A DECADE ON: REFORMING THE FINANCIAL SERVICES LAW REFORMS[*]

DR KEVIN A LEWIS [**]

1. Introduction

With the advent of a new equities exchange later this year, much attention is currently focussed on the law reforms being introduced to facilitate and regulate competition[1] and how the Australian market and its regulators will adapt to the new competitive environment.

Fittingly, this year marks 10 years since the Financial Services Reform Act 2001 (Cth)[2] was enacted. Its grand ambition was to transform a piecemeal and inefficient system for regulating financial products and services into:

> a competitively neutral regulatory system which benefits participants in the industry by providing more uniform regulation, reducing administrative and compliance costs, and removing unnecessary distinctions between products.[3]

It was the FSRA that laid the foundation for competition in our financial markets through its introduction into chapter 7 of the Corporations Act 2001 (Cth)[4] of a single authorisation procedure for financial exchanges and clearing and settlement facilities.[5]

In this paper, I intend to focus on some key parts of the FSRA reforms that in my view are broken or showing early signs of fracture and that I would argue need just as much attention by our lawmakers and regulators as the new competition rules, if our markets are to operate as they should. The areas I intend to address are:

- the definition of 'financial product';
- derivatives;
- continuous disclosure and insider trading;
- short selling;
- product disclosure;
- licensing; and
- the need for Parliament to clean up its Act.

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[**] MBA (Sydney); SJD (Harvard); LLB (Hons), B Juris (Hons) (UWA). The author is an adjunct professor of law and teaches the course *Compliance: Theory and Practices in the Financial Services Industry* in the post-graduate program at the University of Sydney. He is also the Chief Compliance Officer of ASX Limited ("ASX"). The views expressed in this paper are strictly the personal views of the author and should not be taken to be the corporate views of ASX.

[1] See, for example, ASIC Consultation Paper 145 *Australian equity market structure: Proposals*; ASIC Report 237 *Response to submissions on Consultation Paper 145 Australian equity market structure: Proposals* and ASIC Regulatory Guide 223 *Guidance on ASIC market integrity rules for competition in exchange markets*.

[2] Referred to in this paper as the "FSRA".

[3] Financial Services Reform Bill 2001, Revised Explanatory Memorandum, paragraph 1.5.

[4] Referred to in this paper as the "Corporations Act". References to an Act or chapters, parts, divisions or sections of an Act are to the Corporations Act, unless otherwise indicated. References to a regulation are to the Corporations Regulations 2001 (Cth), unless otherwise indicated.

[5] Parts 7.2 and 7.3 respectively.

2. The definition of 'financial product'

Chapter 7 has a 3 pronged approach to defining the term 'financial product':

- a general definition in s763A, which captures facilities for making a financial investment (s763B), managing financial risk (s763C) or making non-cash payments (s763D) and which is subject to a carve-out (s763E) for 'incidental products' (that is, things that may incidentally involve making a financial investment, managing financial risk or making non-cash payments but which do not have that as their main purpose);
- a list of specific inclusions in s764A; and
- a list of specific exclusions in s765A.

These take priority in reverse order, so that if something falls within the list of specific exclusions in s765A, it cannot be a financial product, even if it might otherwise fall within the list of specific inclusions in s764A or the general definition in s763A. Similarly, if something falls within the list of specific inclusions in s764A (and does not fall within the list of specific exclusions in s765A), it will always be a financial product, even if it might not otherwise fall within the general definition in s763A or might otherwise be excluded from that general definition because of the carve-out for incidental products in s763E.

The stated reason for defining 'financial product' in this way was:

> to provide significant flexibility in defining the financial products that are to come within the regime and … to cater for emerging products without the need to amend the legislation.[6]

It was not in fact necessary to adopt this approach to achieve a flexible outcome. Parliament reserved a general power for the regulations to declare something to be, or not to be, a financial product in ss764A(1)(m) and 765A(1)(y) respectively.[7]

The problem with this form of legislated flexibility is that the broadness of the general definition of 'financial product' in s763A and its component parts in ss763B, 763C and 763D, and the vagueness of the exclusion for incidental products in s763E, have the potential to capture things that plainly are not financial products in the ordinary sense of that word, as two recent decisions demonstrate.

A. Section 763B – making a financial investment

In *ASIC v Money for Living (Aust) Pty Ltd (Administrators Appointed) (No 2)*,[8] the defendants (one of whom had a criminal history and was disqualified from being involved in the management of a company) promoted a scheme targeted at retirees and pensioners, enticing them to sell their homes and then lease them back for the balance of their life, purportedly so that they could free up and live off the equity tied up in their family home. The purchase price for the properties was generally payable by way of upfront deposit and monthly instalments over periods that varied from 15 to 30 years, depending on the life expectancy of the home-owner. The rental payable under the lease was a notional $1 per year but a further sum was also deducted on account of rent from the purchase price instalments, effectively also tying the amount of rent payable to the life expectancy of the home-owner. The marketing offered participants a "guaranteed income", which appears to have been a reference to the right to receive instalments of the unpaid purchase price, since interest was not payable on the

[6] Financial Services Reform Bill 2001, Revised Explanatory Memorandum, paragraph 6.45.

[7] ASIC can also declare something not to be a financial product under ss765A(1)(z) and (2).

[8] [2006] FCA 1285 ("*Money for Living*").

outstanding purchase price except in the event of default. It also offered participants a "guaranteed right" to live in their former home for life. The scheme included provisions to enable third party investors to assume the liability of the purchaser to pay the purchase price, subject to recognising the rights of tenancy under the lease. Unfortunately, the scheme collapsed and the purchasers of the homes became insolvent companies under administration, leaving participants owed large sums of money on account of their unpaid purchase price.

ASIC sought various orders in relation to the scheme, which were not opposed by the defendants, on the basis that the sale and lease back transactions fell within the definition of 'making a financial investment' in s763B of the Corporations Act and s12BAA(4) of the Australian Securities and Investments Commission Act 2001 (Cth).[9] Consequently, they involved the marketing of a financial product, which in turn enlivened the court's jurisdiction under s1041H and ss12DA-12DC of those Acts respectively to make orders in relation to misleading conduct involving financial products.

To grant the relief sought by ASIC required the court to be satisfied that the home-owners had given money or money's worth (a *contribution*) to the promoters and that the contribution was used, or intended be used, by the promoters to generate a financial return or other benefit for the home-owners. On this point, Finkelstein J reasoned as follows:[10]

> On what basis, then, can it be said, as ASIC contends, that the sale and lease-back arrangements in question involve the client making a "financial investment"? This is not an easy question to answer. The proper approach in arriving at the answer must be based on the principle that the relevant provisions should be construed broadly: *Australian Softwood Forests Pty Ltd v Attorney-General (NSW) [1981] HCA 49;* (1981) 148 CLR 121. Adopting a broad view, it can be said that the investors (the clients) have contributed their homes for them to be used to generate benefits for themselves. The first benefit was the periodic tax free payments extending over many years. The homes were to generate this benefit as they were to be on-sold to investors who would provide the necessary funds. Also, there were benefits, or potential benefits, arising out of the leases. … [E]ach lease was for the client's life at what appears to be less than the market rent. This gave rise to two benefits; one actual the other potential. First, there was the low rent which was an immediate benefit. Second, there was the potential benefit that would arise if the client were to live longer than expected according to the life tables. ... If the client outlived the age prescribed in those tables he would receive a benefit; effectively the right to occupy the home for the additional period at no cost.
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> Assuming these to be relevant benefits for the purpose of the definition of "financial investment" it is still necessary to decide whether the word "gives" in the phrase "gives money or money's worth" includes a sale with a lease-back. Ordinarily the word "gives" would not carry that meaning. I observe, however, that in the note to s 12BAA there are examples of what acts constitute making a financial investment. One example is the subscription of money for shares in a company. In substance this is the acquisition of an asset for its exchange value in the hope of making either a capital profit or receiving income. If "gives" includes the purchase of an asset there is no reason why it should not also include a sale.

I have to confess that when I first read this decision, I found this conclusion surprising. However, as I have analysed the decision more closely, it seems to me, with respect, to be a correct application of the law, at least in so far as the ASIC Act is concerned.[11]

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[9] Referred to in this paper as the "ASIC Act".

[10] *Money for Living*, n8 above, at paragraphs 21-2.

[11] This includes the initial jarring finding that someone who sells their house is 'giving' it to the purchaser. On closer analysis, however, ss763B and 12BAA(4) clearly use the word "give" not in the sense of "gift" but rather in the sense of relinquishing ownership or possession. The notion clearly captures exchanging money for a chose in action, such as a share or managed investment product, as the notes to those sections confirm. There is no

In this regard, the definitions of 'financial product' and 'financial service' in ss12BAA and 12BAB of the ASIC Act are broader than their counterparts in the Corporations Act.[12] This was a deliberate policy decision on the part of our lawmakers, reflecting a desire that the consumer protection provisions in the ASIC Act should apply to a broader spectrum of products and services than the licensing and disclosure provisions in chapter 7 of the Corporations Act. In particular, there is no equivalent in the ASIC Act to the carve-out for 'incidental products' in s763E of the Corporations Act. Absent such a carve-out, the finding in *Money for Living* that the scheme under consideration involved the making of a financial investment, within the very broad definition of that term in s12BAA(4) of the ASIC Act, was one that was plainly open on the facts of that case.

Insofar as ASIC sought an injunction under s1041H of the Corporations Act, however, the decision in *Money for Living* is wanting in its failure to address whether the carve-out for incidental products in s763E applied. I believe that a strong case can be made that it should have applied on the facts of that case, since the main purpose of the sale and leaseback transactions was not really to make a financial investment but rather to make a divestment to free up cash. Consequently, even if the transactions technically fell within ss763A(1)(a) and 763B, s763E would have precluded them from being a financial product under the general definition of that term and therefore there was no jurisdiction to make any orders in relation to the transactions under s1041H.[13]

For me there are two key learnings from *Money for Living*. First, the words "or other benefit" need to be deleted from s763B of the Corporations Act and s12BAA(4) of the ASIC Act. The defining feature of a financial investment must surely be that there is, or is intended to be, a financial return on the money or money's worth contributed by the investor to the investee. The extension of that definition to any other benefit is just too broad, as *Money for Living* demonstrates.

Secondly, some consideration may need to be given to the way in which our law has split administrative responsibility for actions alleging misleading and deceptive conduct between ASIC and the ACCC. But for s131A of the Competition and Consumer Act 2010 (Cth), which excludes the application of the Australian Consumer Law to the supply or possible supply of financial products and services, *Money for Living* would have been a lay down misère for the ACCC under s18 of the Australian Consumer Law,[14] since the relevant misrepresentations in

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reason, therefore, as Finkelstein J observed, why it should not also capture exchanging other property (money's worth) for a chose in action, such as a promise to pay an amount over a period of time.

[12] For instance, specifically included in the ASIC Act definition of 'financial product' are contracts to exchange one currency for another that are immediately settled (s12BAA(7)(j)) and credit facilities (s12BAA(7)(k)). These are specifically excluded from the Corporations Act definition of 'financial product' (ss765A(1)(m) and (h) respectively). Also, the exclusions from the definition of 'non-cash payment' in s763D(2) of the Corporations Act for single payee payment facilities and letters of credit from, cheques drawn by and on, or guarantees given by, a financial institution have no counterpart in the ASIC Act.

[13] Although there was possibly a different line of argument that ASIC might have used to attract s1041H. The description of the scheme in the *Money for Living* decision would seem to suggest that it involved more than 20 persons contributing property to, and expecting to derive a benefit from, a "common enterprise". If that is so, it involved the marketing of an unauthorised managed investment scheme. Attacking the scheme in this way would have avoided the need to demonstrate that it fell within the general definition of 'making a financial investment', since interests in such schemes are unambiguously financial products under s764A(1)(ba). Not only would this line of attack have grounded an injunction for misleading and deceptive statements about the scheme under s1041H of the Corporations Act and ss12DA-12DC of the ASIC Act, it also would have formed the basis for orders avoiding the home sales under s601MB, and winding up the scheme under s601EE, of the Corporations Act.

[14] Or its predecessor, s52 of the Trade Practices Act 1974 (Cth). Section 131A of the Competition and Consumer Act 2010 had its counterpart in s51AF(1) of the Trade Practices Act 1974.

that case unquestionably happened in trade or commerce. I can't help but wonder whether the court in *Money for Living* would have given the same broad reading to the definition of 'makes a financial investment' if the application for relief had been brought by the ACCC, rather than ASIC, and was being resisted by the defendants under s131A on the basis that it involved a financial product. Given the vagaries and uncertainties around the reach of the definition of 'financial product', I'm not sure a regulatory framework that determines which regulator can sue under which Act based on whether something is or is not a financial product is a desirable one.

B. Section 763C – managing financial risk

In *Chameleon Mining NL v International Litigation Partners Pte Ltd*,[15] the plaintiff, a mining company listed on the ASX, sought to avoid its obligations under a litigation funding deed on a number of grounds, including that it amounted to the provision of a financial service by the litigation funder, which did not have an AFSL authorising it to provide such a service. In particular, it argued that the deed was an arrangement through which it had made a financial investment under s763B and/or managed financial risk under s763C[16] and therefore was a financial product under ss763A(1)(a) and/or (b).[17]

At first instance, Hammerschlag J peremptorily dismissed this argument, holding that if anyone was making a financial investment, it was the litigation funder not the plaintiff, since it had agreed to pay the legal costs of the litigation in the hope of receiving a return on that investment.[18] He also held that while the deed had the effect of minimising one category of financial risk for the plaintiff (namely, the risk that it would incur expense in pursuing the litigation which would be wasted if it did not recover a sufficient sum in the proceedings), on no realistic view could it be said that the deed was a financial product whereby the plaintiff managed that risk. Hammerschlag J found that the object of the deed was to enable the plaintiff to prosecute its claim in the litigation by having the litigation funder pay the legal costs and not to manage the risk of possible failure in that endeavour.[19] While his Honour did not couch his decision in these terms (in fact he did not address s763E at all), the latter finding is consistent with a view that the primary purpose of the deed was not to manage financial risk and that this was only an ancillary purpose and therefore the deed was excluded from being a financial product by s763E.

This decision was reversed on appeal,[20] with all 3 appellate judges holding that the litigation funding deed was in fact a facility through which the plaintiff managed financial risk, namely, the financial consequences to the plaintiff of adverse costs orders and loss of litigation, and possibly also the incurring of its own costs in pursuing the litigation. Giles and Young JJA also held that the deed was not an incidental product within the meaning of s763E, as its principal purpose was in fact to manage that financial risk. Hodgson JA dissented on this issue, holding that the deed had as its main purpose funding litigation and that any management of financial risk was merely incidental to that object.

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[15] [2010] NSWSC 972.

[16] Section 763C provides that a person manages financial risk if they: (a) manage the financial consequences to them of particular circumstances happening; or (b) avoid or limit the financial consequences of fluctuations in, or in the value of, receipts or costs (including prices and interest rates).

[17] A similar argument was raised by the plaintiffs in *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567, discussed in the text accompanying n30 below, but rejected because it was not supported by the pleadings or the evidence.

[18] [2010] NSWSC 972, at paragraph 80.

[19] Ibid, at paragraphs 82-5.

[20] *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50.

Young JA was particularly moved by the need to interpret consumer protection laws widely, saying:[21]

> If one approaches the matter from a common sense practical broad brush commercial viewpoint, I think one balks at the idea that an arrangement which is aimed at funding particular litigation is caught as an illegal financial product. However the approach of the majority in *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd* [2009] FCAFC 147; 180 FCR 11 shows that this initial feeling might well be overcome by looking at the object of the statute, the approach taken by the High Court in *Australian Softwood Forests Pty Ltd v Attorney-General (NSW)* [1981] HCA 49; [1981] HCA 49; 148 CLR 121 and the actual words used in the statute.
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> The majority in *Brookfield Multiplex* held that a funding agreement in the circumstances of that case was a managed investment scheme.
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> The approach of the High Court in *Australian Softwood Forests* at 129-130 was that if you find wide words in a statute to protect the investing public, and the circumstances of the case come within the literal words, there is no reason to read down those general words, unless, at least, one can "glean from the legislative provisions an overall purpose which, being limited in scope, justified a reading down of the definition". That exception does not apply here.
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> Using that approach in the instant case, the facts, as Mr Bathurst has submitted do fit the words of the statute, the statute is one to protect consumers of financial products, here we have a financial product within the definition and one which has a principal purpose to minimise financial risk and there is no reason to read the statute down to remove this type of financial product.

With the greatest of respect, this was not a case raising concerns about the protection of the investing public – it was a case where a publicly listed company was seeking to dishonour legitimate contractual obligations it had freely entered into.

It is all well and good to give consumer protection laws a wide reading to achieve their aim but when Parliament has included a provision such as s763E to mitigate the potential overreaching of the very wide definition of 'financial product' in sections 763A-763D, that section also needs to be given a fair reading, consistent with that purpose. Section 763E plays an important role in ensuring that things that are not really financial products do not accidentally become subject to the licensing and disclosure requirements in chapter 7 because of the breadth of the general definition of 'financial product'. In this regard, it is respectfully submitted that Hodgson JA's reading of s763E is more consistent with the language and intent of s763E than that of Giles or Young JJA and, for that reason, is to be preferred.

3. Derivatives

A. The breadth and vagueness of the definition of 'derivative'

For a long time now, I have held the view that the definition of 'derivative' will prove to be one of the most problematical provisions in the FSR reforms. [22] It is extremely broad and, in the absence of a careful and consistent reading by regulators and the judiciary, has the potential to capture a range of transactions that would not generally be considered to be derivatives by market participants.

Section 761D(1) defines a 'derivative' as:

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[21] Ibid, at paragraphs 206-9.

[22] To illustrate the difficulties in interpreting and applying the definition of 'derivative', you need look no further than the 4 remarkably different views expressed on the interpretation of the definition and its various exclusions in the judgments at first instance and on appeal in the *Chameleon Mining* case, n15 and n20 above, explored below.

an arrangement under which:

(a) a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind or kinds to someone;

(b) that future time is not less than the number of days, prescribed by regulations made for this purpose, after the day on which the arrangement is entered into; and

(c) the amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:

(i) an asset;

(ii) a rate (including an interest rate or exchange rate);

(iii) an index;

(iv) a commodity.

Under s761D(2), anything declared by the regulations to be a derivative for the purposes of s761D is a derivative for the purposes of chapter 7 and this applies despite anything in ss761D(3) and (4).

Section 761D(3) excludes from the definition of derivative:

(a) an arrangement in relation to which:

(i) a party has, or may have, an obligation to buy, and another party has, or may have, an obligation to sell, tangible property (other than Australian or foreign currency) at a price and on a date in the future;

(ii) the arrangement does not permit the seller’s obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property; and

(iii) neither usual market practice, nor the rules of a licensed market or a licensed CS facility, permits the seller’s obligations to be closed out by the matching up of the arrangement with another arrangement of the same kind under which the seller has offsetting obligations to buy;

but only to the extent that the arrangement deals with that purchase and sale;

(b) a contract for the future provision of services;

(c) any of the financial products specifically listed in s764A(1) (other than a derivative); and

(d) anything declared by the regulations not to be a derivative.

Section 761D(4) provides that an arrangement under which one party has an obligation to buy, and the other has an obligation to sell, property is not a derivative for the purposes of chapter 7 merely because the arrangement provides for the consideration to be varied by reference to a general inflation index such as the Consumer Price Index.

In common with many other parts of chapter 7, these provisions are then substantially modified in the regulations. Regulation 7.1.04(1) prescribes that the relevant period for the purposes of s761D(1)(b) is 3 business days if the derivative is also a foreign exchange contract and one business day in all other cases. Regulation 7.1.04(2) then declares that, for the purposes of s761D(2), an arrangement is a derivative if it satisfies the following conditions:

(a) the arrangement is not a foreign exchange contract;

(b) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time (which may be less than 1 day after the arrangement is entered into) consideration of a particular kind or kinds to someone;

(c) the amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount

of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:

(i) an asset;

(ii) a rate (including an interest rate or exchange rate);

(iii) an index;

(iv) a commodity.

