debt instrument – is in reality the bill of exchange itself.

If you accept that a bill of exchange issued under a bill acceptance and discount facility is a separate facility in its own right, how it is regulated under Ch 7 will turn upon:

- whether it involves the making of a financial investment (if not, it is unlikely to be a financial product under s 763A(1), as the other limbs of that section will generally not be applicable);

[59] Mallesons Stephen Jaques, *Australian Finance Law* (5th ed, Lawbook Co., 2003) pp 209 and 211.
[60] See n 13.

- whether it is an incidental component of, or an incidental facility to, a credit facility (in which case, s 763E will apply to deem it not to be a financial product); and
- whether it is a separate credit facility in its own right (in which case, s 765A(1)(h)(i) may apply to deem it not to be a financial product).

Is a bill of exchange a financial investment?

The analysis of whether a bill of exchange issued under a typical bill acceptance and discount facility involves the making of a financial investment is not straightforward. It requires you first to determine who is the "issuer"[61] of the bill, who is the "investor"[62] in the bill and when it is "issued".[63] In the typical case of a bill issued under a bill acceptance and discount facility, there are at least two possible characterisations in this regard.

Characterisation 1: Bank as issuer, purchaser as investor

The first characterisation is that the issuer of a bill of exchange is the bank, as the acceptor of the bill and therefore the person primarily liable under the *Bills of Exchange Act* to make the payments due under the bill to the holder.[64]

As mentioned above, the bill is usually drawn in favour of the drawer or its order, with the drawer indorsing it in blank and delivering it to the bank so that the bank is then in a position to sell the bill to whomever it pleases.

The effect of an indorsement in blank is that the bill becomes payable to bearer.[65] For so long as the bill is held by the bank in its own right, there is effectively no liability on the part of the bank to make the payments due under the bill.[66] It is only when the bank ceases to hold it in its own right, by delivering it to or indorsing it in favour of a third party or declaring that it holds it for the benefit of a third party, that a liability on the bill arises.

On this construction, the bill is issued when it is sold by the bank to the customer who first purchases it and it is that customer who is the relevant investor for the purposes of determining whether a financial investment has been made.

In this regard, the purchasing customer gives money to the bank for the bill with the intention of receiving a financial return, being the difference between the discounted amount at which it purchases the bill and the face value of the bill. The customer will have no day-to-day control over the use by the bank of that money. Accordingly, the only remaining requirement for the facility to be one involving the making of a financial investment within the meaning of s 763B is that the money provided by the customer to the bank can properly be said to be used, or intended to be used, by the bank to generate a financial return or other benefit for the investor.[67]

This issue can be argued both ways. On one argument, when a customer buys a bill of exchange from a bank as an investment, the purchase price they pay to the bank is received by the bank as a sale of property (a negotiable instrument) it holds in its own right. It is not an investment in or with the bank but in the bill of exchange. The return to the investor comes from the payment due on the bill

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[61] *Corporations Act* s 761E(4) defines the "issuer" of a financial product, in effect, as the person responsible for the obligations owed under the governing terms of the financial product to the holder of the product. One of the problems with the definition of "issuer" in s 761E(4) is that it only contemplates an instrument where there is one party liable (or, having regard to the provisions in s 23(b) of the *Acts Interpretation Act 1901* (Cth) that the singular includes the plural, multiple parties jointly liable) as issuer for the obligations under the instrument. It does not cater for an instrument where there may be two or more parties separately liable, and to different extents, for the obligations owed under the instrument (in the case of a bill of exchange, the acceptor, the drawer and possibly also persons who have indorsed the bill).

[62] See the text accompanying n 16.

[63] *Corporations Act* s 761E(2) provides that a financial product is issued to a person when it is first issued, granted or otherwise made available to a person.

[64] *Bills of Exchange Act 1909* (Cth), s 59. The characterisation of the acceptor of the bill as its issuer is also consistent with s 95(2) of the *Bills of Exchange Act 1909* (Cth), which equates the acceptor of a bill to the issuer of a promissory note.

[65] *Bills of Exchange Act 1909* (Cth), s 39(1).

[66] *Bills of Exchange Act 1909* (Cth), s 66.

[67] See n 16 and accompanying text.

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itself, which ultimately is paid by the drawer of the bill, by way of indemnity to the bank for any payments it is legally required to make as the acceptor of the bill.[68] On this argument, the test in s 763B would not be satisfied, the bill would not be a facility for making a financial investment and hence would not be a financial product. Further sales of the bill by the investor or subsequent holders in the secondary market would not attract s 763A(1)(a) or (3)[69] and would therefore not alter its status as an unregulated product.

The other argument is that the bank, as acceptor of the bill, is required to make (and in practice does make) the payment due on the bill, whether or not it receives any funds from the drawer. The economic relationship between a bank that has accepted a bill of exchange and sold it to a customer is no different to the one that exists between a bank and a customer who has been issued a debenture by the bank or who holds a deposit with the bank – the customer has given an amount of money to the bank and expects the bank to repay that amount plus interest. If these latter products satisfy the test in s 763B about use or intended use of funds,[70] then so too should a bill of exchange. On this argument, the test in s 763B would be satisfied and the bill would be a facility for making a financial investment. Accordingly, unless the exclusion for incidental products or credit facilities applies (see below), the bill would be a financial product under s 763A(1)(a). If and when the investor on-sells the bill in the secondary market, s 763A(3) would operate to maintain its status as a regulated financial product.[71] Section 763A(3) would also apply to further sales by subsequent holders in the secondary market.

Characterisation 2: Drawer as issuer, bank as investor

The alternative characterisation is that the issuer of the bill is the drawer of the bill rather than the bank accepting it, since it is the drawer who is ultimately liable under the facility documentation to make the payments due under the bill.[72] On this construction, the bill is issued when the drawer draws it and delivers it to the accepting bank with an indorsement in blank and it is the bank who is the relevant investor for the purposes of determining whether a financial investment has been made.

In this regard, the bank gives the drawer of the bill money (albeit by way of credit) to be used, or with the intention that it be used, to generate a return to the bank[73] – namely, the difference between the discounted amount the bank provided to the drawer under the facility and the face value of the bill. The bank generally will have no day-to-day control over the use of the funds by the drawer to generate that return.[74] Thus, in taking the bill the bank is making a financial investment, within the meaning and intent of s 763B. Accordingly, unless the exclusion for incidental products or credit facilities applies (see below), the bill will be a financial product under s 763A(1)(a) and, when the

[68] Mallesons Stephen Jaques, n 59, p 210.

[69] Section 763A(1)(a) does not apply to secondary sales for the reasons given in n 15. Section 763A(3) is not attracted because that section only operates in respect of something that is a financial product when issued, to deem it to continue to be a financial product when it is on-sold.