Regulations 7.1.04(4), (5), (6) and (7) in turn provide similar carve outs to the extended definition of 'derivative' in r7.1.04(2) to those contained in ss761D(3)(a), (4), (3)(b) and (3)(c) respectively.

The reasons for these drafting gymnastics may not be immediately apparent but the intention and effect is basically to replace the definition of 'derivative' in s761D with the definition in r7.1.04(2), and to exclude from that definition spot foreign exchange contracts, which in accordance with market practice are settled 2 business days after entry.[23]

To understand the complexity of the definition of 'derivative' and what the draftsperson was trying to achieve, it is necessary to turn to the Revised Explanatory Memorandum for the Financial Services Reform Bill for guidance:

> 6.80 The definition of 'derivative' in proposed section 761D has been formulated to replace the existing definition of 'futures contract' in section 72 of the Corporations Act. As recommended by CASAC in its report entitled '*Regulation of On-exchange and OTC Derivatives Markets*' the definition focuses on the functions or commercial nature of derivatives rather than trying to identify each product that will be regarded as a derivative. The definition proposed by CASAC in its report has been used in developing the definition in proposed section 761D.
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> 6.81 Features of the definition of 'derivative' to note are:
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> - under the arrangement a person must or may be required to provide consideration at some future time. This ensures that options that otherwise fall within the definition are captured (proposed paragraph 761D(1)(a));
> - the consideration is of a particular kind or kinds. This would cover those contracts that provide for cash settlement or physical delivery (proposed paragraph 761D(1)(a));
> - contracts, such as spot foreign exchange transactions, which could vary in value as a result of movements in the exchange rate during the settlement period, will be excluded by regulation under proposed paragraph 761D(1)(b);
> - the definition covers all arrangements where the amount of the consideration or the value of the arrangement varies by reference to something else (of any nature whatsoever and whether deliverable or not), including but not limited to a commodity (proposed paragraph 761D(1)(c));
> - it encompasses arrangements under which both the amount of the consideration or the value of the arrangement varies by reference to something else. This ensures that the definition covers deliverable options and futures contacts under which the consideration remains the same but the value of the arrangement varies by reference to something else (proposed paragraph 761D(1)(c));
> - all consideration, including initial or periodic consideration, the amount of which was fixed at the time the arrangement was entered into, is taken into account, ensuring that options under which the obligation to pay the other party a variable amount only arises on the occurrence of a future contingent event [*sic* are covered].

[23] One of the unintended outcomes of this drafting approach is that it is now possible to structure a short-term derivative over foreign currency that will be regulated as a foreign exchange contract rather than a derivative, provided it settles in under 3 business days.

- proposed paragraph 761D(3)(a) excludes from the regime a range of transactions involving the future delivery of something, including such things as contracts for the sale of land with a three month settlement period, while bringing within the regime those forward rate agreements that should be regarded as derivatives, because they are being used for hedging or speculative purposes. This is a difficult dividing line to draw as much depends on the intentions of the particular parties concerned. The existing Corporations Act seeks to deal with this issue by the concept of the likelihood of the agreement being settled other than by delivery (see definition of 'eligible commodity agreement' in section 9 of the Corporations Act). However, CASAC explicitly rejected this test on the basis that the 'unlikely' requirement was not clear and some futures contracts such as deliverable share futures may not be likely to be closed out. Proposed section 761D seeks to address this issue by:
  - applying the relevant exclusion to tangible property only. It would not therefore apply to a deliverable share or bank bill future, as the underlying property is intangible (proposed subparagraph 761D(3)(a)(i));
  - rather than focussing on the mandatory delivery aspect, it looks to whether the arrangement can settled by cash or by set-off between the parties. If the arrangement relates to tangible property and can not be cash settled, it will fall outside the definition of derivative (proposed subparagraph 761D(3)(a)(ii));
  - contracts which provide for some top-up of cash in the event that tangible property does not meet the standard for delivery would none the less be excluded from the definition as a result of the reference to wholly settled by cash in proposed subparagraph 761D(3)(a)(ii);
  - looking to the wider context in which the arrangement is made and recognising that while a contract on its face appears to require delivery of tangible property, market practice or the rules of a market or clearing and settlement facility mean that delivery is not mandatory, but that the contact can be closed out by entering into an offsetting transaction (proposed subparagraph 761D(3)(a)(iii)).
- The definition covers all options other than:
  - options over unissued shares, which fall within the definition of 'security' (proposed paragraph 761D(3)(c));
  - options over tangible property which do not allow for cash settlement. Such options would fall within the exclusion in proposed paragraph 761D(3)(a); and
  - any other options prescribed by regulations (proposed paragraph 761D(3)(d) allows regulations to exclude things from the definition of 'derivative').
- Proposed subsection 761D(4) takes out of the definition of 'derivative' arrangements that only vary by reference to a general inflation index. This is intended to take outside the definition arrangements that would otherwise be derivatives merely because they have an inflation clause in them.

As a point of detail, the list of options in the second last bullet point above said to be excluded from the definition of 'derivative' should also have mentioned options over unissued interests in managed investment schemes[24] and options that confer an equitable right or interest in an issued share or debenture[25] or in an issued interest in a managed investment scheme.[26]

[24] These fall within s764A(1)(b)(iii) if the scheme is registered, and s764A(1)(ba)(iii) if the scheme is not registered, and therefore cannot be a derivative because of s761D(3)(c) and r7.1.04(7).

[25] These fall within paragraph (c) of the definition of 'security' and therefore within s764A(1)(a) and therefore cannot be a derivative because of s761D(3)(c) and r7.1.04(7).

[26] These fall within s764A(1)(b)(ii) if the scheme is registered, and s764A(1)(ba)(ii) if the scheme is not registered, and so again cannot be a derivative because of s761D(3)(c) and r7.1.04(7).

More substantively, if the second last quoted bullet point above is correct and the definition of 'derivative' does indeed capture all deliverable options over property that fall outside the exclusions there mentioned simply because the inherent value of the option will vary with movements in the value of the underlying property, then where do you draw the line? Does it not logically follow that any agreement to buy or sell property that has a fluctuating market value, that falls outside those exclusions and that is not immediately settled, will therefore be a derivative simply because the value of that agreement will vary between the time it is made and the time it is settled, by reference to the fluctuating value of that property?

Take, for example, an agreement to buy shares on the ASX, which settles on a T+3 basis. Over those 3 days, the value of that agreement will vary with movements in the market value of the shares in question. If the market price of the shares goes up then the value of the agreement to buy those shares also goes up, which the buyer can readily realise simply by entering into an agreement to sell the shares at the higher prevailing market price. On the view of the definition of 'derivative' expressed in the Revised Explanatory Memorandum for the Financial Services Reform Bill, the agreement to buy shares would be a derivative.[27]

Consider also a standard equipment lease financing. Typically the customer/lessee will be obliged to pay a residual that will vary by reference to the value of the equipment at the termination of the lease. Potentially this arrangement falls within the definition of 'derivative' – it is an arrangement under which a person (the lessee) may be obliged to make a payment in the future that is ultimately determined or varies by reference to the value of an asset (the equipment). Such an arrangement will generally not be protected by the exclusion for sales and purchases of tangible equipment in s761D(3)(a) and r7.1.04(4) because the equipment lease will usually expressly exclude any option or contract to purchase the equipment (otherwise, it would convert the lease into a hire purchase contract). Nor will it be covered by the incidental product exclusion in s763E – if something is a derivative, it is caught by s764A(1)(c) and therefore specifically excluded from the operation of s763E.[28]

When these provisions were first enacted, I queried whether a court would agree with the view expressed in the Revised Explanatory Memorandum that all non-excluded options are caught by the definition of 'derivative', having regard to the words "something else" in that definition. To my mind, if you have a deliverable (rather than a cash settled) option over a thing and the value of that option varies simply because of variations in the value of that thing, I am not sure it can fairly be said that the variation has occurred because of "something else"?[29]

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[27] Some may seek to argue that an agreement to purchase shares on a stock market gives the purchaser an equitable interest in the shares purchased and therefore falls within paragraph (c) of the definition of 'security' in s761A. Accordingly, it will not be a derivative because of the operation of s761(3)(c) and r7.1.04(7). However, I believe that the better view is that an agreement to buy shares on a stock market does not give the buyer an equitable interest in any underlying shares because of the way in which the clearing and settlement process works and so I don't believe this argument is correct.

[28] Section 763E only applies for the purposes of part 7.1 division 3 subdivision B. It acknowledges in its concluding words that a product that falls within its terms may still be a financial product because of subdivision C (ie under s764A(1)).

Having raised this issue, I would like to think that if it were ever to come before a court, the court would look to the totality of the arrangement and find that it was just a component part of a credit facility and therefore excluded from being a financial product by s765A(1)(h). Nevertheless, the breadth of the definition of 'derivative' does open the door for a recalcitrant lessee who wishes to avoid paying a residual to argue that the payment obligation is a derivative.

[29] Similarly, and by extension, if someone has an agreement to sell a thing to another person and both parties intend for the thing to be delivered by the seller to the buyer (rather than cash settled) and the value of that

This line of argument has found some favour in two recent decisions. In *Keynes v Rural Directions Pty Ltd (No 2)*,[30] the plaintiffs sought to avoid their obligations under forward contracts for supply of wheat and barley on the basis that they were derivatives under the Corporations Act and they had not received an appropriate Product Disclosure Statement (PDS) from the counterparty. Besanko J at first instance granted summary judgment in favour of the defendants, holding that the contracts were not derivatives because they did not satisfy the requirements of s761D(1)(c)[31] and, in any event, were excluded from being derivatives by s761D(3)(a).[32] On the former point, Besanko J stated:[33]

> The consideration under the forward contracts is fixed and the plaintiffs do not rely on that part of the definition which refers to the *amount of the consideration*. They submit that under the forward contracts the *value of the arrangement … varies by reference* to the market price of wheat or barley from time to time. By way of example, they submit that if the price of wheat or barley rise, and a buyer enters into a contract to sell the same quantity at the then market price, the "value of the arrangement" from the buyer's point of view will increase by the increase in market price.
>
> The plaintiffs also call in aid s 761B which provides as follows:
>
> > "If:
> >
> > (a) an arrangement, when considered by itself, does not constitute a derivative, or some other kind of financial product; and
> >
> > (b) that arrangement, and one or more other arrangements, if they had instead been a single arrangement, would have constituted a derivative or other financial product; and
> >
> > (c) it is reasonable to assume that the parties to the arrangements regard them as constituting a single scheme;
> >
> > the arrangements are, for the purposes of this Part, to be treated as if they together constituted a single arrangement."
>
> I do not think s 761B assists the plaintiffs. Taking the example given by the plaintiffs, I do not think another contract, say a contract by the buyer to sell the wheat or barley he has contracted to purchase, can be at one and the same time part of the *arrangement* for the purposes of determining the *value of the arrangement* and be the *something else* within s 761D(1)(c).
>
> On the face of it, the words the *value of the arrangement* are very broad, and, if the plaintiffs' submissions are correct, many transactions would be derivatives, even though they would not be considered to be derivatives as a matter of ordinary language. Almost all forward contracts for goods which are readily obtainable in the market would be caught. Under the regulations, the prescribed period in the case of contracts, other than foreign exchange contracts, is one business day (reg 7.1.04(1) and see also reg 7.1.04(2)). I acknowledge the fact that there are the exceptions in s 761D(3) but even so, one is cautious of an interpretation of subs (1) which would catch an ordinary transaction like the sale and purchase of a motor vehicle with payment of the purchase price today and delivery in one week's time. It seems to me that the answer lies in the meaning of the "something else" referred to in the paragraph. It includes an asset, a rate (including an interest rate or exchange rate), an index or a commodity and things of any nature whatsoever and whether or not deliverable. In my opinion, although the precise boundaries of the definition may be difficult to identify, the matters the plaintiffs relied on, that is, the fact that

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agreement varies simply because of variations in the value of that thing, I am not sure it can fairly be said that the variation has occurred because of "something else".

[30] [2009] FCA 567.

[31] That is, the requirement that the amount of the consideration, or the value of the arrangement, must ultimately be determined, derived from or vary by reference to (wholly or in part) the value or amount of something else.

[32] That is, the exclusion for sales and purchases of tangible property (other than Australian or foreign currency) that meet the requirements set out in that section.

[33] Ibid, at paragraphs 84-8.

> there is a market for goods and that a party to the arrangement may enter into a transaction, is [*sic* not] "something else" for the purposes of paragraph (c).
>
> In my opinion, the forward contracts do not fall within s 761D(1) because the condition in para (c) is not satisfied.

On appeal,[34] the Full Federal upheld the decision under s761D(3)(a) and therefore did not find it necessary to address the s761D(1)(c) argument in any detail, simply saying:[35]

> One may doubt whether such contracts satisfy the requirements of s 761D(1) so as to be derivatives, quite apart from the operation of s 761D(3). Clearly, the amount of the consideration will not vary. The applicants rely on the words "the value of the arrangement". The meaning of that expression is obscure. One immediately asks: "The value to whom?" It may be arguable that if prices rise, the value of the contract to the buyer will rise. It may similarly be arguable that if prices fall, the value to the seller will rise. In each case, the value depends upon the enforceability of the contract. If the arrangement in question is not a contract, then how is it to be valued? Yet the definition of the term "arrangement" clearly contemplates non-contractual arrangements. This line of reasoning might provoke questions concerning the meaning of the term "consideration" in a non-contractual arrangement, leading in turn to an inquiry as to how a party might be required to provide consideration for the purposes of s 761D(1)(a) in a non-contractual context. It may be that it is impossible to work out the actual operation of s 761D(1) other than for a specific "arrangement". If his Honour was correct in concluding that s 761D(3) was decisive of the matter, it will not be necessary further to consider that question. …
>
> [Another matter] … raised by the proposed notice of appeal … is whether, for the purposes of s 761D(1)(c), the values of the forward contracts were determined, derived from or varied by reference to the price of wheat and/or barley. His Honour disposed of the matter as a construction point. We are inclined to the view that if the value of an arrangement (whatever that term means) may vary with fluctuations in the price of the grain in question or some other grain, then the provision may be satisfied. However, given the difficulties in construction to which we have referred, and the evidentiary matters which are necessarily involved, it is better that we not finally determine this question.

A similar argument was raised before the NSW Supreme Court in *Chameleon Mining NL v International Litigation Partners Pte Ltd*, mentioned previously.[36] In that case, the plaintiff also argued that the litigation funding deed was a derivative because it provided for a return to the litigation funder of an amount that was ultimately determined by reference to, and varied according to, the proceeds of the litigation or the legal costs incurred in the litigation. At first instance, Hammerschlag J found that the fact that the deed provided for its immediate cancellation if there was a change of control of the plaintiff and for the payment of a fixed early termination fee in those circumstances was sufficient to take the litigation funding deed outside of the definition of 'derivative', saying:[37]

> Section 761D(1)(c) requires the amount of the consideration or the value of the arrangement ultimately to be determined, derived from or vary by reference to (wholly or in part) the value of something else. The word "ultimately" in the subsection plainly qualifies the words "determined, derived from or varies by reference to" (there being no comma before the words which follow the words in parentheses).
>
> This is no doubt because it is in the nature of a derivative that the value of the arrangement will (as the word "ultimately" connotes) in every case be affected by (and hence derived from) the value of something else. The Deed does not have this invariable operation, as the facts in the

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[34] *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100.

[35] Ibid, at paragraphs 26 and 62.

[36] See n15 above.

[37] *Chameleon Mining NL v International Litigation Partners Pte Ltd*, n15 above, at paragraphs 78-9.

> present case demonstrate. The amount of the Early Termination Fee on the particular Change in Control here is not determined or derived from, nor does it vary by reference to the value of, something else.

On appeal, this interpretation of the word "ultimately" did not find favour with any of the appellate judges.[38] Only Young JA addressed the meaning of "something else", agreeing with the trial judge that the litigation funding deed was not a derivative for this reason:[39]

> Mr Walker defended the primary judge's construction. He also put in written submissions that when looked at "through the functional prism of the legislature, it is clear that the Funding Deed is not a derivative. This is fundamentally because the Funding Deed relates to, and creates interests in, the Federal Court Proceeding. Every possible permutation of the amount of the consideration or value of the arrangement to either party relates directly to this proceeding, as opposed to derivatively to some secondary something else." Thus, the value of the Funding Agreement is not ultimately determined by reference to the value of something else.
>
> Mr Walker puts that the opposing construction is so broad that the category of "derivative" would virtually be rendered meaningless.
>
> My mind has fluctuated as I have been considering this question. Both side's propositions have some merit. However, even giving full weight to the reluctance to read down words in a statute for the protection of investors, it seems to me that Mr Walker is correct when he says that the appellant's construction would make the operation of the definition of "derivative" so broad that it would be virtually meaningless. This is reinforced by the fact that, absent the definition, the present interest comes nowhere near the category of derivative as commercially understood.

Hodgson JA reached the same ultimate conclusion but for different reasons. He found that the part of the arrangement evidenced in the litigation funding deed which provided for the payment of the funding fee, which in some cases was determined by the proceeds of the litigation and in others by the amount of legal costs paid, was potentially a derivative. However, he found that it was excluded from being a derivative by s761D(3)(b) and r7.1.04(6) because it was a contract for future provision of services. Giles JA dissented on this point. He also considered that the deed was a derivative because the value of the arrangement was affected by something else, that is, the legal costs or the outcome of the litigation, but found that it was not excluded from being a derivative by s761D(3)(b) and r7.1.04(6) because it was a contract for the provision of money rather than a contract for the future provision of services.[40]

Hammerschlag J's interpretation of the word "ultimately" has much to commend it, in terms of narrowing an otherwise impossibly wide provision to capture arrangements that would

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[38] The construction put forward by Hammerschlag J as to the meaning of "ultimately" was expressly rejected by Giles JA (n20 above, at paragraphs 50-54) and Hodgson JA (n20 above, at paragraph 131). Young JA recounted the arguments put by opposing counsel on this point but did not express any conclusion as to which was correct (n20 above, at paragraphs 225-30 and 236), instead resting his decision of the meaning of "something else".

[39] *International Litigation Partners Pte Ltd v Chameleon Mining NL*, n20 above, at paragraphs 236-8.

[40] Hammerschlag J at first instance and Young JA on appeal also concluded that the litigation funding deed was not a contract for the future provision of services. Hammerschlag J reached a similar conclusion to Giles JA that the deed was a contract for the provision of money rather than services (n15 above, at paragraph 81). Young JA held that the exclusion in question was intended only to apply to contracts for the provision of services where the amount payable varied by reference to the amount of time involved in providing the services and did not apply on the facts of that case (n20 above, at paragraphs 239-42).

The court at first instance and on appeal also had to consider whether the deed was excluded from being a financial product under s765A(1)(h) by virtue of it being a credit facility. At first instance, Hammerschlag J rejected that argument, finding that the deed did not defer payment of any debt owed by the plaintiff to the litigation funder or result in the plaintiff incurring a deferred debt to the litigation funder and therefore did not involve the provision of 'credit', as defined in r7.1.06(3). On appeal, Young and Giles JJA reached a similar conclusion. Hodgson JA, dissenting on this point, found that the deed was a credit facility.

typically be regarded as derivatives by market participants. It does, however, lend itself to abuse. It would mean, for example, that someone could structure their way around the definition of 'derivative' by the simple expedient of including a right of termination, or a provision providing for a fixed rather than fluctuating payment, that in each case might only be triggered in very exceptional circumstances.

If the view put forward above of the meaning and effect of the words "something else" is accepted, as it appears to have been by Young JA and Besanko and Hammerschlag JJ, then it follows that Parliament has not achieved the ambition outlined in the Revised Explanatory Memorandum for the FSR Bill of capturing all deliverable options that fall outside the exclusions in s761D(3)(a) and r7.1.04(4). It also follows that those exclusions are now largely redundant, as the types of arrangements that they would otherwise exclude from the definition of derivative are not in fact caught by that definition.

The definition of 'derivative' needs to be simplified and redrafted, so that it only captures products that are generally understood to be derivatives. In my view, it should have 2 limbs.[41] The first should capture agreements that substantively provide for a payment of money calculated by reference to the value of something else, or the difference in the value of certain things, at a future time or over a future period. The second should flip s761D(3)(a) and r7.1.04(4) on their heads to provide that:

> For the purposes of this Chapter, an arrangement in relation to which a party has, or may have, an obligation to buy, and another party has, or may have, an obligation to sell property of any kind at a price and on a date in the future is a derivative if:
>
> (i) the arrangement permits the seller's obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property;[42] or

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[41] I would suggest retaining s761D(2), so that the regulations can declare something to be a derivative for the purposes of s761D in case the two tests suggested are found wanting or someone is clever enough to structure their way around those two tests.

[42] As discussed above, in *Keynes v Rural Directions Pty Ltd (No 2)*, n30 above, the Court at first instance also held that forward contracts for supply of grain were not derivatives for the purposes of the Corporations Act because they fell within the exclusion for deliverable contracts over tangible property in s761D(3)(a) and r7.1.04(4). In so doing, the court rejected an argument that the fact the sellers might be liable in damages for failure to deliver the grain meant that the sellers' obligations could be wholly settled by cash, saying (at paragraphs 71-2):

> If it be assumed (as is probably the case), that a failure by a seller to deliver wheat or barley under forward contracts of the type in question in this case would ordinarily lead to an award of damages rather than an order for specific performance, then, putting to one side for the present the effect of washout provisions, it would only be in a very loose sense that it could be said that the seller's obligations could be wholly settled by cash, rather than the delivery of the property. I do not think that that is what s 761D(3)(a)(ii) means. It seems to me that the important words in the paragraph are *arrangement*, *permit* and *rather than*. It seems to me that those words mean that the option wholly to settle an obligation by cash must be in the arrangement, it must be vested in the seller and the alternatives of paying cash or delivering the property must be of a similar nature or standing. The "option" of paying damages is not an option provided by the arrangement, nor is it of a similar nature or standing as the obligation to deliver the property. ...
>
> The obligation to pay damages arises when the seller breaches his obligations, not when he settles them. The buyer's right to recover nominal damages in certain circumstances reinforces the point. There is also force in the submission of counsel for [one of the defendants] that it is inherently unlikely that Parliament would have intended that the application of a provision such as paragraph (ii), with all the consequences that flow therefrom, would turn on whether the discretionary remedy of specific performance was likely to be awarded.

The court rejected a similar argument about a "washout" provision in the contract which provided that the sellers could avoid the contract by paying a liquidated amount in the event their crop failed, saying (at paragraphs 73-4):

> I turn now to the plaintiffs' … submission … that the washout provisions in the forward contracts mean that they fall outside the terms of paragraph (ii) because they permit the seller's (that is, the plaintiffs')

(ii) usual market practice, or the rules of a licensed market or a licensed CS facility, permit the seller's obligations to be closed out by the matching up of the arrangement with another arrangement of the same kind under which the seller has offsetting obligations to buy.[43]

B. The interplay of the definition of 'derivative' with the definition of other financial products

Section 761D(3)(c) and r7.1.04(7) exclude from the definition of 'derivative' anything that falls within the list of specific things that are financial products in s764A(1), other than s764A(1)(c) (which refers to derivatives). One of the incidental effects of this provision is that the definition of 'derivative' is effectively subservient to the definitions of the other financial products mentioned in s764A(1).[44] Thus, if a product falls within the definition of 'derivative' and, say, 'security', s761D(3)(c) and r7.1.04(7) will operate so that it is treated as a security rather than a derivative. This has led to some serious drafting acrobatics to capture hybrid products, such as warrants, and bring them within the regulatory net of chapter 7.[45]

A 'warrant' is defined in r1.0.02(1) to mean a financial product:

(a) that is:

> obligations to be wholly settled by cash, rather than the delivery of the property. I reject that submission because the washout provisions are of a different nature and have a different operation to a permission in the arrangement for the seller's obligations to be wholly settled by cash. First, the washout provisions in the case of the ... first forward contract only operate if the plaintiffs suffer production failure, and they only operate in the case of the [other] forward contract[s] if the seller finds that he is or will be in default. Secondly, it is correct to say that, in essence, the washout provisions operate at the option of the buyer, not the seller. Thirdly, where invoked, the washout provisions result in a measure of damages similar to that specified in s 50(3) of the *Sale of Goods Act 1895* (SA) brought forward to a time at which it has become obvious to the seller that he or she will not be able to meet the obligation to deliver the goods.
>
> In my opinion, it is proper to characterise the washout provisions as contractual provisions as to the buyer's remedies in the case of breach and the measure of damages or compensation payable to the buyer in those circumstances.

Both findings were upheld on appeal (*Keynes v Rural Directions Pty Ltd*, n34 above, at paragraphs 38-46).

[43] In *Keynes v Rural Directions Pty Ltd (No 2)*, ibid, the Court at first instance also held that evidence led by the plaintiffs that growers were able to enter into offsetting contracts to reduce or cancel out their liability on forward contracts in a financial sense, did not constitute a market practice allowing for the sellers' obligations to be "closed out", saying (at paragraph 80):

> It seems to me that what the plaintiffs identified is not a *usual market practice permitting* the closing out of the seller's obligations by the means specified. What the plaintiffs identified was a means of making a profit or capping a liability in a market where goods are readily obtainable. It is the nature of the goods, not usual market practice, which permits the seller to act in the way specified. It is also important to note that what must be *closed out* are the seller's *obligations*. It seems to me that the use of these words and the reference in *matching up … with another arrangement* support the contention of [one of the defendants] that the market practice referred to in the paragraph (iii) is one whereby the seller's obligations are for all practical purposes brought to an end upon the entering into of the offsetting arrangement. That, to my mind, is what the paragraph is directed to and there is simply no evidence of a usual market practice of that nature in the case of forward contracts. The market practice identified by the plaintiffs (if it is a market practice) is not of that nature.

Again, this finding was upheld on appeal (*Keynes v Rural Directions Pty Ltd*, n34 above, at paragraphs 47-61).

[44] Noting that, in the case of foreign exchange contracts, s764A(1)(k) only applies to those foreign exchange contracts that are not derivatives and that do not involve a contract to exchange one currency for another that is to be settled immediately.

[45] A warrant can take the form of a security, a managed investment product or a derivative (see the definition of 'warrant', which is set out in the text accompanying n46 below). However, rr6D.5.01 and 7.9.07A(2) exclude warrants that would otherwise fall within the definition of 'security' from the prospectus disclosure regime in Chapter 6D and make them subject to the PDS disclosure regime in Part 7.9.

(i) a derivative under section 761D of the Act; or

(ii) a financial product that would, apart from the effect of paragraph 761D(3)(c), be a derivative for section 761D of the Act, and is excluded by that paragraph only because:

(A) it is a security under paragraph (c) of the definition of security in s761A of the Act;

(B) it is a legal or equitable right or interest mentioned in subparagraph 764A(1)(b)(ii) of the Act; or

(C) it is a legal or equitable right or interest mentioned in subparagraph 764A(1)(ba)(ii) of the Act; and

(b) that is transferable.[46]

It has taken our lawmakers 3 attempts to get this definition right[47] and, arguably, it is still not correct because it fails to recognise that the definition of 'derivative' in s761D has effectively been displaced by the definition in r7.1.04(2). Hence, the words in paragraph (a)(ii) quoted above arguably need to read something like:

(ii) a financial product that would be a derivative:

- under section 761D of the Act but for the effect of paragraph 761D(3)(c); or
- under regulation 7.1.04(2) but for the effect of regulation 7.1.04(7),

in each case because: …

This is symptomatic of a major problem that infects the whole of chapter 7, to which I will return, that arises because the law has been indiscriminately split between the Act and the regulations, with the regulations often overriding the Act.

The subservience of the definition of derivative to the definition of other financial products may lead to some interesting and difficult characterisation issues in future cases, particularly as to whether something is properly characterised as a derivative or an insurance product. Derivatives and insurance are both used to manage financial risk and typically both involve a payment calculated by reference to the value of "something else" (the underlying property in the case of a derivative and the property insured in the case of an insurance contract). I can

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[46] To explain how this definition is intended to work, s761D(3)(c), referred to in (a)(ii) above, excludes from the definition of 'derivative' anything that is a financial product listed in s764A (other than a derivative).

In relation to (a)(ii)(A) above, paragraph (c) of the definition of 'security' in s761A defines a legal or equitable right or interest in a share or debenture of a body to be a security and therefore a financial product captured by s764A(1)(a). In relation to (a)(ii)(B) above, s764A(1)(b)(ii) captures within the list of specific financial products a legal or equitable right or interest in an interest in a registered managed investment scheme (ie a managed investment product). In relation to (a)(ii)(C) above, s764A(1)(ba)(ii) similarly captures a legal or equitable right or interest in an interest in an unregistered managed investment scheme, other than one that is exempt (or if the scheme is operated outside Australia, one that if operated in Australia would be exempt) from registration under s601ED(1) (ie an interest in a wholesale managed investment scheme).

The effect of s761D(3)(c), therefore, is to exclude from the definition of derivative a legal or equitable right or interest in a share, debenture, managed investment product or interest in an unregistered wholesale managed investment scheme.

So the definition of 'warrant' effectively boils down to a transferable derivative or a transferable legal or equitable right or interest in a share, debenture, managed investment product or interest in an unregistered wholesale managed investment scheme. This latter category can be thought of as a derivative-like interest in a share, debenture, managed investment product or interest in an unregistered wholesale managed investment scheme.

[47] The original definition inserted by the Corporations Amendment Regulations 2001 (No 4) SR 319/2001, as amended by the Corporations Amendment Regulations 2002 (No 3) SR 41/2002 and Corporations Amendment Regulations 2003 (No 1) SR 31/2003.

well see a product issuer wanting to issue a new risk management product seeking to characterise it one way or the other, depending on whether its AFSL authorises it to advise on and deal in derivatives or insurance, and a disappointed client who believes they have done a bad deal and who wants to avoid their obligations in relation to the product seeking to characterise it the other way.

A similar, and potentially more serious, issue arises in relation to interests in managed investment schemes. A product that by itself may be a derivative can easily transmogrify into an interest in a managed investment scheme if it is marketed to more than 20 investors and it involves a pooling of investment funds or a "common enterprise". In fact, if you take some of the managed investment cases at face value,[48] simply having a common marketing document, a pooling of subscription funds into a common trust account[49] and the use of some of those funds in a common hedging strategy may well be enough to tip the scales and turn what would otherwise be a derivative into an interest in a managed investment scheme.

The consequences of a derivative being reclassified as an interest in a managed investment scheme are significant. If retail investors participate in the scheme, it potentially requires the scheme to be registered with ASIC[50] and to be administered by a responsible entity that is a public company and that has an AFSL authorising it to operate the scheme.[51]

In addition to cleaning up the definition of 'derivative' so that it only captures products that are generally understood to be derivatives, consideration should also be given to introducing an exclusion from the definition of 'managed investment scheme' in s9 for derivatives.[52]

C. The inappropriate extension of former futures laws to OTC derivatives and other financial products

The problems with the regulation of derivatives under chapter 7 are more than just definitional. There are a number of issues that have arisen from the manner in which provisions that formerly applied to futures contracts under the pre-FSRA Corporations Act were indiscriminately extended by the FSRA to apply to derivatives or to financial products generally.

(i) Client segregated accounts and margins

One such case is client segregated accounts and margin payments. Under the pre-FSRA chapter 8 regulating the futures industry, a futures broker was required to be a member of a futures organisation[53] and all trading in futures contracts was required to take place on an

[48] See, for example, the wide meanings given to the different component parts of the definition of 'managed investment scheme' in s9 by *Australian Softwood Forests Pty Ltd v A-G (NSW)* (1981) 148 CLR 121, 133 (meaning of "common enterprise"); *ASC v United Tree Farmers Pty Ltd* (1997) 15 ACLC 957 (meaning of "scheme"); *ASIC v Enterprise Solutions 2000 Pty Limited* (2000) 35 ACSR 620, *ASIC v Drury Management Pty Ltd* [2004] QSC 68 and *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd (No 3)* [2009] FCA 450 (meaning of "pooled"); and *Re Risqy Limited* [2008] QSC 107 (meaning of "benefit").

[49] As is required under s1017E(2), if the money paid to subscribe for a financial product is not immediately applied to the issue of the product.

[50] Section 601ED.

[51] Section 601FA.

[52] Similar to the exclusions that currently operate for shares, debentures, convertible notes, deposit products, life company statutory funds, FHSA trusts and various superannuation funds (see paragraphs (d), (g), (h), (ha), (i) and (j) of the definition of 'managed investment scheme' in s9).

[53] Section 1148 of the pre-FSRA Corporations Act made this a statutory condition of a futures broker's licence.

authorised futures market.[54] This effectively obliged the broker to be a member of, and to conduct all their local dealings in futures contracts on, the Sydney Futures Exchange (SFE), that being the only authorised futures market in Australia. The broker was therefore subject to provisions in the Corporations Act and the SFE business rules requiring them to maintain a client segregated account and regulating the withdrawals that could be made from that account.[55] The permitted withdrawals included amounts required for or in connection with the entering into, margining, guaranteeing, securing, transferring, adjusting or settling of dealings in futures contracts effected by the broker on behalf of clients generally.[56] While this created an exposure for each client to any defalcation by another client, clients were protected to a significant degree by the fact that all relevant dealings in futures contracts had to be effected on the SFE, meaning that they were subject to a robust margining regime overseen by the SFE and to provisions in the SFE business rules requiring the broker to maintain a prescribed minimum level of capital and to top up its client segregated account if the account fell into deficit due to a client failing to meet a margin call.[57]

The futures client segregated account and permitted withdrawal provisions in chapter 8 were carried over by the FSRA into chapter 7 and extended to all derivatives by s981D.[58] Hence, they now apply to OTC derivatives as well as exchange traded derivatives.[59] The issuers of OTC derivatives, however, are not subject to oversight by an exchange, currently have only flimsy capital requirements under their AFSL[60] and do not have any obligation to top up a client segregated account in the event that a client fails to meet a margin call. This has opened up a significant credit exposure for clients and represents a substantial weakening of the framework for the protection of client monies in part 7.8 division 2.

Section 981D should be amended to restore the *status quo ante* so that it only applies to derivatives that are able to be traded on a licensed market.

(ii) Takeovers and relevant interests

A similar issue arises in relation to s609(6). Prior to the FSRA, that section used to operate so that a person was deemed not to have a relevant interest in securities merely because of an exchange traded option over securities or a right to acquire securities given by a futures contract, at least until there was an obligation to make or take delivery of the securities under the option or futures contract. Again, by virtue of the provisions described above, the exception for futures contracts only applied in practice to contracts traded on the SFE. In that context the provision made eminent sense since, in common with a person holding an exchange traded option over securities, a person holding a futures contract over securities traded on the SFE would only have a right in contract against the SFE's clearing house and could not possibly be considered to have any practical power over the voting or control of any

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[54] This was the practical effect of s1123 of the pre-FSRA Corporations Act prohibiting a person conducting an unauthorised futures market and the decision of the NSW Supreme Court in *Carragreen Currency Corporations Pty Ltd v Corporate Affairs Commission (NSW)* (1986) 11 ACLR 298.

[55] Section 1209 of the pre-FSRA Corporations Act and the predecessor provisions to rule 2.2.6 of the *ASIC Market Integrity Rules (ASX 24 Market) 2010* ("ASX 24 MIR").

[56] Section 1209(5) of the pre-FSRA Corporations Act.

[57] The predecessor provisions to rule 2.2.6(f) of the ASX 24 MIR.

[58] Section 981D.

[59] See generally paragraphs 65-70 of ASIC Regulatory Guide 212 *Client money relating to dealing in OTC derivatives*.

[60] An issue that ASIC has indicated it intends to address – see ASIC Consultation Paper CP 156 *Retail OTC derivative issuers: Financial requirements*.

underlying securities unless and until the clearing house came under an obligation to deliver those securities to them under the terms of the futures contract.

Section 609(6) was amended by the FSRA to replace the words "futures contract" with "derivative". The result is that it is now theoretically possible for someone to structure an OTC derivative contract[61] in relation to securities that gives them the right to acquire the underlying securities on expiry, as well as a significant degree of de facto control over the underlying securities in the interim,[62] without acquiring a relevant interest in the securities and therefore without breaching any takeover laws until the obligation to make or take delivery of the securities under the derivative actually arises.[63]

Section 609(6) should also be amended to restore the *status quo ante* so that it only applies to derivatives that are able to be traded on a licensed market.

(iii) Order precedence requirements

An example of an inappropriate extension of former statutory provisions regulating futures contracts to financial products more generally can be found in r7.8.18, which sets out rules governing the sequence of transmission of orders to, and the allocation of trades executed on, a licensed market. The main operative provisions of that regulation provide:

> (2) Subject to subregulation (3), [a] financial services licensee must transmit, in the sequence in which they are received, all instructions to deal in a class of financial products at or near the market price for financial products of that class prevailing immediately before execution of the instructions.
>
> (3) If:
>
> (a) a financial services licensee proposes to deal in a class of financial products on the financial services licensee's own account; and
>
> (b) the person by whom or on whose instructions the instructions for the dealing are to be transmitted is aware of instructions of a client of the financial services licensee to deal in that class of financial products at or near the market price for a financial product of that class prevailing at that time (being instructions that have not been transmitted);
>
> that person must not transmit, and must not give instructions to any other person to transmit, the instructions to give effect to the proposal of the financial services licensee to deal in that class of financial products before the instructions of the client are transmitted.
>
> (4) If:

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[61] Note that an option or other instrument that confers an equitable right or interest in an issued share or debenture is not a derivative for these purposes (these fall within paragraph (c) of the definition of 'security' and therefore within s764A(1)(a) and so cannot be a derivative because of s761D(3)(c) and r7.1.04(7)). The same is true of an option or other instrument that confers an equitable right or interest in an issued interest in a managed investment scheme (these fall within s764A(1)(b)(ii) if the scheme is registered and s764A(1)(ba)(ii) if the scheme is not registered and so again cannot be a derivative because of s761D(3)(c) and r7.1.04(7)). Some covered warrants may confer such an equitable right or interest and therefore will not be a derivative for these purposes.

[62] Relying, for example, on the likelihood that the counterparty will need to hold, or have a right to acquire, the underlying securities to hedge its risk to deliver the securities upon expiry.

[63] Although such conduct may amount to unacceptable circumstances, conferring power on the Takeovers Panel to make an appropriate remedial order – see Takeovers Panel Guidance Note 20 *Equity Derivatives*. Note also that even though entering into such an OTC derivative does not confer a relevant interest in the underlying securities under s609(6) and therefore cannot breach takeover laws (at least not until an obligation to make or take delivery of the underlying securities arises), it will still count towards determining whether the holder is required to give a substantial holder notice and, if they do, will have to be disclosed in such a notice (see paragraph(a)(ii) of the definition of 'substantial holding' in s9 and s671B(7)).

(a) during a particular period, a financial services licensee transmits instructions (whether or not those instructions consist of, or include, instructions giving effect to a proposal of the financial services licensee to deal in the class of financial products concerned on the financial services licensee's own account) to deal in a class of financial products at or near the market price for a financial product of that class prevailing immediately before execution of the instructions; and

(b) dealings in that class of financial products are effected pursuant to those instructions;

the financial services licensee must allocate the dealings to those instructions:

(c) in the sequence in which the dealings were effected; and

(d) in the sequence in which the financial services licensee transmitted the instructions.

These provisions were drawn from s1266 of the pre-FSR Corporations Act, which regulated the sequence of transmission of orders to, and the allocation of trades executed on, a licensed futures market. They in fact date back to s138 of the Futures Industry Act 1986, to a time before electronic trading, when futures contracts were traded on the floor of the SFE and orders were conveyed by open outcry to a "chalkie" to be recorded on chalkboards.

I am informed by an old SFE operative that the primary purpose of these provisions was to ensure that client orders that were close to the current market price were given to the chalkie in the order received and thus guaranteed of being executed in an appropriate sequence. However, orders that were some distance away from the current market price could be held back, on the basis that they were unlikely to execute in the short term, and could given to the chalkie later. Obviously, part of the intention of these provisions was also that a floor trader should give priority to transmitting client orders ahead of house orders.