[70] It is fair to say that the test in s 763B about use or intended use of funds to generate a return or benefit is more apposite to equity investments than debt investments and that perhaps is why the two examples of making a financial investment given in the notes to s 763B are both equity investments: shares and managed investment products (see n 16). Nevertheless, the draftsperson of the FSRA plainly thought that depositing funds with a bank constituted the making of a financial investment within the meaning of ss 763A(1)(a) and 763B (see n 115 and accompanying text) and, by extension, that those sections captured debt investments as well as equity investments.

[71] See n 15 and accompanying text.

[72] *Corporations Act* s 761E(4), n 61. See also Mallesons Stephen Jaques, n 59, p 210.

[73] Even if that is not the subjective intent of the bank/customer in any particular instance, the bill of exchange should nonetheless qualify as a financial product under the objective test in s 763A(2) because it will be a facility of a kind through which people (in this scenario, banks) commonly make a financial investment: see n 14 and accompanying text.

[74] This is so even though it would not be uncommon to find an "application of funds" provision in a bill facility requiring the drawer to use the funds in a particular way. It is submitted that would not constitute "day-to-day" control of the use of funds by the bank. At most, it gives rise to a contractual right on the part of the bank to enforce the covenant to use the funds in accordance with that clause. More typically, if breached, it will simply give rise to an event of default enabling the bank to exercise various remedies under the facility.

bank sells the bill to a customer, s 763A(3) will operate to maintain that status.[75] Section 763A(3) will also apply to further sales by that investor or subsequent holders in the secondary market.

Is a bill of exchange an incidental product?

Even if a bill of exchange constitutes the making of a financial investment, if it is an incidental component of, or an incidental facility to, a credit facility (for example, the bill facility under which it is issued), s 763E will apply to deem the bill of exchange not to be a financial product despite s 763A(1)(a).[76] Consequently, s 763A(3) will have no operation in relation to secondary sales of such a bill.[77]

Whether a bill of exchange is incidental to the bill facility under which it is issued can be argued both ways. It is "incidental" in the sense that the very mechanism for providing credit under the bill facility is the issuing and discounting of a bill of exchange. If there was no call for credit under the bill facility, no bills of exchange would be issued.

However, as a negotiable instrument, bills of exchange have a separate life to the bill facility under which they are issued and may give rise to separate and distinct obligations outside that facility if they are (as they often will be) sold or otherwise transferred to persons who are not privy to the bill facility. The better view, therefore, is that they are more than something "happening in fortuitous or subordinate conjunction"[78] to the bill facility and accordingly fall outside of the exclusion for incidental products in s 763E.

Is a bill of exchange a separate credit facility?

As mentioned above, under reg 7.1.06(1)(b), a facility:

(i) known as a bill facility; and
(ii) under which a credit provider provides credit by accepting, drawing, discounting or indorsing a bill of exchange,

is by definition a "credit facility" and therefore not a financial product.[79]

This leads to some interesting and difficult interpretational issues:

1. Is a bill of exchange a "bill facility" for these purposes?

   As a matter of simple statutory construction, the better view has to be no. The natural reading of reg 7.1.06(1)(b) suggests the draftsperson intended to draw a distinction between the facility under which a bill of exchange is issued (as referred to in para (i)) and the bill of exchange itself (as referred to in para (ii)). If that were not the case, para (i) could quite easily have been dropped without doing any violence to the regulation.

2. If the answer to question 1 is no, is the issue of a bill of exchange under a bill facility so inextricably linked to the provision of credit under that facility that the exclusion of bill facilities under reg 7.1.06(1)(b) necessarily picks up the bills of exchange issued under such a facility?

   Quite possibly. The fact that the definition of "credit" specifically includes drawing, accepting or otherwise dealing in a bill of exchange[80] would support this construction. The italicised words in the passage from the Explanatory Statement for the *Corporations Amendment Regulations 2002 (No 3)* quoted above[81] would also lend some support to this construction.

[75] See n 15 and accompanying text.
[76] See nn 44-49 and accompanying text. This is on the basis that the main purpose of the credit facility is not the making of a financial investment, managing a financial risk or making non-cash payments.
[77] For the reasons given in n 69.
[78] See n 47 and accompanying text.
[79] See n 38 and accompanying text.
[80] See n 32 and accompanying text, although one of the complications here is that the phrase "dealing" is only defined in relation to financial products (see s 766C) and therefore has no defined meaning in relation to something that is not a financial product.
[81] See n 41 and accompanying text.

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However, it can just as easily be argued that a bill of exchange is a separate and distinct facility to the bill facility under which it is issued. The fact that a bill facility is an excluded credit facility does not require a bill of exchange issued under that facility to be treated in the same way.

3. If the answers to questions 1 and 2 are both no, is a bill of exchange itself a separate credit facility to the bill facility under which the bill is issued?

   Almost certainly. Like all debt products, the typical bill of exchange has credit aspects to it[82] and these credit aspects potentially attract the exclusion for credit facilities.

   If you accept, however, that a bill of exchange is not a "bill facility" for the purposes of reg 7.1.06(1)(b), then if it is a credit facility, it can only be one falling within reg 7.1.06(1)(a). Consequently, under reg 7.1.06(1)(a)(iv), it will only be excluded from being a financial product if it does not involve the making of a financial investment under s 763A(1)(a). To the extent it does involve the making of a financial investment under s 763A(1)(a), reg 7.1.06A will operate to ensure that the investment component of the bill is appropriately regulated under Ch 7 but the credit component is left untouched.[83]

   This seems a fairly oblique way for the *Corporations Act* and *Regulations* to have tackled bills of exchange (ie, to have an express exclusion for bill facilities but to leave a bill of exchange issued under such a facility to be dealt with by implication under a general exclusion for credit facilities). Curiously, and it would seem more as a matter of good luck rather than good drafting, it probably leads to the right outcome. Under this construction, the treatment of a bill of exchange is on all fours with the treatment of a debenture, which is what a typical bill of exchange would most likely be for the purposes of Ch 7 were it not for the exclusion in para (c)(iii) of the definition of "debenture".[84]

Other bill facilities

The analysis above deals only with the typical case of a bill of exchange issued under a bill acceptance and discount facility. A different analysis is likely to apply to a bill issued under other less commonly used facilities, such as a bill indorsement and discount facility[85] or a simple bill acceptance facility.[86] A different analysis again is likely to apply to a bill issued under a "bill reliquefaction" clause in a standard loan facility[87] or a trade bill.[88]

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[82] See the material quoted in n 29.

[83] See the text accompanying n 39.