The original rationale for r7.8.18 no longer holds true in a world of computerised trading,[64] where orders can be submitted almost instantaneously into a trading platform and are not centralised through a trader operating on the floor of the market but typically are coming from multiple sources, including computerised algorithms trading without any human intervention.

There are real problems in applying r7.8.18 in practice, starting with the fact that the phrase "at or near the market price" is not defined in the regulations. Certainly, the term "at market order" is a commonly used term in financial markets, is widely understood and probably does not require definition. To the extent that r7.8.18(2) requires these types of orders to be transmitted in the sequence they are received, it basically codifies the common law position.[65]

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[64] In this day and age, the clearly safer course for any licensee to follow who receives an order to buy or sell a financial product at a particular price and with no instructions as to timing is to transmit the order to the market as soon as it is received, regardless of how close it is to the current market price, especially given the volatility we have seen in markets in recent years. That way, if the market price moves rapidly in favour of the order, the licensee won't face any issues with the timing of the transmission of the order.

[65] See *Constable v Meyer* (1972) 3 DCR(NSW) 41. In that case, a client (M) telephoned his broker and asked the market price in T. He was told that there was a buyer at $1.30 but no seller. M asked the broker to buy him 2,000 shares in T at market as soon as possible. The order was handed to a floor operator along with an order from another client to buy 2,000 shares. The floor operator bought 4,000 shares at prices ranging from $1.65 to $2.00. He informed the broker of the purchases, who then advised M that his order had been filled but that the broker at that stage did not know at what price. M was told that the market had jumped to between $1.80 and $2.00, whereupon he asked the broker to buy him another 3,000 shares. The floor operator came back with a number of purchases at the end of the day for M and other clients. In accordance with firm practice, the operator allocated the original 4,000 purchase to M and the other client at an average price for the total purchase. The balance of purchases for the rest of the day were allocated to M and the remaining clients also at an average price for the total balance. M rejected the purchases as not being in accordance with his instructions and the broker then sued M for payment. The District Court of NSW held that where a stockbroker is instructed by a number of clients to buy shares at market price in a rapidly rising market, its duty to those clients is to execute their commissions as

However, the term "near market order" is not a term used in financial markets and, in the absence of a definition, is altogether vague and imprecise. Just how close to the current market price must an order be to be "near the market price" and therefore subject to r7.8.18?

Applying r7.8.18 to a limit order that is at or near the current market price, rather than a genuine "at market" order, also leads to some surprising results. Suppose, for example, that the current asking price for a particular security is $1.01 and a client wants to buy at 99¢. If this is considered to be "near the market price", r7.8.18(3) would require the client buy order to be transmitted to the market at 99¢ before any house order could be transmitted. However, that would not stop the house then transmitting a buy order at $1.00 and taking price priority over the client. On that scenario, the regulation would seem to have achieved little.

Suppose further that the house order at $1.00 gets filled and then the market drops so that the client order at 99¢ is also filled. Regulation 7.8.18(4) would seem to require that the $1.00 execution be allocated to the client and the 99¢ execution be allocated to the house, which clearly does not make any sense.

Fortunately, to date, r7.8.18 has not really had any scope to operate because it has been displaced by the *ASIC Market Integrity Rules (ASX Market) 2010*[66] and *ASIC Market Integrity Rules (ASX 24 Market) 2010*[67] and, before them, by the ASX and SFE[68] operating rules.[69] The ASX MIR that apply in this area, however, are not without their own issues. They require a market participant to deal "fairly and in due turn" with (a) clients' orders; and (b) a client order and an order on its own account,[70] and also to allocate market transactions fairly.[71] They list a number of potentially competing factors that should be taken into account in determining whether a participant is acting fairly in this regard,[72] but give no guidance as to the respective weights to be accorded to each factor.[73]

This is another area in need of rationalisation to ensure that we have appropriate rules dealing with the sequence of transmission of orders and allocation of executed trades that take account of contemporary market realities around computerised trading and the fact that many market participants trade large amounts on principal account. It is vital from a systemic risk perspective that those participants are able to manage the risks involved in principal trading without being hamstrung by antiquated rules around client order precedence.

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expeditiously as possible and strictly in the order in which they are received. The broker had failed to do that in this instance and so judgment was entered for the client.

[66] Referred to in this paper as the "ASX MIR".

[67] Referred to in this paper as the "ASX 24 MIR".

[68] ASX 24 is the successor to the former Sydney Futures Exchange.

[69] Regulation 7.8.18(1) provides that r7.8.18 applies in relation to all instructions received by a financial services licensee to deal in financial products through licensed markets, except to the extent that the market integrity rules, or the operating rules of a licensed market in relation to which the financial services licensee is a participant, otherwise provide. Both the ASX MIR and the ASX 24 MIR contain provisions (rules 5.1.3-5.1.6 of the former and rules 3.1.4-3.1.6 and 3.1.15-3.1.18 of the latter) dealing with the sequence of transmission of orders and the allocation of executions and so rr7.8.18(2)-(4) will not apply to dealings on those markets.

[70] ASX MIR 5.1.3.

[71] ASX MIR 5.1.5.

[72] ASX MIR 5.1.4 and 5.1.6 respectively.

[73] One such factor, for example, is whether the client is a wholesale client (ASX MIR 5.1.4(1)(f)). Does this mean that a participant does not have to give precedence to an order from a wholesale client? Or it is simply a factor that should be taken into account in determining whether the treatment of a client's order is fair? If the latter, then what weight should be given to that factor? To what extent does that factor override non-compliance with any of the other factors touching upon fairness?

4. Continuous disclosure and insider trading

Our continuous disclosure and insider trading laws are two of the fundamental pillars intended to protect the integrity of our public markets. They currently have a number of issues that need to be addressed if they are to achieve that purpose.

A. *R v Firns* and readily observable matter

The *sine qua non* for our continuous disclosure and insider trading laws to apply is that there is information that is not "generally available" and that, if it were generally available, a reasonable person would expect it to have a material effect on the price or value of the relevant financial products.[74]

For these purposes, information is considered to be generally available if:

(a) it consists of readily observable matter;

(b) it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in the financial products of a kind whose price or value might be affected by the information and, since it was so made known, a reasonable period for it to be disseminated among such persons has elapsed; or

(c) it consists of deductions, conclusions or inferences made or drawn from information of the type referred to in (a) and/or (b) above.[75]

The reason for the inclusion of "readily observable matter" in this definition was explained thus in the Explanatory Memorandum for the Bill which first introduced these provisions:[76]

> Concern was expressed that … information directly observable in the public arena would not be regarded as generally available… It was considered that a person could be liable for insider trading where he/she traded in securities on the basis of, for example, an observation that the body corporate had excess stocks in a yard. This was not the intention of the provisions.

The meaning of these words fell to be considered in *R v Firns,*[77] a decision handed down the in the same year that the FSRA was enacted. In that case, a subsidiary of a listed company with a mining tenement in PNG challenged a regulation that had the effect of limiting the minerals the subject of its tenement. The PNG Supreme Court upheld the challenge in a judgment delivered on a Friday morning. K, an executive present at the court hearing, bought shares in the company shortly after the judgment was handed down. Another executive director of the company, upon receiving news of the judgment, conveyed the news to his son, F, who also bought shares in the company.[78] The company made an announcement to the market about the judgment on the following Monday morning and its share price materially increased in response. K and F were both charged with insider trading. K was acquitted,[79] with the trial judge directing the jury that readily observable meant observable anywhere and that the judgment in the PNG court was readily observable matter and therefore generally available information. In a separate trial, F was convicted, with the trial judge directing the jury that readily observable meant observable by someone in Australia and therefore the

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[74] See s674(2)(c) and the definition of 'inside information' in s1042A.

[75] Sections 676 and 1042C.

[76] Explanatory Memorandum, Corporations Legislation Amendment Bill 1991 (at paragraph 326).

[77] (2001) NSWCCA 191; (2001) 51 NSWLR 548 ("*Firns*").

[78] F bought the shares in a fictitious name – a combination of his forename and his wife's maiden name – a fact which would tend to suggest that F probably knew that he was doing something wrong!

[79] *R v Kruse* [1999] 98/11/0908 (Unreported, O'Reilly J, District Court NSW, 2 December 1999).

judgment in the PNG court was not readily observable matter. F appealed and his conviction was overturned.

The Court of Appeal held that there was no warrant for introducing a territorial component to these provisions and that readily observable meant readily observable by anyone anywhere. The court remarked that information did not have to be readily observable by the human senses unaided and that information could be readily observable through modern means of telecommunication, such as via the internet, television, phone or fax. It also commented that information could be readily observable even if no one in fact observed it. The court found that the information embodied in the PNG judgment was available, understandable and accessible to a significant group of the public, being those persons present in open court at the time. It added that the fundamental principles of open justice are based on the assumption that everything that happens in open court is capable of being observed and reported upon, thereby ensuring continuing accountability. The court therefore found that the PNG judgment was readily observable, notwithstanding that some time would inevitably elapse before the profession or the market generally learnt about it and absorbed its effect.

It is hard to imagine a more glaring case of insider trading (in the sense that expression is normally understood rather than in the manner in which the offence has been defined in the Act) than *Firns*. The fact that our insider trading laws were found not to apply in that case was not only a travesty of justice, it was and is a major indictment of those laws.[80] The fact that 10 years have been allowed to pass since *Firns* without any corrective law reform does not reflect well on our legal process.

The fix for *Firns* is not, as some have suggested, simply dropping the reference to readily observable matter from the definition of generally available information in s1042C. Our so-called "insider trading laws" are not in fact laws that prohibit insider trading in any conventional sense of that expression – they are laws that prohibit anyone with a material informational advantage about relevant financial products from dealing in those products. By defining the offence in this manner, it is also necessary for the law to define and include exceptions for when someone might have a legitimate informational advantage. The inclusion of readily observable matter in the definition of generally available information was an attempt to define one such exception.[81] Simply dropping that exception without replacing it with something else that defines when someone might have a legitimate informational advantage would render our insider trading laws altogether far too broad.

On this score, our insider trading laws already breach a cardinal principle of good regulation, namely, that a law should be drafted no more widely than is necessary to prevent the evil it is intended to stop. Those laws currently apply where the person doing the trading is not an

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[80] In saying this, I hasten to add that I am not intending to be critical of the decision of the Court of Appeal in *Firns* but rather of the way in which our insider trading laws have been formulated. While I can construct an argument that the words "readily observable" could have been construed more narrowly by the Court of Appeal, having regard to the purpose for those words outlined in the Explanatory Memorandum (see the text accompanying n76 above), the finding the court reached was certainly one available on the facts and on a literal reading of s1042C(1)(a).

[81] The inclusion of s1042C(1)(c) (which effectively makes it permissible for someone to trade who has an informational advantage deriving solely from deductions, conclusions or inferences they have been smart enough to draw from other generally available information) can also be regarded as an example of when someone has a legitimate informational advantage, as can the "own intentions" exceptions in ss1043H, 1043I and 1043J and the defence in ss1043M(2)(a) and (3)(a) for information that comes into a person's possession solely as a result of it having been disseminated to investors in a manner intended to bring it to the attention of persons who commonly invest in relevant products.

"insider"[82] and has not acquired their information from an "inside source".[83] They apply where the person doing the trading is not actually using their informational advantage for the purposes of their trading (for example, they apply to someone who has "bad" information and despite that is buying, or someone who has "good" information and despite that is selling, even though they do not profit from their inside information and no-one is harmed by their trading).[84] It has been held that they apply (at least in civil, rather than criminal, cases[85]) to an off-market trade where both parties to the trade know the same inside information and neither is harmed by the trading.[86] I have even heard it suggested that they apply to trading in shares in private companies, notwithstanding that such trading has nothing to do with the rationale usually put forward for having insider trading laws (namely, protecting the integrity of public markets). Hence it has been suggested that the usual rule of *caveat emptor* no longer applies in such sales and a vendor of shares in such a company has a legal duty to disclose to the purchaser all information that investors would consider material in determining the value of the shares in the company, or else breach s1043A when they sell.[87]

[82] The term "insider" is defined in s1043A as anyone who possesses inside information. The term "inside information" is defined in s1042A as any information that is not generally available and that, if it were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products. This applies regardless of the source of the information.

[83] This runs counter to the philosophy espoused by the Griffiths Committee on insider trading, that: "The offence of insider trading must have its genesis in the use of information derived from within a company" (*Fair Shares for all - Insider Trading in Australia*, Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, October 1989, at paragraph 4.3.5). That whole notion has been lost in the drafting of our insider trading laws.

[84] The usual answer to this point is that the regulators would be unlikely to pursue someone who trades against their inside information and therefore does not profit from it. However, *ASIC v Citigroup Global Markets Australia Pty Limited (No. 4)* [2007] FCA 963 demonstrates that regulators don't always act as you would expect. In that case, ASIC pursued Citigroup for alleged insider trading in connection with a sale of a large parcel of Patricks shares by one of its proprietary traders. The inside information he was said to possess was that a client of the firm was about to launch a takeover offer for Patricks. The court found that he did not in fact possess that information. A key factor in reaching this conclusion was that if he had known information about the impending takeover offer for Patricks and had been motivated to insider trade, he would have been buying, or at the very least holding, Patrick shares rather than selling them (ibid, at paragraph 505).

[85] In a criminal case, it is a defence to a prosecution if the accused proves that the other party to the transaction, agreement or communication knew, or ought reasonably to have known, of the information beforehand (ss1043M(2)(b) and (3)(b)).

[86] See *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd (No 2)* (1996) 14 ACLC 1514, although, for the reasons mentioned in n104 below, I would submit that this case was wrongly decided. This was a summary dismissal action involving a dispute about the terms of certain convertible notes issued by Ampolex. There was a hitherto undiscovered error in the drafting of the convertible notes trust deed which could be read as meaning that the conversion ratio was 6.6:1 rather than the intended 1:1. A holder of the notes sold them to a group of brokers and investors, who then applied for their conversion under cover of a letter claiming to be entitled to a 6.6:1 conversion ratio and who made an announcement to the ASX advising what they had done. Ampolex sued for damages arguing that the parties to the transaction had engaged in insider trading by dealing in the notes knowing of the intention of the purchasers to make the ASX announcement. All the parties to the trade were aware of the intention to make that announcement and so they applied for summary dismissal of the action. The court refused to dismiss the case, saying that its prima facie view was that the information in question could be expected to have a material effect on the price or value of Ampolex's convertible notes sufficient to ground an action for insider trading.

[87] While such an argument is clearly open on the language of part 7.10 division 3, including the fact that 'Division 3 financial product' is defined in s1042A to include securities generally and therefore clearly captures shares in a proprietary company, I believe that a court would baulk at this suggestion and that there is a fair likelihood that it would either read down part 7.10 division 3 as not intended to apply in such circumstances or, alternatively, exercise its discretion not to make an order in such circumstances (cf *Exicom Pty Ltd v Futuris Corporation Ltd* (1995) 13 ACLC 1758 ("*Exicom*"), and *ICAL Ltd v County Natwest Securities Aust Ltd* (1988) 6 ACLC 467).

Our lawmakers should go back to the drawing board and re-write our insider trading laws from the ground up. They need to be drawn widely enough to capture clear cases of insider trading, such as *Firns*, but they also need to be reasonable and proportionate and go no further than is necessary to stop actual instances of insider trading.

B. The impact of *Firns* on our continuous disclosure laws

ASX Listing Rule 3.1 requires a listed entity to tell ASX as soon as it becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of its securities.[88]

ASX Listing Rule 15.7 provides that a listed entity must not release information that is for release to the market to any person until it has given the information to ASX and has received an acknowledgement that ASX has released the information to the market.

In tandem, these rules seek to ensure that material information that will affect the price or value of listed securities is widely disseminated to market participants and investors in a fair and timely manner, via ASX's announcements platform and voiceline service.

Listing Rule 3.1 is reinforced by s674, which provides:

> (1) Subsection (2) applies to a listed disclosing entity if provisions of the listing rules of a listing market in relation to that entity require the entity to notify the market operator of information about specified events or matters as they arise for the purpose of the operator making that information available to participants in the market.
>
> (2) If:
>
> (a) this subsection applies to a listed disclosing entity; and
>
> (b) the entity has information that those provisions require the entity to notify to the market operator; and
>
> (c) that information:
>
> (i) is not generally available; and
>
> (ii) is information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of ED securities of the entity;
>
> the entity must notify the market operator of that information in accordance with those provisions.

A breach of s674 attracts significant criminal and civil penalties,[89] making that section an important part of the armoury for enforcing our continuous disclosure rules.[90]

The decision in *Firns* has exposed a serious flaw in the drafting of s674, namely, that it is only engaged where information is not generally available, as defined in s676. Under the latter section, information will be generally available if it is readily observable, as in *Firns*, or

[88] This obligation is subject to the exceptions set out in Listing Rule 3.1A.

[89] Breach of s674 is a criminal offence punishable by a fine of 200 penalty units and/or imprisonment for 5 years for individuals (s1311) and a fine of 1,000 penalty units for corporations (s1312). It is also a financial services civil penalty provision (s1317E), which is punishable by a civil penalty of up to $200,000 for individuals and $1,000,000 for corporations (s1317G(1A)) and which renders the offender and anyone else involved in the contravention liable to pay compensation to anyone suffering loss or damage because of the contravention (s1317HA). In addition, ASIC can issue infringement notices imposing "on the spot" fines of up to $100,000 (s1317DAC).

[90] Apart from s674, the only practical remedy that the ASX can exercise against a listed entity that fails to comply with its continuous disclosure obligations is to suspend trading in its securities until it does comply or, in an extreme case, to terminate its admission to the official list.

if has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in listed securities.

To illustrate the problems this causes, suppose that, instead of being prosecuted as an insider trading case, *Firns* had been prosecuted as an action under s674 against the listed entity and its directors for failing to make an announcement about the PNG judgment on the Friday morning immediately after it was handed down (remembering that such an announcement was not made until the following Monday morning). Given the finding in *Firns*, such a prosecution would necessarily have failed, as information about the judgment was readily observable, and therefore generally available, from the moment it was handed down in court. At that point, s674 could no longer have any application. Effectively, this meant that the listed entity had no obligation under s674 to make any announcement at any time to ASX about the PNG judgment.

If you take the dicta in *Firns* to its logical conclusion, the act of a listed entity doing anything that makes relevant information readily observable – such as holding a press conference, issuing a press release, or posting it on its website, FaceBook or Twitter – arguably relieves it of any further obligation under s674 to make an announcement about that information to ASX. This completely undermines Listing Rule 15.7.

Section 674 needs to be amended to repeal s674(2)(c). This will require some consequential changes to s674(1) so that it is more descriptive of Listing Rule 3.1. In this regard, I would suggest replacing the reference in s674(1) to notifying the market operator of "information about specified events or matters as they arise for the purpose of the operator making that information available to participants in the market" with something like "information that a reasonable person would expect to have a material effect on the price or value of the entity's securities for the purpose of the operator making that information available to participants in the market".[91]

C. Issues with the attribution of inside information to bodies corporate

The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Cth)[92] amended the definition of 'officer' in the main body of the Act as part of a general exercise of rationalising the duties and obligations of corporate officers and employees under the Act. Those amendments had some quite unintended and potentially far-reaching consequences for the rules in chapter 7 dealing with the attribution of inside information to bodies corporate and how those rules interplay with the various Chinese walls defences.

Section 1042G provides that a body corporate is taken to possess any information which an officer of the body corporate possesses and which came into his or her possession in the course of the performance of duties as an officer. There are corresponding provisions in s1042H for partnerships which provide, in effect, that a partnership is taken to possess any information which any partner or employee possesses and which came into his or her possession in the course of the performance of duties as a partner or employee.

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[91] With these changes, ss676 and 677 would no longer be needed for the purposes of s674. Accordingly, if the changes suggested in the text are made, the references in s676(1) and 677 to "sections 674 and 675" should also be amended to refer only to "section 675".

[92] Referred to in this paper as the "CLERP 9 Act". In addition to implementing the recommendations from the CLERP 9 paper *Corporate disclosure: Strengthening the financial reporting framework*, this Act also implemented a recommendation from the HIH Royal Commission to delineate better the duties and obligations of corporate officers and employees under the Corporations Act.

Prior to the amendments made by the CLERP 9 Act, 'officer' was defined in s82A in relation to a body corporate to include a director, secretary, executive officer or employee of the body. This had the quite proper effect that if, say, an employee in the corporate advisory team of a financial services organisation was working on a material non-public transaction in particular securities (for example, a takeover), the entire organisation, including the stockbroking arm, would be precluded from trading in those securities, whether as principal or agent, unless there was a proper Chinese wall around the corporate advisory team that met the requirements of ss1043F, 1043G or 1043K, as applicable.[93] This applied whether the financial services organisation took the legal form of a body corporate or a partnership.

The CLERP 9 Act repealed s82A and amended the definition of 'officer of a corporation' in s9[94] so that it only applies (relevantly) to a director, secretary or person who: (a) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; (b) has the capacity to affect significantly the corporation's financial standing; or (c) in accordance with whose instructions or wishes the directors of the corporation are accustomed to act – in effect, a director, secretary or senior executive.

These changes were made without the draftsperson appearing to recognise the impact they would have on the insider trading provisions in s1042G, 1043F, 1043G and 1043K.[95] Now those provisions only operate in the intended manner if the employee of a body corporate who is in possession of inside information is a director, secretary or senior executive. This is in sharp contradistinction to partnerships, where the knowledge of a mere employee continues to be attributed to the partnership.

This issue was highlighted, without counsel or the court seemingly recognising it as a drafting error, in *ASIC v Citigroup Global Markets Australia Pty Limited (No. 4).*[96] In that case, one of the number of grounds on which the first insider trading allegation against Citigroup was dismissed, was that the employee alleged to be in possession of insider information (Manchee, the proprietary trader) was not an officer of Citigroup and therefore his knowledge could not be attributed to Citigroup under s1042G.[97]

To restore these provisions so that they have their intended effect, s1042G needs to be amended to insert "or employee" after each reference to "officer".

D. Issues with the test to determine the materiality of information

Both our continuous disclosure and insider trading laws test the materiality of information by reference to whether a reasonable person would expect the information to have a material

[93] The Chinese wall exception in s1043F applies in relation to principal trades by a body corporate, s1043G applies in relation to principal trades by a partnership and s1043K applies in relation to agency trades by a financial services licensee.

[94] The CLERP 9 Act also introduced a new definition in s9 of 'officer of an entity that is neither an individual nor a corporation'. This definition potentially may apply to a body corporate that is not a corporation. However, in such a case, it only captures a person who: (a) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the entity; or (b) has the capacity to affect significantly the entity's financial standing.

[95] The fact that this was a drafting oversight is amply demonstrated by the continuing references to both officers and employees in the body corporate Chinese wall defence in s1043F and in the body corporate "own intentions" defence in s1043I(2) and (3), as if the knowledge of mere employees is still imputed to a body corporate.

[96] *Citigroup*, n84 above, at paragraphs 479-501.

[97] A second allegation of insider trading did pass this hurdle (although it failed on others) because the persons alleged to be in possession of inside information included persons who were plainly officers of Citigroup (the CEO, the Head of Equities and the Head of Equity Capital Markets). Ibid, at paragraph 574.

effect on the price or value of financial products. Prior to the FSRA that notion was defined in essentially identical terms for the purposes of both laws.[98]

The FSRA lifted the continuous disclosure rules from the market offence provisions in chapter 7 and relocated them into chapter 5C. It also replaced the former duumvirate of insider trading laws applying separately to securities and futures contracts with a single set of insider trading laws applying to 'Division 3 financial products'. In the course of making these changes, the FSRA introduced some curious drafting differences into the respective tests for determining materiality of information under the continuous disclosure and insider trading laws.

For continuous disclosure purposes, s677 provides:[99]

> a reasonable person would be taken to expect information to have a material effect on the price or value of ED securities of a disclosing entity ***if*** the information would, or would be likely to, influence persons who commonly ***invest*** in securities in deciding ***whether*** to acquire or dispose of the ED securities. [Emphasis added.]

For insider trading purposes, s1042D provides:[100]

> a reasonable person would be taken to expect information to have a material effect on the price or value of ***particular*** Division 3 financial products ***if (and only if)*** the information would, or would be likely to, influence persons who commonly ***acquire*** Division 3 financial products in deciding ***whether or not*** to acquire or dispose of the first-mentioned financial products. [Emphasis added.][101]

I would like to think that the inclusion of the word "particular" in s1042D, and the corresponding reference to "particular Division 3 financial products" in the definition of 'inside information' in s1042A, were deliberate and intended to reinforce the decisions in *Exicom*[102] and *Westgold Resources NL v St George Bank Ltd.*[103] Those cases effectively held that the question posed by s1042D is not to be answered in the abstract by looking at the hypothetical impact of the relevant information on the trading decision of a hypothetical investor considering whether or not to acquire the relevant products generally but rather by considering the impact of the information on an investor looking to acquire or dispose of the particular products being traded in the circumstances in which they were being traded. Thus, in *Exicom*, the NSW Supreme Court refused to grant an injunction to an aggrieved suitor to restrain a company from issuing shares to a competing suitor with whom the company had shared confidential price sensitive information. In answering the allegation that this would constitute a breach of insider trading laws, the court noted that since the company and the competing suitor were both privy to the relevant information and had negotiated the price for

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[98] See nn99 and 100 below.

[99] Section 1001D of the pre-FSRA Corporations Act provided that for the purposes of the then continuous disclosure laws "a reasonable person would be taken to expect information to have a material effect on the price or value of securities if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell, the firstmentioned securities."

[100] Section 1002C of the pre-FSRA Corporations Act provided that for the purposes of the then insider trading laws "a reasonable person would be taken to expect information to have a material effect on the price or value of securities of a body corporate if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell the firstmentioned securities."

[101] These provisions were the legislator's attempt to encapsulate the notion of the "reasonable investor" originally put forward by the Griffiths Committee on insider trading (*Fair Shares for all - Insider Trading in Australia*, n83 above, Recommendation 4).

[102] See n87 above.

[103] [1998] WASC 352; (1998) 29 ACSR 396 ("*Westgold*").

the issue of the shares, one could assume the effect of the information had been factored into the price for the shares and that the price therefore would not have changed if the information had been made generally available.[104] In *Westgold*, the WA Supreme Court reached the eminently sensible conclusion that a bank which held a put option over particular shares as part of its security arrangements was able to exercise that option without breaching insider trading laws even though it had access to confidential non-public information about the financial difficulties of the issuer of the shares through its banking relationship with the issuer which suggested that those shares were worth considerably less than both the put price and their current market price.[105] The court said:[106]

> The astonishing proposition underlying this aspect of the plaintiff's case is that to exercise a put option granted 11 months previously requiring the optionor to purchase shares at 40 cents at a time when the shares are trading on the market at 10 cents will amount to insider trading if the optionee has insider information which if generally known, would depress the share price even further. There could not be the remotest connection between information which might adversely affect the market price of shares trading at 10 cents and a decision to exercise a put option at 40 cents. Another way of putting this is to say that the insider information did not affect the price of the securities in question, that is, the securities to be delivered under the put option. The price of those securities was set by the terms of the put option at 40 cents and that price could not be affected by insider information.

Hence, I would argue that the presence of the reference to "particular Division 3 financial products" in s1042D and its absence in s677 is both explicable and desirable. The test in s1042D is inevitably being applied in the context of a particular transaction involving Division 3 financial products to determine whether or not one of the parties to the transaction entered into it while they had a material informational advantage. It is therefore entirely appropriate to test that in relation to the particular products the subject of that transaction rather than in relation to products of that type generally. By contrast, the test in s677 is inevitably being applied to determine whether or not material information known to the issuer of securities ought to be disclosed to the market at large and it is appropriate to test that in relation to the impact the information would have on the market in its securities generally.

The fact that s677 does not include the parenthetical qualification "(but only if)" that appears in s1042D is more difficult to explain but probably of no practical significance. While the absence of these words led the WA Court of Appeal to conclude in *Jubilee Mines NL v Riley*[107] that it is possible to show that information might have a material effect on the price or

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[104] To contrary effect is the decision of the same court the following year in *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd (No 2)*, n86 above. While the court did not specifically address the issue of which securities had to be affected by the inside information, it clearly determined that issue in relation to Ampolex convertible notes generally and not the particular convertibles notes that had been sold in that case. It is submitted that this was wrongly decided. The application for summary dismissal should have been granted on the basis that both parties to the transaction were aware of the inside information and therefore it could be assumed that, even if the information had been made generally available, it would not have had any impact on the price at which the particular convertible notes changed hands. *Exicom* should have been followed on this point, but it was not even referred to in the judgment.

[105] Of course, if the question before the court had been whether the bank could dispose of the shares on market given the inside information it had about the financial difficulties of the issuer, or whether the issuer should have disclosed that information to the market under its continuous disclosure obligations, the result would have been very different.

[106] (1998) 29 ACSR 396, at 440.

[107] [2009] WASCA 62; (2009) 40 WAR 299 ("*Jubilee Mines*").

value of securities without necessarily relying on the test in s677, Martin CJ (with Le Miere AJA agreeing) observed:[108]

> in practical terms, it is very difficult to envisage a circumstance in which a reasonable person would expect information to have a material effect on the price or value of securities if the information would not be likely to influence persons who commonly invest in those securities in deciding whether or not to subscribe for, or buy or sell them. The price of securities quoted on a stock exchange is essentially a function of the interplay of the forces of supply and demand. It is therefore difficult to see how a reasonable person could expect information to have a material effect on price, if it was not likely to influence either supply or demand. Rather, on the face of it, the scope of information which would, or would be likely, to influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell those securities is potentially wider than information which a reasonable person would expect to have a material effect on price or value, because there is no specific requirement of materiality in the former requirement.

Also difficult to explain is the differentiation between "persons who commonly ***invest*** in securities" in s677 and "persons who commonly ***acquire*** Division 3 financial products" in s1042D, especially when you compare these provisions to the provisions which define when information is "generally available". In this regard, s676(2)(b)(i) refers to information being made known in a manner that would, or would be likely to, bring it to the attention of "persons who commonly ***invest*** in securities of a kind whose price or value might be affected by the information." Section 1042C(1)(b)(i) likewise refers to "persons who commonly ***invest*** in Division 3 financial products of a kind whose price or value might be affected by the information."

Perhaps, given the FSRA's extension of our insider trading laws to derivatives,[109] the draftsperson of s1042D felt uncomfortable using the verb "invest" in relation to derivatives and determined that "acquire" was a more appropriate expression to use. Whatever the reason, the change of language could be significant. The word "invest" has a purposive connotation to it – it implies an acquisition made for the purposes of making a financial return. The word "acquisition" has no such purposive connotation.

Having said this, the waters here have been muddied somewhat by the decision at first instance in *Jubilee Mines*. There the Master held the reference in s677 to persons who commonly invest in securities meant those who commonly invest in securities of the kind in question – in that particular case, the shares of junior mineral explorers. The Master concluded that those persons were traders looking to derive profit from an increase in the share price in the short term, rather than long-term investors seeking dividends. Since neither party to the appeal challenged that aspect of the Master's decision, the Court of Appeal was not required to rule on the issue.[110]

With respect, this aspect of the Master's decision in *Jubilee Mines* cannot be correct and should not be followed in future cases.[111] Sections 677 and 1042D both need to be interpreted

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[108] Ibid, at paragraph 59.

[109] See paragraph (b) of the definition of 'Division 3 financial products' in s1042A.

[110] [2009] WASCA 62, at paragraphs 122 (Martin CJ, with whom Le Miere AJA agreed) and 163 (McLure J).

[111] There does not appear to be any sound interpretational reason for reading down the general reference in s677 to persons who commonly invest in securities, as the Master did, so that it only applies to those who commonly invest in securities of a particular kind. Indeed, the references in s676(2)(b)(i) to persons who commonly invest in securities, and in s1042C(1)(b)(i) to persons who commonly invest in Division 3 financial products, in each case "of a kind whose price or value might be affected by the information", would tend to lead to the opposite conclusion. If Parliament had intended to add a qualification to ss677 and 1042D of the type suggested by the

in light of the purpose behind them. They seek to define when information about a financial product is material by reference to whether it is likely to influence the investment decision of persons who commonly invest in the relevant products. This only makes sense in the context of investors who are making investment decisions on the basis of information – that is, persons investing on fundamentals – rather than those who are trading on the basis of price movements in the market and looking to profit in the short term. This is an important point of interpretation. High frequency traders have taken day trading to a whole new stratosphere. They trade massive volumes of stock on the basis of micro-movements in price. If all that is required to meet the test of materiality in ss677 and 1042D is a price movement that is likely to influence high frequency traders to buy or sell, that test has lost all meaning.

Also of potential significance is the difference in language between the phrase "***whether*** to acquire or dispose" in s677 and "***whether or not*** to acquire or dispose" on s1042D. The former implies that the information must be material to the investor making a positive decision to acquire or dispose of a product. The latter clearly extends to information that is material either to a positive or a negative decision to acquire or dispose of a product. Theoretically, this latter test could be met by information that simply confirms the investor's current view on value.

If only for the sake of consistency, I would like to see the words "(and only if)" added after the word "if" in s677, the word "acquire" in s1042D replaced with "invest in", and the words "or not" in s1042D deleted. As to the Master's decision in the *Jubilee Mines* case, that hopefully will get addressed at some point by a superior court.

5. Short selling

In 2009, in response to events that unfolded during the GFC, new provisions were introduced into chapter 7 to regulate short selling.[112] Amongst other things, those provisions repealed s1020B(4)(d),[113] which conditionally permitted a short sale covered by an arrangement that enabled the seller to deliver the sold products within T+3, and replaced it with a new

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Master, one would have expected it to use similar language in ss677 and 1042D to that used in ss676(2)(b)(i) and s1042C(1)(b)(i).

[112] Sections 1020AA-1020AF and rr7.9.99-7.9.102. These provisions were introduced by the Corporations Amendment (Short Selling) Act 2008 and the Corporations Amendment Regulations 2009 (No. 8) SR 327/2009.

[113] The former s1020B(4)(d) provided:

> Section 1020B(2) does not apply in relation to ... a sale of s1020B products in the following circumstances:
>
> (i) the person who sold the products is not an associate of the body corporate that issued the products;
>
> (ii) arrangements are made before the time of the sale that will enable delivery of products of the class sold to be made to the buyer within 3 business days after the date of the transaction effecting the sale; and
>
> (iii) if the sale is made on a licensed market:
>
> (A) the price per unit in respect of the sale is not below the price at which the immediately preceding ordinary sale was effected; and
>
> (B) the price per unit is above the price at which the immediately preceding ordinary sale was made, unless the price at which the immediately preceding ordinary sale was made was higher than the next preceding different price at which an ordinary sale had been made;
>
> and the operator of the market is informed as soon as practicable that the sale has been made short in accordance with this subparagraph.

The requirement in (iii) above was often abbreviated to "the sale must take place on the uptick" and hence referred to as the "uptick rule".

disclosure regime in ss1020AA-1020AF for short sales covered by a securities lending arrangement.[114]

The Explanatory Memorandum for the Bill that introduced these provisions stated:[115]

> Section 1020B generally prohibits the sale of a section 1020B product unless a person has a 'presently exercisable and unconditional right' to vest the product at the time of sale. …
>
> ***A naked short sale occurs where a seller does not own or has not borrowed or <u>arranged to borrow</u> securities at the time of sale*** but intends to purchase or borrow securities in order to meet the three business day settlement obligation. …
>
> ***[A] covered short sale occurs where the seller <u>has arranged to borrow</u> stock in order to meet their delivery obligations***. …
>
> It is understood that most market participants consider that a covered short sale falls within subsection 1020B(2) and so need not be disclosed … on the argument that they are not truly 'short' because the seller, relying on the borrowed stock, has a 'presently exercisable and unconditional right to vest the product' at the time of sale. [Emphasis added]

How participants came to hold such a view is something of a mystery.[116] Nevertheless, it is apparent from the definition of 'securities lending arrangement' in s1020AA(1) and the

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[114] For these purposes a short sale is "covered" by a securities lending arrangement if, before the time of the relevant sale, the seller has "entered into or gained the benefit of a securities lending arrangement" and, at the time of the sale, "intends that the securities lending arrangement will ensure that some or all [*sic* of] the [relevant products] can be vested in the buyer" (ss1020AB(1)(b) and (c)).

The use of the phrase "securities lending arrangement" is a little confusing, since the definition covers not only lending arrangements for securities, but also for managed investment products and other financial products.

[115] Explanatory Memorandum, Corporations Amendment (Short Selling) Bill 2008, paragraphs 4.3, 4.5, 4.6, 4.9 and 4.10.

[116] I suspect that this interpretation of the phrase "presently exercisable and unconditional right" can be traced back to ASX Business Rules Guidance Note 11/97. That Guidance Note was published at a time when the predecessor to the now repealed s1020B(4)(d) was on foot (see n113 above). Amongst other things, it dealt with when a securities borrowing arrangement would give rise to a presently exercisable and unconditional right to vest securities. On this topic, the ASX said:

> The Exchange takes the view that the phrase 'presently exercisable and unconditional right to vest the security in the buyer' encompasses more than mere ownership of securities. Accordingly, if a seller has entered into an enforceable agreement which grants the seller an unconditional right to transfer a number of securities to the buyer, the seller has a 'presently exercisable and unconditional right to vest the Security in the buyer'. It follows that, in such a situation, there is no short selling under the Corporations Law and the Business Rules ...
>
> Assume a seller [who does not own the relevant securities] entered into a securities borrowing arrangement with an owner of securities prior to making a sale. In such circumstances the issue is whether the seller having a borrowing arrangement in place has a 'presently exercisable and unconditional right to vest the security in the buyer'? This will depend on the terms of the borrowing arrangement. Each arrangement must be considered on its own terms ... For example, where there is a master securities borrowing agreement and the agreement requires:
>
> (i) the seller/borrower to make a request for a transfer of the securities when he/she wishes to borrow the securities; and
>
> (ii) the transfer of securities is conditional upon the lender's agreement,
>
> the Exchange is of the view that the seller/borrower does not have a 'presently exercisable and unconditional right to vest the security in the buyer' ***until such time as the lender has agreed to the request of the seller/borrower***. If, at the time of the sale of securities the lender has not agreed to the request of the seller/borrower, the seller does not have a presently exercisable and unconditional right to vest the security in the buyer. [Emphasis added.]

I understand that the highlighted words above may have been interpreted, somewhat creatively, by some market participants and legal advisers as supporting the view that if a lender agreed to a securities borrowing request, however informally, that would give rise to a presently exercisable and unconditional right on the part of the borrower to vest the securities and therefore any subsequent sale by the borrower of those securities was not a

manner in which the short seller disclosure obligation has been crafted in s1020AB(1)(c), that the new regime was drafted on an assumption that this view is correct – that is, that someone who has arranged to borrow relevant products under a securities lending arrangement has a presently exercisable and unconditional right to vest those products in a buyer at that point. Otherwise, they would breach the general prohibition against short selling in s1020B(2) by offering or agreeing to sell products they do not own but have arranged to borrow, given that there is no longer any specific exception to s1020B(2) (like the former s1020B(4)(d)) that applies generally to protect short sales covered by a securities lending arrangement.

However, for the reasons I am about to explain, I do not believe that the commonly held market view expressed in the Explanatory Memorandum is correct and, that being so, I believe that the new short selling laws have been drafted on a false premise.

ASIC has opined that a seller only has a presently exercisable and unconditional right to vest relevant products in a buyer if, at the time of sale, the seller has an absolute ability to give the buyer title to the products.[117] With respect, that view must be correct. It is supported not only by the ordinary meaning of the words "presently exercisable and unconditional" in s1020B(2), but also by the very presence of the exception in s1020B(4). The fact that an express exception was considered necessary for short sales covered by purchases that are conditional only on payment of the purchase price and delivery of title and transfer documentation would suggest that for so long as there is any impediment or conditionality to the capacity of the seller to deliver title to a buyer, the seller does not have a presently exercisable and unconditional right for the purposes of s1020B(2).[118]

The Australian Master Securities Lending Agreement (AMSLA), the market standard master agreement used for securities lending transactions in Australia, requires the terms of each securities loan to be agreed prior to the commencement of the loan, either orally or in writing (including any agreed form of electronic communication) and confirmed in such form and on such basis as is agreed between the parties.[119] Normally this is done by the borrower making a request to borrow securities which is accepted by the lender, thereby giving rise to a contract between the parties to borrow and lend the relevant securities respectively on the terms set out in the AMSLA.