[84] Assuming, of course, it was drawn or accepted by a "body" (as defined in *Corporations Act* s 9) and evidenced an undertaking by the body to repay as a debt money deposited with or lent to the body: see the text accompanying n 21.

[85] Under a bill indorsement and discount facility, the bank indorses bills that have been accepted by someone else (usually the client being provided with credit or a related entity) and undertakes to discount them. By indorsing a bill of exchange, the bank becomes secondarily liable for the payments due under bill if the acceptor and drawer of the bill default in making those payments: see ss 59 and 60 of the *Bills of Exchange Act 1909* (Cth). That arguably changes the analysis of who is the issuer of the bill (as it is the acceptor of the bill, rather than the bank, who will be primarily liable to make the payments on the bill to the customer holding it). Bill indorsement and discount facilities are now relatively uncommon in the Australian market: see Carew, *Fast Money 4: the Best Selling Guide to Australia's Financial Markets* (Allen & Unwin, 1998) pp 123-124, and Mallesons Stephen Jaques, n 59, p 214.

[86] Under a bill acceptance facility, the bank simply accepts bills and thereby lends its credit rating to them, without undertaking to discount them. The accepted bills are then sold in the market so that funds are provided to the drawer by the person buying the bill in the market and not by the acceptor of the bill: see Carew, n 85, p 129, and Mallesons Stephen Jaques, n 59, p 215. In this case, it is much easier to take the view that the initial sale of the bill in the market is part and parcel of a credit facility.

[87] It is not uncommon in bank loan facilities to include a "bill reliquefaction" clause that enables the bank to reliquefy its commitment under the facility by having the borrower draw bills for some or all of that commitment, which the bank can then accept and discount (see Mallesons Stephen Jaques, n 59, p 214). Notwithstanding the presence of such a clause, these facilities would not generally be regarded or referred to as a bill facility. Hence, it is submitted, these facilities fall within reg 7.1.06(1)(a) rather than reg 7.1.06(1)(b). This may give room for regs 7.1.06(1)(a)(iv) and 7.1.06A to apply to exclude reliquefaction bills from the carve-out for credit facilities in s 765A(1)(h), resulting in the investment aspects of the reliquefaction bills being regulated under the FSRA while the credit aspects of the underlying facility are unregulated. However, that will depend upon whether the acquisition of the reliquefaction bills can properly be said to involve the making of a financial investment within the meaning of ss 763A(1)(a) and 763B.

The analysis above also deals only with bills of exchange that are issued as part of a credit facility or otherwise involve a credit element. Although not common in this day and age, a bill of exchange can be used as a non-cash payment facility without any provision of credit, by being drawn to be payable on demand rather than at a fixed or determinable future time. Such a bill of exchange is unambiguously a regulated financial product under ss 763A(1)(c) and 763D and not a credit facility.

Summation

To determine whether Ch 7 applies to any particular bill of exchange requires an analysis of the type of bill involved, the type of facility under which it is issued and the circumstances of its issue to determine who is the issuer of the bill and who is the investor in the bill and whether the acquisition of the bill involves the making of a financial investment by that investor. If it does, there is a reasonable prospect that regs 7.1.06(1)(a)(iv) and 7.1.06A will apply to ensure that the investment component of the bill of exchange is regulated as a financial product, while the credit aspects of the bill are left unregulated.

ASIC's conclusion that bills of exchange issued on normal commercial terms are not financial products because they are credit facilities is both an over-generalisation and an over-simplification. In some, perhaps even many, cases that conclusion will not be correct.

As Ch 7 presently stands, the position almost certainly is that some bills of exchange are regulated financial products whereas others may not be. The difficulties that this could give rise to in practice should be immediately apparent. A person giving financial advice in relation to, or dealing on behalf of another in, a bill of exchange may not know or even be able to find out the information needed to do the analysis mentioned above and, even if they do or can, the lack of clarity in the law in this area will still lead to considerable uncertainty in the outcome. They therefore may not know, or may be quite unsure, whether that advice or dealing is regulated by Ch 7.

All this complexity and uncertainty stems from the failure of the FSRA to address the status of bills of exchange expressly in one or other of ss 764A(1) or 765A(1), which leaves their status to be determined under the general definition of financial product in s 763A(1), as affected by the exclusion for credit facilities. In doing so, it lays bare a number of the interpretational difficulties with the general definition and the manner in which it interacts with the exclusion for credit facilities.[89]

[88] Trade bills are often used to pay for goods in international and domestic trade: see n 29 and see also Carew, n 85, pp 122-123, and Mallesons Stephen Jaques, n 59, p 208. Typically, the purchaser of the goods accepts a bill drawn by the seller as evidence of its obligation to pay the purchase price at a nominated future date. This gives the seller a negotiable instrument it can sell to realise immediate funds. Often the seller will do this by selling the bill to a bank or merchant bank for an amount equal to the face value of the bill less a discount. It is submitted that there is greater scope in this type of facility to argue that there are multiple components to the facility – the purchase of goods on agreed payment terms (a credit facility) and a mechanism for making non-cash payments through the issue of a bill (a non-cash payment facility) – and that s 762B applies and operates so that the latter facility is regulated while the former is unregulated (see n 39). There is also room to argue that a bill issued in this way does not involve the provision of credit in any relevant sense, but in fact simply evidences credit previously given (being the debt owing for the purchase price of the goods).

[89] These include: (1) the blurred distinction between a facility and a component of a facility and the difficulties in determining where to draw the boundaries around and between facilities (see nn 55-58 and accompanying text and the analysis above of the different ways these concepts might apply to a bill of exchange issued under a bill acceptance and discount facility); (2) the fact that the definitions of "making a financial investment", "issue" and "issuer" only contemplate an instrument where there is one party liable (or perhaps multiple parties jointly liable) as issuer for the obligations under the instrument and do not cater for an instrument where there may be two or more parties separately liable and to different extents for the obligations under the instrument (see nn 16, 61 and 63 and accompanying text); (3) the impreciseness in the requirement in the definition of making a financial investment that investment funds have to be used, or intended to be used, *to generate* a return or benefit for an investor (see n 70 and the text accompanying nn 107-115); and (4) generally, the rather poor way in which Ch 7 deals with products acquired by way of investment in the secondary market (see n 15), especially in a situation where the product was originally issued under a credit facility (see the analysis above of the different ways s 763A(3) might apply, or not apply, to the sale of a bill of exchange issued under a bill acceptance and discount facility).

Policy considerations

Putting these interpretational difficulties to one side, it must be asked whether the draftsperson of the FSRA really contemplated that bills of exchange would be wholly excluded from regulation under Ch 7.