Under the AMSLA, unless the requirement for collateral is waived, on the settlement date specified in the borrowing request, the borrower must deliver agreed collateral to the lender

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short sale. That, in turn, led to some fairly dubious securities lending arrangements being put in place to circumvent the prohibition on short sales and, in particular, the requirement in s1020B(4)(d)(iii) for a short sale relying on the securities borrowing exception to take place on the uptick.

In my view, this interpretation of ASX Business Rules Guidance Note 11/97 was, being charitable, misguided.

If this interpretation were correct, there would hardly have been any need for the exception in the now repealed s1020B(4)(d) and the former "uptick rule" in s1020B(4)(d)(iii) would rarely, if ever, have had any scope to operate. The reference in the repealed section to arrangements having been made before a sale that "enable" securities to be delivered within 3 business days after the sale must have meant that there was a securities lending agreement in place at the time of the sale, with the lender indicating that they had or were able to get the securities in question and were prepared to lend them to the seller. Hence, for the former s1020B(4)(d)(iii) to make any sense, there had to have been an assumption underpinning s1020B(4)(d) that a borrower in that position still would not have a presently exercisable and unconditional right to vest securities in a buyer for the purposes of s1020B(2).

[117] ASIC Regulatory Guide 196 *Short selling* ("RG 196"), at paragraph 28.

[118] The one exception to this statement is in relation to products that are subject to a charge or pledge in favour of another person to secure the repayment of money. Section 1020B(3)(b) specifically deems that not to make the right of a person to vest those products in another person conditional.

[119] AMSLA, cl 2.1.

simultaneously against delivery of the borrowed securities by the lender to the borrower.[120] While the AMSLA does not expressly deal with the point, it seems strongly arguable that the obligation of the borrower to deliver any agreed collateral, and the obligation of the lender to deliver the borrowed securities, are cross-conditional. So a lender formally accepting a borrowing request under an AMSLA, of itself, generally would not give the borrower a presently exercisable and unconditional right to vest securities in a buyer, since the borrower's ability to vest those securities is not absolute – it is conditional on the borrower delivering collateral and the lender providing the necessary documents or instructions to transfer the borrowed securities to the borrower. In other words, they are exactly on all fours with someone who has entered into an agreement to purchase the relevant products that is conditional only on payment of the purchase price and delivery of title and transfer documentation – save that, unlike such a purchaser who then proceeds to sell those products, they do not have the benefit of a specific exception equivalent to s1020B(4) to avoid breaching s1020B(2).

In the original version of RG 196 issued in September 2008, ASIC expressed the view that the requirement to have an absolute ability to vest title in the buyer meant that a seller relying on a securities lending arrangement must have an enforceable obligation against the lender "***and have satisfied all their obligations under the arrangement at the time of sale***" [emphasis added]. The logical extension of that view, of course, is that unless the obligation to deliver agreed collateral has been satisfied or waived, the borrower of securities under an AMSLA does not have a presently exercisable and unconditional right to vest those securities in a buyer and therefore cannot purport to sell them without breaching s1020B(2).

ASIC subsequently deleted the highlighted comment in its April 2010 revision of RG 196. In that revision, and in the current revision issued in April 2011, ASIC noted the "common market practice to rely on securities obtained under a securities lending arrangement to satisfy the need to have a presently exercisable and unconditional right to vest the securities in the buyer",[121] and simply opined that a borrower will not have a presently exercisable and unconditional right to vest products unless the lender has given the borrower a firm legally-binding commitment to deliver the products.[122] While it did acknowledge that a borrower is usually required to give the lender collateral as security,[123] ASIC said nothing further on how this might affect the ability of the borrower to unconditionally vest title in a buyer, other than its general warning that:

> We recognise that arrangements between lenders and borrowers will vary. Whether the arrangements are sufficient to reflect a presently exercisable and unconditional right to vest will depend on the particular circumstances of these arrangements.[124]

ASIC's acknowledgment in RG 196 of the common market practice mentioned above, and its presumed knowledge that the new short selling laws were drafted on the basis of the common market understanding mentioned above, would suggest that ASIC is unlikely to take regulatory action against someone who covers a short sale before it is made by issuing a borrowing request and having it accepted by the lender under an AMSLA. However, this is not the end of the matter. If the view expressed above is correct and a borrower of securities under an AMSLA does not have a presently exercisable and unconditional right to vest those

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[120] AMSLA, cl 6.1.

[121] RG 196.30.

[122] RG 196.32. In other words, a "best endeavours" undertaking on the part of the lender to obtain the securities will not suffice (see RG 196.33).

[123] RG 196.31.

[124] RG 196.34.

securities in a buyer unless the obligation to deliver agreed collateral has been satisfied or waived and the lender has provided the necessary documents or instructions to transfer the borrowed securities to the borrower, then the borrower will breach s1020B(2) by offering or entering into an agreement to sell the securities to a buyer before those conditions have been satisfied. There is no saving provision in the Act or the regulations providing that a transaction is not invalidated by reason of breaching s1020B(2). On general principles, therefore, this is likely to make any such agreement for sale unenforceable on the part of the borrower/seller (as this would require them to rely on their own illegal act) and possibly even entitle the buyer to avoid the transaction for illegality.

This uncertainty is, I submit, unacceptable in a market worth billions of dollars and should be corrected. The required correction, I think, is a relatively straight forward one – an amending Act or regulation to the following effect:

> Section 1020B(2) does not apply in relation to a sale of section 1020B products by a person who, before the time of sale:
>
> (a) has entered into a securities lending arrangement; and
>
> (b) has an enforceable right under the securities lending arrangement to borrow those s1020B products;
>
> and whose right to obtain those section 1020B products under the securities lending arrangement is conditional only upon all or any of the following:
>
> (c) payment or delivery by the person of any collateral required under the securities lending arrangement in respect of the loan;
>
> (d) the receipt by the person of a proper instrument of transfer in respect of the products; and
>
> (e) the receipt by the person of the documents that are, or are documents of title to, the products.[125]

6. Product disclosure

One of the core promises of the FSRA was a regulatory regime that would deliver "consistent and comparable financial product disclosure".[126]

I would like to interject a personal story here because I think it well illustrates some of the failings with the product disclosure regime introduced by the FSRA. A few years back my wife and I sold our house and downsized to an apartment. The apartment we had purchased was subject to deferred settlement so we had to rent for a few months after the sale of our house and before the purchase of our apartment was due to settle. We therefore had a sum of money from the sale of our house, some of which needed to be invested for the short term

[125] The drafted exception is obviously based on the exception in s1020B(4) for sales that are covered by purchases that are conditional only on payment of the purchase price and delivery of title and transfer documentation. I would note that there is a perhaps contrived but not entirely disrespectable argument, as yet untested in the courts, that would bring a sale covered by a securities lending arrangement within s1020B(4). That argument acknowledges that, at law, a securities lending arrangement does not really involve a loan as such, but rather is an agreement by the lender to transfer securities to the borrower for consideration with a promise by the borrower to re-transfer equivalent securities back to the lender at the conclusion of the "loan". Accordingly, it can be argued that if a lender has agreed to a borrowing request under clause 2.1 of an AMSLA, that gives rise to a contract on the part of the borrower to "purchase" the securities (ie accept a transfer of the securities for consideration) which is conditional only on the payment of the "purchase price" (ie delivery of the collateral) and the delivery of title and transfer documentation for the securities. If that argument is correct, then the securities lending arrangement would fall within the exception in s1020B(4) and any sale of the securities intended to be borrowed would not infringe s1020B(2), yet would still fall within the disclosure regime in ss1020AA-1020AF.

[126] Financial Services Reform Bill 2001, Revised Explanatory Memorandum, paragraph 1.4.

pending the settlement on our new apartment, and some of which was surplus to requirements and could be invested for the longer term. We chose to put the former into a short term fixed interest investment and the latter partly into the share market and partly into superannuation.

To realise our share market ambitions, we decided to open a CommSec trading account. To do that, we were required to have a deposit account with Commonwealth Bank to which CommSec could make debits and credits for sales and purchases of shares and its fees. That account could only be opened with a minimum balance of $5,000. Due to the debit and credit arrangements that applied to the account, the view had obviously been taken by Commonwealth Bank (I think probably correctly) that the account did not qualify as a 'basic deposit product', within the meaning of the Corporations Act, even though it was the most rudimentary of deposit accounts. It therefore required a PDS,[127] which we were duly delivered – a document of some 80 pages that included the detailed terms and conditions applicable to the account, as well as heap of other diatribe that we did not want, we did not need and we did not read.

By contrast, for the much larger sum that we had decided to put into a short term fixed interest investment, we received a two line email from my personal banker recommending that we buy a bank bill of a particular maturity and advising the implied interest rate.

I ask you how is that consistent and comparable disclosure – an 80 page PDS for a $5,000 deposit account with one of our safest banks and a 2 line email for an investment many times larger in bank bills?

My use of this example is perhaps a little mischievous because, as I will discuss shortly, ASIC has ruled that bank bills are not financial products and therefore do not attract the product disclosure requirements in part 7.9. The amount we were investing in bills was also large enough that, had ASIC deemed them to be financial products, it would have qualified as a wholesale investment and therefore not required a PDS. However, the example does serve to illustrate two points: (1) that we do not have consistent and comparable disclosure across the spectrum of financial products because some products have been excluded from the PDS regime; and (2) that consistent and comparable disclosure does not necessarily translate into concise and effective disclosure.

A. Consistency and comparability – the non-regulation of bills of exchange

Quite appropriately, a number of things that would generally be considered financial products have been excluded from the product disclosure requirements in part 7.9. In some cases, this has been manifested through the exclusion of those products from the definition of 'financial product', such as applies to simple money changing transactions,[128] single payee payment facilities[129] and letters of credit from, cheques drawn by and on, or guarantees given by, a financial institution.[130] In other cases, it has been manifested by a specific exemption from the obligation to provide a PDS, such as now applies to basic deposit products, facilities for making non-cash payments that are related to a basic deposit product and travellers

[127] A PDS is not required in relation to a basic deposit product, provided certain conditions are met – see r7.9.07FA.

[128] These are excluded from being financial products by s765A(1)(m).

[129] These are excluded from being financial products because of their exclusion from the definition of 'non-cash payments' (s763D(2)(a)).

[130] These are excluded from being financial products by virtue of their exclusion from the definition of 'debenture' (see paragraph (c) of the definition of "debenture" in s9) and from the definition of 'non-cash payments' (s763D(2)(b)).

cheques.[131] These exclusions reflect a perfectly legitimate value judgment by our lawmakers that these financial products are relatively simple and/or low risk products that do not warrant the level of regulation applied to most financial products in chapter 7.

However, before the FSRA came fully into effect, ASIC made a value judgment of its own that bills of exchange and promissory notes with a face value of $50,000 or more should also be excluded from regulation as financial products.[132] This it did in a most inappropriate manner – answers to FAQs published on its website[133] simply expressing the conclusion that these products are not financial products for the purposes of the Corporations Act, without favouring the reader with any exposition of the reasons that had led ASIC to such a counter-intuitive conclusion. This is a topic on which I have written at length previously[134] and I will not dwell on it here. Suffice to say, ASIC's position on promissory notes with a face value of $50,000 or more was, I think, clearly wrong and created a potentially significant loophole in the law.[135] Fortunately, Parliament has since legislated to remove any doubt that promissory notes with a face value of $50,000 or more are indeed financial products.[136]

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[131] Regulation 7.9.07FA.

[132] Bills of exchange are excluded from being a 'debenture' under paragraph (c)(iii) of the definition of that term in s9 and therefore are not a 'security' within s764A(1)(a). At the time, promissory notes with a face value of $50,000 or more were also excluded from being a "debenture" under paragraph (d) of the definition of that term in s9 and therefore were not a 'security' within s764A(1)(a) (although this has since been reversed – see n136 below). Neither product falls within the list of the other financial products specified in s764A(1)(b)-(m).

However, it seems to me almost incontrovertible that both products are facilities for making a financial investment within the meaning of s763B and therefore financial products under s763(1)(a), especially when you have regard to the broad reading given to that phrase in *Money for Living*, n8 above.

[133] QFS 132: *Is a bill of exchange a financial product?* (available at http://www.asic.gov.au/asic/asic.nsf/ASIC+FSR+FAQ+DisplayW?ReadForm&unid=51C788323D373F77CA256DE20012538B) and QFS 115: *Is a promissory note a financial product?* (since withdrawn), respectively.

[134] See Lewis, "When is a Financial Product not a Financial Product?" (2004) 22 CSLJ 103.

[135] Although it has to be said that having created the loophole by ruling that promissory notes with a face value of $50,000 or more were not financial products *per se*, ASIC did then try to plug that loophole and bring these products back into the regulatory fold by arguing in FAQ 115 that, in an appropriate case, they could be interests in a managed investment scheme and therefore financial products under s764A(1)(b) or (ba).

ASIC successfully ran that line of argument in *ASIC v Emu Brewery Mezzanine Limited* [2004] WASC 241. In that case, a company had raised money by issuing debt instruments styled as promissory notes with a face value of $50,000 or more under an information memorandum. In an application for rulings on various issues, the WA Supreme Court ruled that the instruments were promissory notes for the purposes of s89 of the Bills of Exchange Act 1909 (Cth) and s9 of the Corporations Act. They were therefore not debentures and accordingly were not subject to the prospectus requirements in chapter 6D. The court held however that the promissory notes were an interest in a managed investment scheme and, although this point was not expressed in the judgment, it necessarily followed that they were therefore subject to the product disclosure requirements in Part 7.9 unless the investors to whom they were sold were all wholesale investors. Interestingly, while the questions for ruling initially included whether the promissory notes were a 'financial product' for the purposes of the Corporations Act, the parties chose not to make submissions on this point and the court therefore was not required to, and did not, address the contentious issue as to whether the promissory notes might be a financial product under ss763A(1)(a) and 763B. One might ask, if ASIC was confident in correctness of the views it had expressed on this subject in QFS 115, why did it choose not to have those views tested and confirmed by the judiciary?

The decision that the instruments in question were promissory notes and not debentures was upheld by a majority of the WA Court of Appeal in *Emu Brewery Mezzanine Limited (in liq) v ASIC* [2006] WASCA 105. The Court of Appeal was not called upon to address whether the company had been involved in marketing a managed investment scheme or whether promissory notes were a financial product for the purposes of the Corporations Act.

The reticence by ASIC to test FAQ 115 before the courts ultimately proved to be of no avail. In *Financial Industry Complaints Service Ltd v Deakin Financial Services Pty Ltd* [2006] FCA 1805, the Federal Court held that a promissory note with a face vale of $50,000 or more is a facility for making a financial investment within s763B and therefore a financial product under s763A(1)(a).

A problem still remains, however, in relation to bills of exchange. The bill market in Australia is enormous[137] and a critical part of the funding sources for our banking industry. It is all well and good for ASIC to announce that bills of exchange are not financial products and that it will administer the law on that basis. However, that does not preclude a client or counterparty who has invested in a bill of exchange from a bank whose Australian financial services licence (AFSL) does not authorise it to deal in such products and who is disappointed with, or wants to avoid their obligations in relation to, their investment, from taking a contrary view and seeking to avoid the transaction under s925A or to recover the fees paid on the bill under s925F. Why should banks be exposed to that risk? If ASIC truly believes that bills of exchange should not be regulated as financial products, it has the power to formalise that position by making a declaration under ss765A(1)(z) and (2) that bills of exchange are not a financial product. I would like to suggest, however, that bills of exchange warrant closer examination by our lawmakers to ensure that the regulatory settings for them are appropriate before they are wholly excluded from chapter 7.[138]

B. Consistency and comparability – the disclosure requirements for listed trusts

One of the outcomes of the FSRA's push for consistency and comparability of product disclosure was the transfer of the disclosure requirements for interests in managed investment schemes from the prospectus regime in chapter 6D to the PDS regime in part 7.9. The assumption that underpinned this change was that managed investment schemes are often used as vehicles for investment in a range of financial products rather than as vehicles for conducting specific business ventures and therefore they are more appropriately regulated in a like manner to investment life insurance products and superannuation products, rather than in a like manner to securities in a company.[139] However, this is not universally true. There are plenty of examples of business ventures that have chosen, usually for tax reasons, to structure themselves as trusts (and therefore managed investment schemes), rather than as companies.

Investors subscribing for securities in a listed company get the benefit of a prospectus that is required to contain all the information that they ***and their professional advisers*** would reasonably require, and reasonably expect to find in the prospectus, to make an informed

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See also *ASIC v Great Northern Developments Pty Ltd* [2010] NSWSC 1087, where the NSW Supreme Court held that a defendant who had issued promissory notes with a face value of $50,000 or more to 27 lenders to fund its property development business, was not operating an unregistered managed investment scheme. The court held that the subscribers to the promissory notes only received a right to repayment of principal and interest on their notes and did not receive any rights to benefits produced by a "scheme". Importantly, in that case, there had been no representation that noteholders would receive any right to receive benefits produced by defendant's business of raising of money and property development. Nor was there any evidence that noteholders intended their funds to be pooled or used in a common enterprise.

[136] Schedule 3 s1 of the Corporations Legislation Amendment (Financial Services Modernisation) Act 2009 (Cth) repealed paragraph (d) of the definition of 'debenture'. That paragraph previously excluded from the definition of 'debenture' an undertaking to pay money under a promissory note that had a face value of at least $50,000. With the repeal of paragraph (d), these products are now clearly debentures, which in turn makes them securities under s761A and therefore financial products under s764A(1)(a).

[137] According to a paper published by the Working Group of Officials, *National Competition Policy Review of the Bills of Exchange Act 1909*, in July 2003, the face value of bank bills (ie bills of exchange accepted or indorsed by a bank) on issue as at March 2003 was $76 billion, around 35% of the total $219 billion of short-term money market instruments on issue (ibid, at 11-12). The working paper is available online at: http://www.treasury.gov.au/documents/688/PDF/Final%20Bills%20of%20Exchange%20Act%20Review.pdf.

[138] According to the Working Group of Officials, *National Competition Policy Review of the Bills of Exchange Act 1909*, ibid (at 13), at the time of its writing, the retail market for bank bills represented approximately 50% of bank bills on issue, with significant volumes issued in denominations between $50,000 and $250,000.

[139] See the discussion at paragraphs 14.18-14.21 of the Revised Explanatory Memorandum for the Financial Services Reform Bill 2001.

assessment of the assets and liabilities, financial position and performance, profits and losses and prospects of the company.[140] They also get the benefit of a strict liability regime that effectively imposes a requirement for the company and its directors and advisers to undertake due diligence enquiries aimed at ensuring that the prospectus contains all such information.[141] Investors subscribing for units in a listed trust, on the other hand, are only entitled to this information if and to the extent it falls within the specific heads of disclosure in s1013D(1)[142] or the general disclosure requirement in s1013E,[143] and then only to the extent that it is reasonable for a retail client considering whether to acquire the product to expect to find the information in the PDS.[144] In addition, there is no requirement in the PDS liability regime for the trustee or its directors and advisers to undertake any due diligence enquiries to determine the contents of the PDS.[145] This does not meet the FSRA's policy goal of consistency and comparability.

In considering product disclosure issues, one needs to consider not just the information needs of retail investors, but also the information needs of professional investors and the vital role they play in the price discovery process. The requirement for an entity seeking admission to the official list of ASX as an equity listing to produce a prospectus or PDS[146] is an absolutely central provision that underpins the whole listing process. It seeks to ensure that the market receives an appropriate level of information to enable secondary trading to take place after listing in a reasonably informed manner. The amount and quality of information provided to the market should be the same, whether it relates to a security in a listed company or a unit in a listed trust.