Bills of exchange constitute a significant component of the short-term money market in Australia[90] and the involvement of retail investors in that market is substantial:

> The retail market for bank bills … represents approximately 50 per cent of bank bills … on issue. It is largely comprised of small business (non-corporates), rural clients and individuals[91] who buy directly from the major banks, which issue bank bills … from their own portfolios and maintain the securities in their own safe custody.
>
> Apart from the large denominations of bank bills issued and (actively) traded in the wholesale market, there is a significant volume of transactions in bank bills issued in denominations between $50,000 and $250,000, as well as non-bank accepted or indorsed bills primarily related to trade transactions (involving small to medium businesses and also import/export finance). Many banks limit retail sales to either over $100,000 or over $500,000, although bills drawn on the Commonwealth Bank may be purchased through Commonwealth Securities (online) for a minimum of $10,000.[92]

From the economic standpoint of an investor, there is very little difference between buying a bank accepted or indorsed bill of exchange and depositing funds in a bank term deposit. Both are fixed term debt instruments that pay a principal and interest style of return[93] and whose risk and credit rating is determined by the creditworthiness of the participant bank.

A bank is required to hold an Australian financial services licence (AFSL) and (in the case of retail clients) to issue product disclosure statements, to offer its customers a basic term deposit. Yet, on ASIC's view of the law, it is free to sell them bills of exchange – which are substantially more complicated products, given the requirements around presentment, dishonour and the like – without any regulation whatsoever under the *Corporations Act*. That position defies any logical analysis and is contrary to the spirit and intent of the FSRA reforms, the professed aim of which was to provide a single licensing regime and a consistent and comparable disclosure regime for all financial products.[94] It is therefore a bad policy outcome.

Cheque facilities

ASIC's view that bills of exchange are not financial products may also lead to some anomalous results in relation to cheques. A cheque is, of course, a bill of exchange drawn on a banker payable on demand.[95] In its FAQ on bills of exchange, ASIC expresses the view that:

> An arrangement between a service provider and client that is a cheque facility (rather than a bill facility) is a financial product because it is a facility for making non-cash payments under s 763A(1)(c) and is not a credit facility. This is the case even though each individual cheque drawn under the facility will be a bill of exchange.[96]

Again, the general definition of financial product in ss 763A to 763D gives way to the specific exclusions in s 765A. Since a cheque is a bill of exchange, you can arguably characterise a cheque facility as a bill facility. On this characterisation, a cheque facility that provides the user with a line of credit (ie, an overdraft) would be a bill facility under which credit is provided and accordingly, on ASIC's view of the law, an excluded credit facility. It would therefore not be a regulated financial

[90] In March 2003, the face value of bank bills (ie, bills of exchange accepted or indorsed by a bank) on issue was $76 billion, around 35% of the total $219 billion of short-term money market instruments on issue: Working Group of Officials, n 29, pp 11-12.

[91] These, of course, are precisely the groups targeted to benefit from the FSRA reforms.

[92] Working Group of Officials, n 29, p 13.

[93] In the former case by reference to the discount at which the bill is purchased and in the latter case more explicitly pursuant to the governing terms of the deposit.

[94] See n 5 and accompanying text.

[95] *Bills of Exchange Act 1909* (Cth) s 78(1).

[96] ASIC FAQ QFS 132, n 52.

product even though it might otherwise involve the provision of a facility for making non-cash payments under ss 763A(1)(c) and 763D. This result is plainly contrary to the express intention of Parliament in seeking to regulate cheques facilities as non-cash payment facilities.[97]

Even if you take the view that a cheque facility is not a bill facility (and in everyday parlance one would not normally refer to a cheque facility in this way), contrary to what ASIC says in its FAQ, if it has an overdraft attached, it will still be a credit facility under the general definition of that term[98] and the fact that it also involves a facility for making non-cash payments will be irrelevant. It will only be a regulated financial product if, in addition to the overdraft, it also attaches (as it inevitably will) a deposit facility.[99] Section 762B and regs 7.1.06(1)(a)(vi) and 7.1.06A will then operate to ensure that the deposit facility is appropriately regulated but the credit facility is left untouched by Ch 7.[100]

Recommended course of action

All this suggests that our lawmakers and regulators need to reconsider the application of the FSRA to bills of exchange. To be consistent with the professed aims of the FSRA, the investment aspects of bills of exchange should be clearly and unequivocally regulated as financial products. To put the position beyond doubt requires:

- either an amendment to s 764A(1), or a regulation under s 764A(1)(m), to include bills of exchange within the list of products specifically stated to be financial products;
- an amendment to reg 7.1.06(1)(b) to include equivalent provisions to reg 7.1.06(1)(a)(iii) – (vi);[101]
- an amendment to reg 7.1.06A to extend its operation to bill facilities under reg 7.1.06(1)(b);[102] and
- for completeness, an amendment to s 761E, or a regulation under s 761E(7), to clarify who is the issuer of a bill of exchange and when it is issued.

It should also be apparent from the analysis above that the issues around the applicability of Ch 7 to bills of exchange are substantially more complex and uncertain than is conveyed in ASIC's short FAQ on the topic. That FAQ ought to be withdrawn.

PROMISSORY NOTES

On 14 July 2003, ASIC announced the release of an FAQ to "assist issuers of promissory notes in understanding their obligations under the *Corporations Act*".[103] Ignoring the questions and focusing on the answers, the FAQ states:[104]

> Generally, a simple promissory note with a face value of more than $50,000 would not be a financial product. Other promissory notes may either be a debenture or another sort of financial product, as set out below …
>
> A financial product that is *just* a promissory note with a face value of more than $50,000 is not a debenture.

[97] See the examples cited in n 18 and at [6.54] of the FSRA Explanatory Memorandum, n 3.
[98] See the text accompanying n 37.
[99] Such a facility would be a deposit product, and therefore a financial product, under s 764A(1)(i).
[100] See n 33-41 and accompanying text. See also [6.38] and [6.85] of the FSRA Explanatory Memorandum, n 3.
[101] Alternatively, reg 7.1.06(1)(b) could just be deleted on the basis that, without the express mention of bill facilities in that regulation, they will fall within the general provisions of reg 7.1.06(1)(a).
[102] Alternatively, if reg 7.1.06(1)(b) were just deleted, as suggested in the previous note, one could leave reg 7.1.06A as is, on the basis that bill facilities would then fall within reg 7.1.06(1)(a) and reg 7.1.06A already applies to facilities under reg 7.1.06(1)(a).
[103] ASIC Information Release IR 03-16, *ASIC regulation of promissory notes*, 14 July 2003, available online at: http://www.asic.gov.au/asic/ASIC_PUB.NSF/byid/6455F588FEAAA630CA256D63000C6036?opendocument.
[104] ASIC, Frequently Asked Questions about FSR, QFS 115: *Is a promissory note a financial product?*, published 14 July 2003 and revised 24 November 2003: http://www.asic.gov.au/asic/asic.nsf/ASIC+FSR+FAQ+DisplayW?ReadForm&unid=87A2D3E36115387BCA256D8100184B11.

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However, ASIC considers the exclusion of promissory notes from the definition of debenture only includes those instruments that are simple promissory notes or similar debt instruments (such as Negotiable Certificates of Deposit), which do not have any other significant obligations or undertakings arising from the note or other instrument. These types of instruments meet the definition of promissory note contained in the *Bills of Exchange Act 1909* …

Even if not a debenture, if the person who is issued the note has been led to understand that the payment under the note will be produced by the use of the proceeds of the note issue in a common enterprise or from a pool to produce those benefits, the note may be an interest in a managed investment scheme. If the managed investment scheme has more than 20 members or the promoter is in the business of promoting managed investment schemes, the interest will be a financial product.

Also if the person who is issued the note, or the issuer intends that the proceeds from the note issue be used to enable the payment under the notes, then the notes could also be a facility for making a financial investment. Generally such a facility will also be a financial product.[105]

(emphasis added)

Again, this seems a surprising result. If Parliament had intended "simple" promissory notes with a face value of more than $50,000 (which for convenience will be referred to just as "simple promissory notes" without mentioning their face value)[106] to be wholly excluded from the FSRA, you would have expected it to include them in the list of products specifically stated not to be financial products under s 765A.

Beyond affirming that such notes are not debentures and therefore not financial products under s 764A(1)(a), ASIC's FAQ on promissory notes does not give any statement of its reasons for coming to the conclusion that simple promissory notes are not financial products. One is therefore thrown back to inference and supposition to determine what those reasons might be.

Is a simple promissory note a financial investment?

For ASIC to have determined that a simple promissory note is not a financial product, it must have concluded that investing in such an instrument is not the making of a financial investment within the meaning of ss 763A(1)(a) and 763B.[107]

By necessary inference, ASIC must therefore believe that the test in s 763B(a) (the use or intended use of the investment) will generally not be satisfied for simple promissory notes, since the test in s 763B(b) (the investor having no day-to-day control over the use of the contribution to generate the return or benefit) will almost always be satisfied.[108] The basis for this belief is not immediately apparent but the final paragraph of the FAQ italicised above[109] provides a clue.

At the outset, it is fair to say that the underlying rationale for the final paragraph of ASIC's FAQ is rather obscure. It is not immediately apparent why ASIC considers that the use of the proceeds raised by an issue of simple promissory notes to fund the payments due to investors under the notes

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[105] It is noteworthy that this last paragraph in ASIC's FAQ alludes to only two of the three tests in the first limb of the definition of "making a financial investment" in s 763B – that the investor, or the issuer, intends that the investor's contribution will be used to generate a financial return or other benefit for the investor (even if no return or benefit is in fact generated). It does not mention the third of the three tests in s 763B(a) – that the issuer in fact uses the contribution to generate a financial return or other benefit for the investor (see n 16 and accompanying text).

[106] The references in ASIC's FAQ to promissory notes having a face value "in excess of $50,000" should in fact be to promissory notes having a face value "of at least $50,000" (ie, $50,000 or above) – see para (d) of the definition of "debenture" in s 9 of the *Corporations Act*. References in the text to simple promissory notes should be taken to mean promissory notes having a face value of at least $50,000 and that do not have any extraneous terms attached that would prevent them from satisfying the definition of "promissory note" in s 89(1) of the *Bills of Exchange Act 1909* (Cth) (see n 111 and accompanying text).

[107] Even if ASIC were to consider promissory notes to be covered by the exclusion for credit facilities, in the same way as it does bills of exchange, they would be credit facilities of the type caught by reg 7.1.06(1)(a) rather than reg 7.1.06(1)(b). Accordingly, under reg 7.1.06(1)(a)(iv), they will only be excluded from regulation under Ch 7 if they are not financial products under s 763A(1)(a) (see nn 33-41 and accompanying text and the text accompanying nn 118-119).

[108] Even where the facility under which the promissory note is issued has an "application of funds" clause requiring the funds raised to be applied in a particular way, it is submitted that would not constitute "day-to-day" control of the use of funds by the investor (see n 74).

[109] See the text accompanying n 105.

should cause it to become a facility for making a financial investment, when it would seem that ASIC considers that the use of those proceeds in the general business operations of the issuer would not cause it to be such a facility, even though those business operations will generate the cash required to service the payments due to investors under the notes.

Some further clues to ASIC's reasoning can be found in the information release accompanying the publication of its FAQ. There ASIC gave as a further example of a promissory note that would involve an offer of a financial product:

> an arrangement [whereby] … investors' money (raised through the offer of promissory notes) is used to partly fund the purchase and development of property and investors are led to understand that repayment is dependant on the success of the development.[110]

With respect, this example makes little sense. In the absence of a definition of "promissory note" in the *Corporations Act*, it is reasonable to resort, as ASIC did, to the definition of that term in the *Bills of Exchange Act*. Under the latter Act, a promissory note must be an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person, or to bearer.[111] If the repayment of a note was dependent on a contingency, such as the success of a property development, it would not be an unconditional promise to pay and therefore would not be a promissory note.

Leaving that issue to one side, the fact that ASIC felt the need to add the reference to investors being led to understand that the repayment of the note was dependant on the success of the development suggests it believes that, for the test in s 763B(a) to be satisfied, there needs to be some form of causal link between the use or intended use of the investment contribution by the issuer and the return or benefit to the investor from the investment.

In the example quoted above that link is the tying of the right to receive a return on the note to the profitability of the project in which the proceeds raised by the issue of a note were to be used (in that example, a property development). The link identified in the final paragraph of its FAQ is the use of some or all of the proceeds raised by the issue of a note to fund the payments due to the investor under the note.

The construction that, for s 763B(a) to be satisfied, there needs to be some form of causal link between the use or intended use of an investment contribution and the return or benefit to the investor from the investment, is manifestly open on the language of that section. On its face, that section requires the investment contribution to be used, or intended to be used, *to generate* a return or benefit for the investor.[112] However, it is submitted that it is not a construction that should lightly be adopted. It does great violence to the intended reach of the general definition of making a financial investment and opens or exposes what could be a significant loophole in that definition for potential exploitation.

To illustrate the point, take the example of a company issuing to investors a financial instrument to raise funds for the avowed purpose of repaying or replacing a maturing bank debt. Such a use of proceeds does not, in and of itself, generate any direct return or benefit to the investors who acquire the instrument.[113] The money that comes in to the company from the issue of the instrument gets paid straight back out again to the bank owed the maturing debt. If there needs to be a causal link of the type posited in the previous paragraphs, the acquisition of this instrument would fail the test in

[110] ASIC, n 103.