I would therefore like to suggest that interests in listed trusts[147] should be carved out of the disclosure regime in part 7.9 and reinstated into the disclosure regime in chapter 6D. Not only would this address the issues identified in the previous paragraphs, it would also remove the current anomaly of hybrid listed entities with stapled securities and trust units having to issue a prospectus with one set of content requirements in relation to the former and a PDS with a different set of content requirements in relation to the latter.

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[140] Section 710(1).

[141] See ss710(1)(b)(ii) (which extends the content requirement for prospectuses to include matters that could reasonably be ascertained by making enquiries) and 731 (the due diligence defence for prospectuses, which requires a person seeking to raise the defence to have made reasonable enquiries and to have believed on reasonable grounds that the prospectus was not defective).

[142] The specific heads of disclosure in s1013D(1) are set out in the text accompanying n171 below.

[143] As mentioned below, s1013E requires a PDS to contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product.

[144] Section 1013F(1).

[145] Compare the provisions in n141 above with ss1013C(2) (which provides that information is only required to be included in a PDS if it is actually known by relevant persons) and 1021E(4) (the due diligence defence for PDSs, which only requires a person seeking to raise the defence to have taken reasonable steps to ensure that the PDS was not defective).

[146] See ASX Listing Rule 1.1 condition 3.

[147] This would only apply to entities admitted to the official list of ASX as an ASX Listing. It would not apply to entities admitted to the official list as an ASX Debt Listing or ASX Foreign Exempt Listing, nor would it apply to trusts that are not admitted to the official list but simply have their units quoted as managed fund products on ASX's AQUA market.

C. Consistency and comparability – the disclosure requirements for market traded derivatives

The current disclosure regime that applies to market traded derivatives can be found, in part, in the PDS provisions in the Act and regulations[148] and, in part, in rules 3.1.2, 3.1.6(1)(a), (b) and (c), 3.1.7(1)(b) and 3.1.8 of the ASIC MIR. It is fair to say that these provisions do not meld well.

Under the PDS provisions, the issuer of a derivative[149] is required to provide a PDS in relation to that product[150] that includes information about the significant characteristics or features of the product and the rights, terms, conditions and obligations attaching to the product,[151] as well as any significant risks associated with holding the product.[152]

For these purposes, if a derivative (other than a derivative that also happens to be a warrant[153]) is entered into or acquired on a financial market through an arrangement made by a financial services licensee or an authorised representative of a financial services licensee acting on behalf of another person, as they inevitably are in the case of market traded derivatives, the issuer of the derivative is taken to be the financial services licensee.[154] Hence, the person responsible for preparing a PDS in relation to a market traded derivative (other than a derivative that also happens to be a warrant) will be the market participant through whom the client acquires the derivative.

Under ASX MIR 3.1.2, before an ASX market participant accepts an order from a retail client[155] to enter into a market transaction in respect of an exchange traded option (ETO), low exercise price option (LEPO) or warrant, the participant must give the client a copy of the current explanatory booklet published in respect of those products by ASX,[156] together with any updates to that explanatory booklet.

Under ASX MIR 3.1.6, before accepting an order from a client[157] to enter into a market transaction in respect of ASX futures, an ASX market participant must have a written

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[148] The PDS regime for these products is supplemented by the provisions in the Corporations Act requiring a financial services licensee who provides personal advice to a retail client to deal in such products to have a reasonable basis for that advice (s945A) and to provide a written Statement of Advice setting out or confirming that advice (s946A).

[149] The same applies to the issuer of a warrant. A warrant can take the form of a security, an interest in a managed investment scheme or a derivative (see the definition of 'warrant', which is set out in the text accompanying n46 above). Regulations 6D.5.01 and 7.9.07A(2) exclude warrants that would otherwise fall within the definition of 'security' from the prospectus disclosure regime in Chapter 6D and make them subject to the PDS disclosure regime in Part 7.9.

[150] Section 1012B.

[151] Section 1013D(1)(f).

[152] Section 1013D(1)(c).

[153] By virtue of regulation 7.9.07A(3) and (4), s761E(6) does not apply to warrants. Instead, the person who determines the terms of the warrant and is responsible for the obligations owed under the terms of the warrant is deemed to be the issuer of the warrant and is therefore responsible for preparing the PDS for the warrant. This applies even where a financial services licensee or an authorised representative of a licensee is involved in arranging the acquisition of the warrant on a financial market.

[154] Section 761E(6).

[155] A participant is not required to give these documents to a wholesale client unless the client requests them.

[156] The ASX explanatory booklets for ETOs, LEPOs and warrants are available online at:
http://www.asx.com.au/documents/resources/UnderstandingOptions.pdf
http://www.asx.com.au/documents/resources/UnderstandingLEPOs.pdf
http://www.asx.com.au/documents/resources/understandingwarrants.pdf.

[157] This requirement applies equally to retail and wholesale clients.

agreement with the client that includes certain prescribed minimum terms. These include 3 terms in the nature of risk disclosure statements – paragraph (a) requires an acknowledgement that trading in futures contracts involves a risk of loss as well as the potential for profit; paragraph (b) requires an acknowledgement that the client has read the contract specifications for relevant futures market contracts; and paragraph (c) requires an acknowledgement that the client should consider its objectives, financial situation and needs and whether a dealing in futures contracts is suitable for its purposes.

Under ASX MIR 3.1.7, before accepting an order from a retail client to enter into a market transaction in respect of ETOs, an ASX market participant must have a written agreement with the client that includes certain prescribed minimum terms. These include one term in the nature of a risk disclosure statement – paragraph (b) requires an acknowledgement that the client has received and read ASX's current explanatory booklet for ETOs.

Under ASX MIR 3.1.8(1), before accepting an order from a retail client to enter into a market transaction[158] in respect of warrants, an ASX market participant must have a written agreement with the client that includes certain prescribed minimum terms. While the heading to this rule describes the agreement as a "client agreement", it is really in the nature of a risk disclosure statement. All 3 of the prescribed terms for the "agreement" involve an acknowledgement by the client of some of the risks involved in trading in warrants. Under ASX MIR 3.1.8(2), the written agreement must also include an acknowledgement that the client has received and read ASX's current explanatory booklet for warrants.

There are currently no provisions in the ASX MIR imposing any requirement to give an explanatory booklet in relation to futures contracts traded on the ASX market (grain, wool and the S&P/ASX 200 A-REIT index futures) and no such booklets currently exist (although there is considerable educational material about these products on the ASX website).

There is no equivalent framework to the provisions described above in the ASX 24 MIR. ASX has published an explanatory booklet in relation to contracts for difference (CFDs) traded on the ASX 24 market,[159] however, there is no requirement in the ASX 24 MIR for an ASX 24 participant to give a copy of that booklet to retail clients. There are currently no ASX explanatory booklets in relation to futures contracts or futures options traded on the ASX 24 market (although again there is considerable educational material about these products on the ASX website). Further, while ASX 24 MIR 2.2.5 does impose a requirement that before accepting an order from a client[160] to trade in products on that market, an ASX 24 participant must have a written agreement with the client that includes certain prescribed minimum terms, none of those terms addresses the risks involved in trading those products.

Hence, to the extent the retail investor protection regime for market traded derivatives is based around the requirement for clients to be given exchange-issued explanatory booklets, the regime is deficient because:

- The range of products covered by this requirement does not extend to the full range of market traded derivatives. The requirement to give explanatory booklets currently only applies to ETOs, LEPOs and warrants. It does not apply to futures contracts traded on the ASX market, nor to any products traded on the ASX 24 market.

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[158] These requirements do not apply to a contract to sell a warrant (ASX MIR 3.1.8(3)).

[159] The ASX explanatory booklet for CFDs is available online at: http://www.asx.com.au/documents/resources/understanding_asx_listed_cfds.pdf.

[160] This requirement applies equally to retail and wholesale clients.

- The range of explanatory booklets is not complete. Currently, there are no explanatory booklets for futures contracts traded on the ASX market or for futures contracts or futures options traded on the ASX 24 market.
- In the case of LEPOs, there is no requirement for a retail client to acknowledge having received and read any explanatory booklet they have been given. Even with ETOs and warrants, where there is such a requirement, there can be no guarantee that a client who is provided with an explanatory booklet in fact has read it and, if they did, that they in fact have understood it.

To the extent the retail investor protection regime for market traded derivatives is based around the requirement for certain risk disclosures to be included in client agreements, the regime is deficient because:

- The range of products covered by this requirement does not extend to the full range of market traded derivatives. Currently, there are no risk disclosure requirements for futures contracts, futures options or CFDs traded on the ASX 24 market.
- The quality and level of detail in the risk disclosures for those products that do attract this requirement are quite varied.
- Having risk disclosure requirements in client agreements runs the risk that they are not given the prominence that is appropriate – they may be "buried in the fine print" or lost in the middle of what can be very lengthy client documentation.
- Anecdotally, many retail investors sign client agreements without reading them, on the assumption that they are standard form agreements that cannot be altered. Hence, even though they may be signing to acknowledge certain risks, they may not be aware that they are doing so.

The PDS regime for market traded derivatives also has its deficiencies. In this regard, r7.9.07B contains some very important modifications to the content requirements for a PDS for a market-traded derivative. It provides that the information required to be set out in a PDS by ss1013D(1)(b), (c), (d) and (f)[161] can be included as general information about the type of derivative, such as information about its exercise price, expiry date and exercise style.[162] It also permits market data and educational material made available to the public by the relevant market operator about derivatives and their underlying products to be taken into account under s1013F[163] in determining the contents of the PDS.[164] Hence, theoretically at least, the PDS prepared by a broker for a market traded derivative does not need to repeat material that

[161] These provisions ordinarily require a PDS to contain: (b) information about any significant benefits to which a holder of the product will or may become entitled; (c) information about any significant risks associated with holding the product; (d) information about the cost of the product and amounts that will or may be payable by a holder of the product in respect of the product after its acquisition; and (f) information about any other significant characteristics or features of the product.

[162] Regulation 7.9.07B(2).

[163] Section 1013F provides that information is not required to be included in a PDS if it would not be reasonable for a person considering, as a retail client, whether to acquire the product to expect to find the information in the PDS. Factors that can be taken into account include the extent to which the product is well understood by the kinds of person who commonly acquire products of that kind as retail clients and the kinds of things such persons may reasonably be expected to know.

[164] Regulation 7.9.07B(3). I should add that my summary in the text of the effect of this regulation is a "plain English" version of what the regulation seeks to achieve. The actual drafting of the regulation is not as clear as the summary in the text might suggest.

is included, for example, in ASX's explanatory booklets for ETOs, LEPOs and CFDs or in the educational materials about derivatives on its website.[165]

Regulation 7.9.07B is expressed to apply where:

> (a) the standard terms and conditions relating to a type of derivative are specified by the market operator and made generally available to the public;
>
> (b) the financial services licensee in relation to the derivative is taken to be the issuer of the derivative under s761E(6); and
>
> (c) a retail client for the derivative has agreed to the terms and conditions as applicable to the financial product or products that are the subject of the transaction.[166]

As can be seen from paragraph (a) quoted above, r7.9.07B only applies to market traded derivatives with standardised terms and conditions that are made known by the market operator to the public. So what on earth is requirement (c) above all about?[167] How do you show that a retail client has agreed to the terms and conditions applicable to a market traded derivative? Do you have to explain all of those terms and conditions to the client and get their express agreement? If you are entitled to assume that a client is aware of market data and educational material published by the market operator about a market traded derivative in preparing your PDS, why can't you do likewise for the published terms and conditions that apply to the derivative? More generally, shouldn't you be able to assume that a retail client who places an order to buy or sell a market traded derivative has agreed to its terms and conditions by the very act of placing the order?

Putting these issues to one side, there are real practical problems with the way the PDS regime interacts with the various explanatory booklets published by ASX:

- the fact that each broker is required to prepare their own PDS for market traded derivatives (other than warrants) inevitably leads to inconsistencies between them and differences in the quality and completeness of risk disclosures – this is especially so in relation to futures and futures options, given the absence of any ASX issued explanatory booklets for these products to provide a common base for product disclosure;

- in the case of ETOs and LEPOs, even though r7.9.07B is intended to minimise duplication between ASX's explanatory booklets and broker-issued PDSs, anecdotally,

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[165] A similar provision (r7.9.07A(5)) applies in relation to warrants. In crafting the contents of a PDS for a warrant, the warrant issuer is entitled to take account of market data and educational material made available to the public by the relevant market operator about warrants and their underlying products and hence, theoretically at least, does not need to repeat material that is included, for example, in ASX's explanatory booklets for warrants or in the educational materials about warrants on its website.

Again, I should add that my summary in this footnote of the effect of r7.9.07A(5) is a "plain English" version of what the regulation seeks to achieve. The actual drafting of the regulation is not as clear as the summary above might suggest.

[166] Regulation 7.9.07B(1).

[167] The Explanatory Statement for the amending regulations that introduced these provisions (the Corporations Amendment Regulations 2002 (No 2) SR 16/2002) does not shed any light as to why r7.9.07B(1)(c) was included. It simply says:

> The exemption from providing particular information in a product disclosure statement in relation to particular market-traded derivatives will be subject to the retail client agreeing to the terms and conditions applicable to the financial product or financial products that are the subject of the transaction (see paragraph 7.9.07B(1)(c)). However, paragraph 7.9.07B(1)(c) is not intended to prevent retail clients allowing a licensee to operate a discretionary account, that is, without the client's specific approval of particular transactions, and to place orders on the client's behalf in relation to, for example, a range of prices or types of derivatives.

there is substantial duplication between them – with clients required to be given both documents, this has the potential to cause information overload; and

- whether r7.9.07B should operate in the case of CFDs to avoid the need for a broker-issued PDS to duplicate the materials in ASX's explanatory booklet for CFDs is questionable, given the absence of any legal requirement for brokers to give that explanatory statement to their clients.

The product disclosure requirements for market traded derivatives are in real need of rationalisation. Where the terms for market traded derivatives are standard terms specified by the market operator (such as ETOs, LEPOs, futures and CFDs), it is hard to see a sound policy reason why individual brokers should have to prepare the PDS for that product and, where the exchange has published an explanatory booklet for those products, why there is a need for clients to be given both the explanatory booklet and a PDS. Surely, the explanatory booklet should suffice. Conversely, in the case of warrants, where the terms are set by the warrant issuer and not standardised and therefore investors really need to receive and read the relevant PDS to understand what it is they are buying, it is hard see what purpose a generic explanatory booklet about warrants really serves.

D. The failure to produce concise and effective product disclosure

I think most commentators would agree that the quality of product disclosure generated by the FSRA leaves much to be desired. Treasury itself conceded as much in 2005:

> PDSs have as a rule turned out to be complex and lengthy documents. Consumer feedback suggests that the average retail investor finds it difficult to absorb the large volume of information in some PDSs, and is therefore deterred from using the information to make investment decisions.[168]

My example of the 80 page PDS for a simple $5,000 bank account exemplifies the point.

Parliament did attempt to pre-empt this happening by imposing an obligation in s1013C(3) for the information included in a PDS to be worded and presented in a clear, concise and effective manner,[169] something that ASIC has sought to reinforce time and time again[170] to no avail.

To understand why the requirement for conciseness has been universally ignored, one need look no further than the ham-fisted manner in which the FSRA sought to execute the principle of consistent and comparable disclosure. Instead of imposing like disclosure requirements to like products, the FSRA sowed the seeds of its own ineffectualness by imposing the same disclosure requirements to all financial products.

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[168] Explanatory Statement, Corporations Amendment Regulations 2005 (No 5) SR 324/2005.

[169] That obligation was extended to disclosure documents for securities by s715A, which was inserted into the Act by the CLERP 9 Act.

[170] See, for example, ASIC Media Release 04-062 *FSR disclosure to be clear, concise and effective* (available online at http://www.asic.gov.au/asic/asic.nsf/byheadline/04-062+FSR+disclosure+to+be+clear%2C+concise+and+effective?openDocument) and ASIC Information Release 04-71 *ASIC issues guidance on PDS disclosure* (available online at http://www.asic.gov.au/asic/ASIC_PUB.NSF/byid/397106FFCE58CD50CA256F70007DFB3B?opendocument). There are also numerous references to this obligation in ASIC Regulatory Guide 168 *Disclosure: Product disclosure statements (and other disclosure obligations)*. ASIC has recently conceded that prospectuses suffer much the same problems: see Consultation Paper 155 *Prospectus disclosure: Improving disclosure for retail investors*.

In this regard, s1013D(1) imposes a general obligation, which applies across the board for all financial products that are subject to the PDS regime, for a PDS to include:

> the following statements, and such of the following information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product:
>
> (a) a statement setting out the name and contact details of:
>
> (i) the issuer of the financial product; and
>
> (ii) if the PDS relates to a sale situation - the seller;
>
> (b) information about any significant benefits to which a holder of the product will or may become entitled, the circumstances in which and times at which those benefits will or may be provided, and the way in which those benefits will or may be provided;
>
> (c) information about any significant risks associated with holding the product;
>
> (d) information about:
>
> (i) the cost of the product;
>
> (ii) any amounts that will or may be payable by a holder of the product in respect of the product after its acquisition, and the times at which those amounts will or may be payable; and
>
> (iii) if the amounts paid in respect of the financial product and the amounts paid in respect of other financial products are paid into a common fund - any amounts that will or may be deducted from the fund by way of fees, expenses or charges;
>
> (e) if the product will or may generate a return to a holder of the product - information about any commission, or other similar payments, that will or may impact on the amount of such a return;
>
> (f) information about any other significant characteristics or features of the product or of the rights, terms, conditions and obligations attaching to the product;
>
> (g) information about the dispute resolution system that covers complaints by holders of the product and about how that system may be accessed;
>
> (h) general information about any significant taxation implications of financial products of that kind;
>
> (i) information about any cooling-off regime that applies in respect of acquisitions of the product (whether the regime is provided for by a law or otherwise);
>
> (j) if the product issuer (in the case of an issue PDS) or the seller (in the case of a sale PDS) makes other information relating to the product available to holders or prospective holders of the product, or to people more generally - a statement of how that information may be accessed;
>
> (k) any other statements or information required by the regulations;
>
> (l) if the product has an investment component - the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment; and
>
> (m) unless, in accordance with the regulations and a determination by ASIC, information to be disclosed in accordance with paragraphs (b), (d) and (e) must be stated as amounts in dollars.[171]

In addition, s1013E requires a PDS to contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product.

Consistency and comparability are virtues only when there is a need for comparison. A person wanting to buy travel insurance has very different information needs to someone wanting to

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[171] Section 1013D(1)(m) has been modified by r7.9.15A to read as set out in the text.

invest in a complex leveraged derivative product. Information about the latter product will have absolutely no bearing on the purchase decision for the former. The premise, therefore, that underpinned the drafting of ss1013D and 1013E that the PDSs for all of the different types of financial products needed to be consistent and comparable and therefore subject to the same set of detailed disclosure requirements was plainly wrong.

Confronted by the lengthy list of content requirements in s1013D, the open ended content requirement in s1013E, and the significant criminal and civil consequences that flow from having a defective PDS,[172] it is hardly surprising that the issuers of financial products and their advisers have erred on the side of caution and sought to include as much information as could conceivably be relevant in their PDSs.

To give credit where it is due, Treasury did try to redress this in 2005 by introducing regulations[173] simplifying the PDS requirements for general insurance products[174] and purporting to introduce an optional short-form PDS regime for other products, in the latter case via a set of modifications to the Act set out in schedule 10BA of the regulations. Key amongst those modifications was the deemed introduction of ss1017H(1) and 1017I(1) into the Act. The former allows a regulated person who is required to give a PDS for a financial product (other than a general insurance product) instead to provide them with a short-form PDS. The latter provides that a short-form PDS need only contain:

> (a) a summary of the statements and information referred to in paragraphs 1013D(1)(a), (b), (c), (d), (e), (g) and (i)[175] that were included in a [PDS] for the product;
>
> (b) a statement:
>
> (i) notifying the retail client in relation to the product that the client may ask for the [PDS] for the product; and
>
> (ii) setting out the means by which the client may ask for the [PDS].