[111] *Bills of Exchange Act 1909* (Cth) s 89(1).

[112] That s 763B(a) focuses on the use to which an investment contribution is put is perhaps unfortunate. It may have been better if it focused instead on the expected return on the investment and read something along the following lines: "the investor gives money or money's worth (funds) to another person and at that time the investor or the other person intends or expects that the other person will provide a financial return or other benefit to the investor for the use of the funds (even if no return or benefit is in fact provided)."

[113] Perhaps the best that can be said is that it might produce a benefit by reducing the interest burden being borne by the company, although that will depend on the comparative interest rate the company was paying on the maturing bank facility and the return it is expected to pay on the new financial instrument.

s 763B(a) and would therefore not be considered the making of a financial investment for the purposes of s 763A(1)(a). Consequently, it would only be a financial product if:

- it could be shown that the financial instrument in question is one through which people commonly do one of the things mentioned in s 763A(1), even though that was not the intention of the parties in this particular case;[114] or
- the financial instrument was one of the products specifically stated to be a financial product under s 764A(1).

That cannot be what Parliament intended when it enacted s 763B. A person issuing financial products may use the funds raised for multifarious purposes. For example, a bank receiving funds through the issue of deposit products might use the proceeds to fund its loan book, to make investments, to acquire capital assets, to meet its operating expenses, to reduce its gearing, to provide the cash to pay a dividend to its shareholders and so on. Some of these uses may generate a direct return or benefit for the bank, and by extension for the investor, but some may not.

It is submitted that when Parliament defined making a financial investment to require the investment contribution to be used, or intended to be used, to generate a return or benefit for an investor, it did not contemplate the need for a direct connection between the use of the funds and the generation of the return or benefit.

There is some support for this view in the Explanatory Memorandum for the FSRA, in which the following observation was made about the definition of making a financial investment:

> By focussing on the actual, as well as the intended, use of the money the definition is intended to cover deposit accounts, which for many consumers are used for transactional purposes, although they also generate some return.[115]

Plainly, the draftsperson of the FSRA considered that the various uses an ADI may make of the funds that customers invest with it by way of deposit is sufficient to satisfy the requirement in s 763B(a)(i) that the ADI use those deposits to generate a financial return or other benefit for its customers. From this it can be inferred that Parliament intended that it would be sufficient to satisfy s 763B(a) that the funds raised from issuing a financial product are used, or intended to be used, as part of the general pool of resources available to the issuer in its business, with the general aim of that business generating the cash required to provide a return or benefit to the investor on their investment.[116] Applying this test, it is submitted that when a person gives an amount of money or money's worth to a person in exchange for the issue of a simple promissory note and in the expectation of earning an investment return,[117] they will be making a financial investment within the meaning of ss 763A(1)(a) and 763B.

Is a simple promissory note a credit facility?

Even though it is not stated in its FAQ, it is possible that ASIC may consider simple promissory notes to be covered by the exclusion for credit facilities, in the same way it does bills of exchange.

Like all debt products, a promissory note has credit aspects to it and these credit aspects potentially attract the exclusion for credit facilities. However, unlike bills of exchange, there can be no doubt whatsoever that promissory notes fall within the general definition of credit facility in reg 7.1.06(1)(a) rather than within any of the other limbs of that definition. Accordingly, under reg 7.1.06(1)(a)(iv), they will only be excluded from regulation under Ch 7 if they are not financial products under s 763A(1)(a).[118]

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[114] So as to attract the operation of s763A(2): see n 14 and accompanying text.
[115] FSRA Explanatory Memorandum, n 3 at [6.50].
[116] The examples of facilities said to involve the making of a financial investment given in the notes to s 763B (see n 16) are also expressed in a way that is consistent with this interpretation. Those examples talk of a company using the money subscribed for shares to generate dividends for the subscriber and a responsible entity of a managed investment scheme using the money subscribed for managed investment products to generate financial or other benefits for the subscriber.
[117] That return could be either the interest payable under the terms of the note if it has a coupon attached or it could be the difference between the face value of the note and the discounted amount at which it is purchased if it does not.
[118] See nn 33-41 and accompanying text.

For the reasons given above, a promissory note will generally be a financial product under s 763A(1)(a). Accordingly, regs 7.1.06(1)(a)(iv) and 7.1.06A will operate to ensure that the investment component of the promissory note is appropriately regulated under Ch 7 while the credit component is left untouched.[119]

Policy considerations

All this is a rather lengthy analysis of what the author supposes (in the absence of ASIC actually informing us) were the underlying reasons for ASIC's determination that a simple promissory note is not a financial product and, if that supposition is correct, why those reasons, in the author's view, are not well-founded.

More generally, from the economic standpoint of an investor, there is very little difference between buying a debenture and buying a simple promissory note. Both are corporate debt instruments that pay principal and interest type returns[120] and whose risk and credit rating is determined by the underlying creditworthiness of the issuing corporation. Yet the views expressed by ASIC in its FAQ on promissory notes, if correct, would have the consequence that advice on and dealings in the former instrument are subject to the full rigours of the FSRA licensing and disclosure requirements while the same activities in the latter instrument are completely unregulated by the *Corporations Act*.

It is difficult to discern any policy reason why a person who advises on or deals in a BHP Billiton or Telstra debenture of any denomination should be required to hold an AFSL and (when dealing with retail clients) to issue financial services guides, statements of advice and product disclosure statements in connection with that advice or dealing but a person who advises on or deals in an HIH or One.Tel promissory note with a face value of $50,000 or more should be free to do so without any regulation whatsoever under the *Corporations Act*. Again, that position defies any logical analysis and is contrary to the spirit and intent of the FSRA reforms, the professed aim of which was to provide a single licensing regime and a consistent and comparable disclosure regime for all financial products.[121] It is therefore a bad policy outcome.

Negotiable certificates of deposit

ASIC's view that simple promissory notes are not financial products may also lead to some anomalous results in relation to negotiable certificates of deposit (NCDs). NCDs are often drafted as promissory notes in order to attract the negotiability accorded to those instruments by the *Bills of Exchange Act*[122] and, even when not consciously drafted that way, if they are paper-based, will often fall within the definition of "promissory note" in that Act in any event.[123]

Where an NCD is issued by an ADI, as many are,[124] it will also fall within the definition of "deposit product"[125] and will therefore be a regulated financial product under s 764A(1)(i), notwithstanding that it may also a promissory note.[126]

It would seem a perverse regulatory result that a retail investor wanting to invest a minimal amount in a Commonwealth Bank NCD should attract the full panoply of FSRA protections but one

[119] See the text accompanying n 39.
[120] In the case of a debenture, usually explicitly, and in the case of a promissory note, sometimes explicitly but more usually by reference to the discount at which the promissory note is purchased.
[121] See n 5 and accompanying text.
[122] See ss 36-46 and 95 of the *Bills of Exchange Act 1909* (Cth).
[123] See Working Group of Officials, n 29, pp 46-47 and the materials there cited.
[124] Bank certificates of deposit (CDs) constitute a significant component of the short-term money market in Australia and the proportion of that market which involves retail investors is substantial. In March 2003, the face value of bank CDs on issue was approximately $88 billion, around 40% of the total $219 billion of short-term money market instruments on issue, and the retail proportion of that market was said to be 40%: Working Group of Officials, n 29, pp 11 and 13.
[125] *Corporations Act* s 761A.
[126] Although, given the recent adoption of reg 7.1.06(1)(a)(vi) by the *Corporations Amendment Regulations 2003 (No 10)*, there is an argument that an NCD issued by an ADI, or indeed any ADI deposit, is an unregulated credit facility because the whole or predominant purpose of it is, or is intended to be, the provision of credit by the depositing customer to the ADI (see n 37).

investing $50,000 or more in an HIH or One.Tel promissory note should have no equivalent protection.

Recommended course of action

All this suggests that ASIC needs seriously to reconsider its FAQ on promissory notes. While it leads to a bad policy outcome, ASIC's FAQ on bills of exchange at least had a reasonably arguable legal basis – the express exclusion of bill facilities as credit facilities, especially when interpreted in light of the italicised words in the passage from the Explanatory Statement for the *Corporations Amendment Regulations 2002 (No 3)* quoted above.[127] Not only does ASIC's FAQ on promissory notes lead to a bad policy outcome, there does not appear to be any reasonable basis in law or fact to support the view expressed in it that a simple promissory note is not a financial product. That FAQ should be withdrawn immediately.

To provide certainty to industry participants, particularly in terms of how the exclusion for credit facilities should operate in relation to simple promissory notes, it would be desirable for the law to be changed so that simple promissory notes are treated in the same way as debentures, that is to say:

- either an amendment to s 764A(1), or a regulation under s 764A(1)(m), to include simple promissory notes within the list of products specifically stated to be financial products;
- an amendment to reg 7.1.06(1)(a) to include a reference to simple promissory notes in reg 7.1.06(1)(a)(v) so that reg 7.1.06A operates in relation to simple promissory notes in the same way it operates for debentures; and
- an amendment to reg 7.1.06(1)(b)(ii) to delete the erroneous reference to promissory notes.[128]

CONSEQUENCES FOR INDUSTRY PARTICIPANTS

ASIC appends the following disclaimer to its FAQs on bills of exchange and promissory notes:

> These FAQs provide general information about how we are implementing the Financial Services Reform legislation. We are unable to provide legal advice or interpretations of the legislation. These FAQs should not be treated as legal advice, nor as statements of our policy.

Notwithstanding this disclaimer, the author understands that many industry participants who advise on or deal in bills of exchange and simple promissory notes have relied on the views expressed by ASIC in its FAQs and not sought an authority in their AFSL to do so. The few who have had doubts about ASIC's position and requested such an authority have generally been persuaded by ASIC to drop the request, on the basis that they should be prepared to rely on the publicly stated views of the regulator.[129]

That would be fine if ASIC's views on bills of exchange and simple promissory notes were indisputably correct. However, for the reasons given above, there is a very strong likelihood that they are not. This puts industry participants who advise on or deal in these products in an invidious position. If they do these things with sufficient system, repetition and continuity to constitute the carrying on of a financial services business and they do not have an AFSL that authorises these activities, the consequences are serious indeed.

It is a criminal offence, punishable by a fine of up to 200 penalty units and/or imprisonment for up to two years for individuals and a fine of up to 1,000 penalty units for bodies corporate.[130] The client they advise or for whom they deal (if not themselves the holder of an AFSL) may be able to rescind agreements connected with that advice or dealing within a reasonable period of becoming aware that the non-licensee does not hold the required licence[131] and the non-licensee may not able to

[127] See n 41 and accompanying text.
[128] See n 38.
[129] See n 136.
[130] See ss 911A, 1311 and 1312 and Sch 3 of the *Corporations Act*. Individual representatives of the non-licensee may also be liable to the same criminal penalties for breaching s 911B.
[131] *Corporations Act* s 925A.

enforce or rely on those agreements.[132] The non-licensee may also cease to be entitled to recover any brokerage, commission or other fee otherwise payable by the client[133] and, if the client has already paid any brokerage, commission or other fee, they may be able to take action to recover it.[134]

No doubt, at a practical level, non-licensees may take some comfort from the fact that ASIC is unlikely to take criminal enforcement action against them for not having an AFSL authorising them to advise on or deal in bills of exchange and simple promissory notes when ASIC has publicly encouraged that position through its published FAQs. However, that does not protect non-licensees from the civil consequences of not holding the required AFSL. A disgruntled or recalcitrant customer who is not entirely satisfied with, or who otherwise wants to walk away from, advice given to them, or a dealing done on their behalf, in relation to a bill of exchange or simple promissory note by a non-licensee, is unlikely to feel any compunction about testing the correctness of ASIC's FAQs in civil proceedings against the non-licensee under the *Corporations Act*.

WHERE TO FROM HERE?

It is submitted that our law makers and regulators need to provide greater certainty to the financial services industry about the application of Ch 7 to bills of exchange and simple promissory notes than ASIC's FAQs do at present. If our law makers and regulators want to stay true to the professed aims of the FSRA, the proper course is for the law to be amended in the fashion recommended above. Until that occurs, given the substantial uncertainty under the current law about whether an AFSL is required for these purposes, ASIC should change its approach and encourage industry participants who advise on or deal in bills of exchange or simple promissory notes to seek an appropriate authorisation in their AFSL to do so.

This will require something of a change to the way in which ASIC is presently administering the AFSL process. Currently, ASIC will only grant an AFSL authorising the holder to provide nominated financial services in relation to nominated financial products.[135] For these purposes it uses the categories of financial products listed in s 764A(1), supplemented by a "mop-up" category of "miscellaneous financial facility". Bills of exchange and simple promissory notes do not fit within any of the categories of financial products listed in s 764A(1) and therefore can only fall within the category of "miscellaneous financial facility".

ASIC has said that it expects AFSL applicants will only nominate the miscellaneous financial facility category in rare situations and that it will only consider an application seeking an authorisation in that category if the applicant provides a detailed legal opinion that:

- describes the product and how it operates and/or how it is used;
- supports the view that the product does not fit into any of the other product authorisation categories, giving a detailed analysis of why the other products are not appropriate; and
- supports the view that the product is likely to be a financial product,[136]

[132] *Corporations Act* s 925E.
[133] *Corporations Act* s 925F.
[134] *Corporations Act* s 925H.
[135] ASIC, *How to Apply for an AFS Licence, AFS Licensing Kit: Part 1, Version 4 – October 2003*, pp 11-18, available online at: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Licensing_kit_s1_v4.pdf/$file/Licensing_kit_s1_v4.pdf. ASIC is required to ensure that an AFSL is subject to a condition that specifies the particular financial services or class of financial services that the licensee is authorised to provide (*Corporations Act* s 914A(6)). It may do so by reference to particular financial products or classes of financial products, but that is not mandatory (*Corporations Act* s 914A(7)).
[136] The author has been involved in an AFSL application in which an authority was sought by an ADI to advise on and deal in bills of exchange and promissory notes under the miscellaneous financial facility category where even more onerous requirements than those outlined in ASIC's Licensing Kit were imposed. The ASIC officer handling the application insisted upon a "comprehensive and conclusive" legal opinion that bills of exchange and simple promissory notes were financial products for the purposes of the *Corporations Act*, rather than one merely supporting that view. The opinion was required to contain a detailed legal analysis explaining why bills of exchange and simple promissory notes did not fit within any of the categories of financial products listed in s 764A(1) of the *Corporations Act* (notwithstanding that ASIC had effectively said as much in relation to simple promissory notes in its FAQ on the topic) and also why they did not fall within the exclusion for credit facilities. The officer also required a written statement of reasons why the applicant was not prepared to accept the view

together with suggested wording for the product description in the licence authorisation that strictly limits the authority granted to that particular product.[137]

It is submitted that ASIC ought to take a more lenient approach with bills of exchange and simple promissory notes and not put AFSL applicants to the trouble and expense of these extra requirements. As the primary regulator of the financial markets in Australia, it should not need or require an explanation of how bills of exchange and simple promissory notes are used in the market. It should accept that there is legal uncertainty around whether these instruments are financial products and that the appropriate way to address that uncertainty, even if only out of an abundance of caution, is to grant an applicant who advises on or deals in these instruments an express authority in their AFSL to do so (assuming they otherwise satisfy ASIC's licensing criteria). It should not be difficult for ASIC to come up with pro forma wording that limits the authority granted to these particular instruments.

It is strongly recommended that those industry participants who advise on or deal in bills of exchange or simple promissory notes and who already have an AFSL that does not expressly authorise them to do so, should apply to ASIC under s 914A(2)(b) to have their AFSL amended to confer that authority. This will give rise to a significant administrative burden for ASIC but, frankly, that is largely of ASIC's own making because of the approach it has taken in its FAQs on bills of exchange and promissory notes and to granting authorisations to advise on or deal in miscellaneous financial facilities.[138]

If our law makers and regulators want to disregard the professed aims of the FSRA and exclude bills of exchange and simple promissory notes from regulation under Ch 7, that should be done explicitly through an amendment to s 765A, a regulation under s 765A(1)(y) or an ASIC class order under s 765A(1)(z) and (2), rather than implemented through poorly reasoned and expressed regulatory interpretations set forth in non-legally binding FAQs.

CONCLUSION

If you were looking for an example of "piecemeal and varied" regulation "determined according to the particular industry and the product being provided", "giving rise to opportunities for regulatory arbitrage" and leading to "regulatory … confusion", it would be hard to go past ASIC's current approach to bills of exchange and promissory notes.[139]

The FSRA was supposed to bring an end to that type of regulation in the financial services industry.

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expressed in ASIC's FAQ on promissory notes that simple promissory notes were not financial products for the purposes of Ch 7 (its FAQ on bills of exchange had not been published at the time). The written request for these materials was made by ASIC in mid November 2003 and supplemented with oral representations that, to that point in time, ASIC had not granted any other industry participant an authority to advise on or deal in bills of exchange or promissory notes and that other AFSL applicants were prepared to rely on ASIC's FAQ on promissory notes and the views it had been expressing privately (and since has confirmed publicly in its FAQ on the topic) that bills of exchange are unregulated credit facilities. The applicant sought to comply with these requisitions but ultimately ASIC refused to grant the requested authorisation, stating that "it was not apparent" from the applicant's submissions that bills of exchange and simple promissory notes were financial products and therefore "it would be inappropriate" for ASIC to grant an AFSL with such an authorisation.

[137] ASIC, *Answering the questions in your AFS licence application, AFS Licensing Kit: Part 2, Version 4 – October 2003*, p 21, available online at:
http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Licensing_kit_s2_v4.pdf/$file/Licensing_kit_s2_v4.pdf.

[138] See nn 136-137 and accompanying text. One way to spread that administrative burden would be for a regulation to be passed under s 914A(8) deeming any AFSL that contained an authorisation to advise on or deal in securities (and therefore debentures) or deposit products also to confer a corresponding authorisation to advise on or deal in bills of exchange and simple promissory notes, on the basis that licensees who have the institutional capabilities to do the former should also have the wherewithal to do the latter. That regulation could have a 2 year sunset so that AFSL holders would then have a 2 year transition period within which to seek an appropriate amendment to their AFSL. Another option perhaps would be to amend the definition of debenture in s 9 to provide that the purposes of Ch 7 (other than Pt 7.11 dealing with title and transfer), bills of exchange and simple promissory notes shall be taken to be debentures. That way, any person who has an AFSL authorising them to advise on or deal in securities will be automatically authorised to conduct those activities in relation to bills of exchange and simple promissory notes.

[139] The quotations are from the FSRA Explanatory Memorandum, n 3 at [1.3].

ASIC is the regulator charged with the responsibility of carrying the torch for the FSRA reforms. To stay true to the professed aims of the FSRA, ASIC should be working towards bringing bills of exchange and simple promissory notes into the regulatory net of Ch 7 in an enlightened and considered manner rather than promoting legislative readings directed to achieving the contrary outcome.

It is indeed curious that ASIC has chosen to act via equivocal regulatory interpretations expressed in non-legally binding FAQs, when it has the capacity to deal with the matter unequivocally in a legally binding class order under s 765A(1)(z) and (2) declaring bills of exchange and simple promissory notes not to be financial products. Perhaps ASIC prefers to hide in the shadows of the interpretational difficulties that have been created by the legislators than to stand in the spotlight and be seen to be doing something that is so plainly contrary to the spirit and intent of the FSRA reforms.

Hopefully this article will shine some light on this issue. It will be interesting to see if and how ASIC responds.

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