However, short-form PDSs attract much the same the criminal and civil consequences if they are defective as a regular PDS.[176] Users are required to make a value judgment as to how much information has to be included to constitute an adequate summary for the purposes of paragraph (a) above.[177] They are also still required to prepare a full blown PDS and make it

[172] See, for example, ss1016F, 1021D, 1021E and 1022B.

[173] Corporations Amendment Regulations 2005 (No 5) SR 324/2005.

[174] The modified PDS regime for general insurance products can be found in rr7.9.15D, 7.9.15E and 7.9.15F.

[175] The explanatory statement for the Corporations Amendment Regulations 2005 (No 5) SR 324/2005 also made the point that s1013D(1)(m) (the requirement for certain information in the PDS to be stated in dollars) also impliedly applies to short-form PDSs because it applies to and qualifies s1013D(1)(b), (d) and (e) – see the passage cited in n177 below.

[176] This is the effect of items 3.9-3.32 of part 3 of schedule 10BA.

[177] This issue was confounded somewhat by the following passage in the explanatory statement for the Corporations Amendment Regulations 2005 (No 5) SR 324/2005:

> Subsection 1017I(1) prescribes that a Short-Form PDS for a financial product has to contain a summary of such statements and information included in a PDS for the product as required by paragraphs 1013D(1)(a), (b), (c), (d), (e), (g) and (i) of the Act. These paragraphs relate to information about the issuer of the product, significant risks and benefits, costs and commissions, dispute resolution mechanisms and cooling-off periods. ***Because the provision requires a summary of the relevant PDS content it indirectly transfers the effect of a number of provisions from the PDS to the Short-Form PDS.*** Paragraph 1013D(1)(m), for instance, which requires the statement of certain amounts in dollars, is made applicable to the Short-Form PDS by virtue of the requirement to summarise the PDS. [Emphasis added].

Apart from s1013D(1)(m), it is hard to see what other provisions applicable to long-form PDSs might be transferred across to short-form PDSs by the requirement to summarise the information in the PDS.

available where a retail client requests one.[178] So instead of simplifying product disclosure, short-form PDSs have really just added an extra burden on issuers adopting that measure to generate a second disclosure document. It is hardly surprising, therefore, that short-form PDSs have not been widely embraced by industry.

Interestingly, if you look for schedule 10BA in the current compilation of the Corporations Regulations on ComLaw, all you will find is a statement saying: "See note 3". Note 3 sets out the relevant amending regulation which purportedly introduced schedule 10BA[179] and follows that with the statement: "The proposed amendment was misdescribed and is not incorporated in this compilation."

As best I can tell, the reason for this is that the relevant amending regulation provided for schedule 10BA to be inserted after schedule 10B and there was no schedule 10B in the regulations at the time.[180] This is symptomatic of the problems caused by a multiplicity of regulations amending the Act, a topic to which I will return shortly.[181] The fact that our lawmakers have clearly known about this problem for more than 5 years[182] and have not taken any corrective action is also reflective of something of a cavalier attitude to both the law and to the rule of law. This is a serious issue because, if schedule 10BA has not been lawfully introduced into the regulations, those industry participants who are using short-form PDSs are breaching the law by doing so. Presumably, our lawmakers do not see this as a matter of any urgency because ASIC no doubt will go on administering the law as it was intended to be,[183] rather than as it is, and not take regulatory action against those issuing short-form PDSs that otherwise comply with schedule 10BA. However, this ignores the fact that it is not just ASIC that can take action for breaches of chapter 7. I can well see a client who received a short-form PDS for a financial product and who is disappointed by the performance of, or otherwise wants to avoid their obligations in relation to, the product taking the point that they should have received a long-form PDS under the law as it currently stands.

While this should be corrected, and promptly, retrospectively legitimising schedule 10BA is unlikely to fix the core problems with PDSs. If our lawmakers and regulators want better and shorter PDSs, the approach they have recently taken in relation to first home saver accounts (FHSAs),[184] standard margin lending facilities,[185] most superannuation products[186] and simple

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[178] Section 1017H(2), as introduced by part 3, item 3.1 of schedule 10BA.

[179] Schedule 3 item 3 of the Corporations Amendment Regulations 2005 (No 5) SR 324/2005.

[180] There was a schedule 10A and 10D. Schedules 10B and 10C had been omitted earlier in 2005 by schedule 1 item 12 of the Corporations Amendment Regulations 2005 (No 1) SR 31/2005.

[181] The short-form PDS provisions are also another example of the complexity and opacity that has crept into chapter 7 through the inappropriate use of regulations to modify the Act. You won't find any reference to short-form PDSs in the Act. To locate these provisions, you first have to find r7.9.61AA, which defines 'short-form PDS' for the purposes of various provisions in the Act and provides that parts 7.7, 7.8 and 7.9 of the Act are modified in their application to short-form PDSs in the manner set out in schedule 10BA. That schedule in turn makes 34 separate piecemeal modifications to parts 7.7, 7.8 and 7.9 of the Act, one of which (item 3.1 of part 3) deems new divisions 3A and 3B (ss1017H-1017Q) to have been inserted into the Act. To understand the overall effect of these 34 amendments, you either need to have a great deal of time and patience to flip between the Act and the regulations to analyse the impact of each separate amendment or you need to content yourself with reading the summary of their effect in the explanatory statement for the amending regulations that introduced them.

[182] The superseded version of the Corporations Regulations number F2006C00025 published on ComLaw on 21 December 2005 acknowledged this issue (what is currently note 3 was then note 2).

[183] ASIC Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* specifically refers to the ability of product issuers to issue short-form PDSs without mentioning that there might be doubts about the legal efficacy of schedule 10BA (see paragraphs 103-5).

[184] These provisions were introduced by the Corporations Amendment Regulations 2008 (No 4) SR 158/2008 and came into effect on 19 July 2008.

managed investment schemes[187] has much to commend it and is a signpost to the way forward. For these products, schedules 10B, 10C, 10D and 10E of the regulations impose significantly modified and highly prescriptive PDS requirements. They mandate, for example, minimum font sizes[188] and maximum page lengths.[189] They completely replace the usual PDS content requirements and instead prescribe standard headings that must appear in the PDS, the order in which those headings must appear and the contents that must appear under those headings. The headings and content requirements are tailored to suit the particular product on offer.

There is substantial overlap between schedules 10B, 10C, 10D and 10E and the drafting could be rationalised and simplified, but they will guarantee that PDSs for the products to which they apply are consistent, comparable, concise and more relevant and helpful to retail investors. I would therefore like to suggest that our lawmakers and regulators should apply a similar approach to all of the different categories of financial products covered by chapter 7 – consult with industry and consumer groups to ascertain the key information needs that retail investors have for each type of financial product and then codify those as the disclosure requirements for that product in the regulations. Then ss1013D and 1013E can be replaced with a provision in the Act simply requiring a PDS to meet the applicable content requirements set in the regulations. This will benefit industry through clearer and less open-ended disclosure requirements and consumers through better and shorter disclosure.

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[185] These provisions were introduced by the Corporations Amendment Regulations 2010 (No 5) SR 135/2010 and came into effect on 1 January 2011.

[186] These provisions were also introduced by the Corporations Amendment Regulations 2010 (No 5) SR 135/2010 and are now due to come into effect on 22 June 2012, although issuers can opt in from 22 June 2011 if they are ready (see ASIC Class Order CO 11/576).

The modified PDS requirements apply to all superannuation products to which part 7.9 division 4 subdivision 4.2B applies. This is essentially all superannuation products, other than those that consist solely of an interest in a defined benefits fund or a pension product (r7.9.11K). Combined accumulation/pension products and combined accumulation/defined benefits products are still included in the regime, however, a person can apply to ASIC, on a case-by-case basis or on a product-wide basis, for relevant relief from these requirements, where appropriate.

[187] These provisions were also introduced by the Corporations Amendment Regulations 2010 (No 5) SR 135/2010 and are now due to come into effect on 22 June 2012, although issuers can opt in from 22 June 2011 if they are ready (see ASIC Class Order CO 11/576).

'Simple managed investment scheme' is defined in r1.0.02(1) to mean a registered management investment scheme which is or was offered because it meets one of the following requirements: (a) the scheme invests at least 80% of its assets in money in an account with a bank on the basis that the money is available for withdrawal immediately during the bank's normal business hours or at the end of a fixed-term period that does not exceed 3 months; (b) the scheme invests at least 80% of its assets in money on deposit with a bank on the basis that the money is available for withdrawal immediately during the bank's normal business hours or at the end of a fixed-term period that does not exceed 3 months; or (c) the scheme invests at least 80% of its assets under one or more arrangements by which the responsible entity of the scheme can reasonably expect to realise the investment, at the market value of the assets, within 10 days.

[188] In each case, the minimum font size for text in the PDS is 8 points for the name, address, ABN, ACN and AFSL of the person giving the PDS and 9 points for all other text.

[189] For FHSA products and standard margin lending facilities, the maximum length of a PDS (including any title page, contents or matter in writing that is applied, adopted or incorporated by the PDS) must not exceed: (a) 4 pages if it is printed on A4; (b) 8 pages if it is printed on A5; or (c) 12 pages if it is printed on DL. For superannuation and simple managed investment schemes, the maximum length is double these allowances.

7. Licensing

Another of the core promises of the FSRA was "a single licensing regime for financial sales, advice and dealings in relation to financial products",[190] which in turn was one of the main underpinnings for its further promise that it would reduce administrative and compliance costs for industry participants.[191]

Regrettably, in a move that runs directly counter to one of the centrepieces of the FSRA reforms, Parliament has recently seen fit to introduce a whole new licensing regime for ADIs and other financial institutions that provide credit or credit-related services to consumers as part of their product offering. They are now required by s29 of the National Consumer Credit Protection Act (Cth) 2009 [192] to hold an Australian credit licence (ACL), in addition to the AFSL that many of them will hold. The NCCPA licensing regime is modelled on the AFSL

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[190] Financial Services Reform Bill 2001, Revised Explanatory Memorandum, paragraph 1.4.

The claim that the FSRA introduced "a single licensing regime for financial sales, advice and dealings in relation to financial products" has always intrigued me. Before and after the FSRA came into effect:

- organisations selling banking products were, and still are, required to have an authority carry on banking business under the Banking Act 1959 (Cth);
- organisations selling life insurance products were, and still are, required to be registered as life insurance companies under the Life Insurance Act 1995 (Cth);
- organisations selling general insurance products were, and still are, required to obtain an authorisation under the Insurance Act 1973 (Cth) to carry on business as a general insurer; and
- organisations selling superannuation products (other than interests in self managed superannuation funds) were, and for a period of time afterwards continued to be, required to be approved by APRA under part 2 of the Superannuation Industry (Supervision) Act 1993 (Cth). They are now required to hold an RSE licence under s29J of that Act.

With the introduction of the FSRA, these organisations were also required to have an AFSL to sell their primary products. Granted, the governing legislation for ADIs, insurers and superannuation entities is now administered by APRA and mostly directed to matters of prudential regulation, whereas the AFSL regime is administered by ASIC and is mostly directed to non-prudential matters, particularly concerning the protection of retail clients. The AFSL regime also includes provisions intended to avoid any conflict between APRA's and ASIC's respective regulatory remits (see, for example, ss911A(1)(g), 912A(1)(d) and (h), 912D(1C), 914A(4) and (5), and 915I). Nevertheless, the fact remains that the FSRA did not really introduce a single licensing regime for all financial product sales. For ADIs, insurers and superannuation entities, the FSRA actually increased, rather than reduced, their licensing burden by requiring them to obtain a second licence, over and above the authorisation, registration or licence required under their governing legislation, to sell their primary products.

[191] While I have no empirical data to support this assertion, I have absolutely no doubt that the savings in administrative and compliance costs the authors of the FSRA predicted that it would generate have not eventuated. Any costs savings the industry might have reaped from a single licensing regime were well and truly outweighed by the extra costs involved in the licence application process itself, as well as the very substantial additional regulatory burdens the FSRA imposed on licensees. These included the extension of the "good advice" regulations (rr7.3.02 - 7.3.02D of the pre FSRA Corporations Regulations) that previously only applied to the holders of securities licences to all licensed providers of financial services, requiring them to have appropriate supervisory and training arrangements in place for their staff, to provide retail clients with a Financial Services Guide (formerly referred to as a Advisory Services Guide), to give retail clients prescribed warnings when giving them general advice or personal advice based on incomplete information, to have internal processes for resolving complaints by retail clients that complied with the Australian Standard on complaints handling, and to be a member of an external complaints resolution scheme approved by ASIC. They also included the imposition of a new requirement for licensees to provide a Statement of Advice confirming any personal advice given to a retail client and significantly more burdensome product disclosure requirements.

[192] Referred to in this paper as the "NCCPA".

regime and subjects licensees to similar, but not identical, ongoing compliance requirements.[193]

To complicate things further, Parliament has seen fit to amend chapter 7 so that it applies to margin lending facilities.[194] This means that a bank or other financial institution recommending that a retail client invest in shares via a margin loan has to hold an AFSL and provide them with a Financial Services Guide, a Statement of Advice, a PDS and an assessment as to whether the loan will be unsuitable.[195] The same bank or financial institution offering the same client a loan to purchase a residential investment property has to hold an ACL and provide them with a Credit Guide, an assessment as to whether the loan will be unsuitable, an information statement in the prescribed form explaining the debtor's statutory rights and obligations under the NCCPA and a pre-contractual statement disclosing mandatory details about fees and charges.[196]

Most folk would regard the provision of credit and credit related services as just another category of 'financial services', within the ordinary meaning of that term.

How much more efficient would our regulatory regime have been if, instead of introducing a whole new licensing regime for credit, the AFSL regime had simply been extended to cover the provision of credit and credit related services?

While it is a big task, I believe there is considerable merit in looking to rationalise chapter 7 and the NCCPA and bring them into one legislative framework that applies to all forms of financial services, including the provision of credit and credit related services, and that has a single licensing regime for all such services.

8 The need for Parliament to clean up its Act

A. The law has become a labyrinth

In the past decade, chapter 7 has been the subject of 6 substantive amending Acts[197] and no less than 58 amending regulations,[198] many of which have made material modifications to the

[193] Compare part 7.6 of the Corporations Act with part 2-2 of the NCCPA. The closest we get to any attempt to dovetail the two regimes is the requirement in s43(2) of the NCCPA that where a licensee holds both an AFSL and an ACL, the licence number given to each should be the same.

[194] See s764A(1)(l), introduced into the Act by the Corporations Legislation Amendment (Financial Services Modernisation) Act 2009.

[195] See respectively ss911A, 941A, 946A, 1012A and 985F.

[196] See respectively ss29, 126 and 129 of the NCCPA and s16 of the National Consumer Credit Code in the schedule to the NCCPA. Note, however, that it is possible to combine a Financial Services Guide and a Credit Guide under the NCCPA into one document – see r7.7.08B.

[197] Financial Services Reform (Consequential Provisions) Act 2002, Financial Services Reform Amendment Act 2003, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004, Corporations Legislation Amendment (Simpler Regulatory System) Act 2007, Corporations Amendment (Short Selling) Act 2008 and Corporations Legislation Amendment (Financial Services Modernisation) Act 2009.

[198] Corporations Amendment Regulations 2001 (No 4) SR 319/2001, Corporations Amendment Regulations 2002 (No 1) SR 15/2002, Corporations Amendment Regulations 2002 (No 2) SR 16/2002, Corporations Amendment Regulations 2002 (No 3) SR 41/2002, Corporations Amendment Regulations 2002 (No 4) SR 53/2002, Corporations Amendment Regulations 2002 (No 5) SR 126/2002, Corporations Amendment Regulations 2002 (No 6) SR 145/2002, Corporations Amendment Regulations 2002 (No 7) SR 182/2002, Corporations Amendment Regulations 2002 (No 8) SR 265/2002, Corporations Amendment Regulations 2002 (No 9) SR 282/2002, Corporations Amendment Regulations 2003 (No 1) SR 31/2003, Corporations Amendment Regulations 2003 (No 2) SR 48/2003, Corporations Amendment Regulations 2003 (No 3) SR 85/2003, Corporations Amendment Regulations 2003 (No 4) SR 126/2003, Corporations Amendment Regulations 2003 (No 5) SR 127/2003, Corporations Amendment Regulations 2003 (No 7) SR 202/2003, Corporations

provisions in the Act.[199] There has also been a plethora of ASIC class orders issued under s1075A which effect modifications to, or correct drafting flaws in, the Act.[200]

Consequently, there are now literally hundreds of modifications to the Act in the regulations and hundreds more in ASIC class orders.

The problem, of course, with amendments to an Act that are made via regulation or class order is that they do not get consolidated into a single legislative instrument in the way that an Act amending another Act, or a regulation amending another regulation, would. This has the result that simply finding the applicable law on a particular issue in amongst the Act, the regulations and the various ASIC class orders can be a major challenge for anyone who is not intimately familiar with the area.

Take, for example, the definition of 'retail client', an absolutely central provision to the operation of chapter 7. To understand the richness of that definition, you first have to traverse ss761G and 761GA of the Act and then turn to the regulations to consider the farrago of amendments to s761G made by rr7.6.02AB, 7.6.02AC, 7.6.02AD, 7.6.02AE and 7.6.02AF.[201]

Amendment Regulations 2003 (No 8) SR 282/2003, Corporations Amendment Regulations 2003 (No 9) SR 367/2003, Corporations Amendment Regulations 2003 (No 10) SR 368/2003, Corporations Amendment Regulations 2003 (No 11) SR 369/2003, Corporations Amendment Regulations 2004 (No 1) SR 10/2004, Corporations Amendment Regulations 2004 (No 2) SR 25/2004, Corporations Amendment Regulations 2004 (No 3) SR 26/2004, Corporations Amendment Regulations 2004 (No 4) SR 36/2004, Corporations Amendment Regulations 2004 (No 5) SR 145/2004, Corporations Amendment Regulations 2004 (No 6) SR 149/2004, Corporations Amendment Regulations 2004 (No 7) SR 208/2004, Corporations Amendment Regulations 2004 (No 8) SR 398/2004, Corporations Amendment Regulations 2005 (No 1) SR 31/2005, Corporations Amendment Regulations 2005 (No 2) SR 38/2005, Corporations Amendment Regulations 2005 (No 3) SR 139/2005, Corporations Amendment Regulations 2005 (No 5) SR 324/2005, Corporations Amendment Regulations 2006 (No 3) SR 102/2006, Corporations Amendment Regulations 2007 (No 1) SR 102/2007, Corporations Amendment Regulations 2007 (No 6) SR 197/2007, Corporations Amendment Regulations 2007 (No 10) SR 259/2007, Corporations Amendment Regulations 2007 (No. 11) SR 323/2007, Corporations Amendment Regulations 2007 (No 12) SR 324/2007, Corporations Amendment Regulations 2008 (No 1) SR 93/2008, Corporations Amendment Regulations 2008 (No 2) SR 94/2008, Corporations Amendment Regulations 2008 (No 3) SR 130/2008, Corporations Amendment Regulations 2008 (No 4) SR 158/2008, Corporations Amendment Regulations 2008 (No 5) SR 194/2008, Corporations Amendment Regulations 2009 (No 1) SR 12/2009, Corporations Amendment Regulations 2009 (No 3) SR 52/2009, Corporations Amendment Regulations 2009 (No 4) SR 70/2009, Corporations Amendment Regulations 2009 (No 5) SR 103/2009, Corporations Amendment Regulations 2009 (No 8) SR 327/2009, Corporations Amendment Regulations 2009 (No 10) SR 386/2009, Corporations Amendment Regulations 2009 (No 11) SR 387/2009, Corporations Amendment Regulations 2010 (No 1) SR 54/2010, Corporations Amendment Regulations 2010 (No 2) SR 55/2010, Corporations Amendment Regulations 2010 (No 3) SR 88/2010, Corporations Amendment Regulations 2010 (No 4) SR 89/2010, Corporations Amendment Regulations 2010 (No 5) SR 135/2010, Corporations Amendment Regulations 2010 (No 7) SR 210/2010, Corporations Amendment Regulations 2010 (No 9) SR 301/2010 and Corporations Amendment Regulations 2011 (No 1) SR 66/2011.

[199] Relying on various provisions in chapter 7 that allow regulations to be made that modify or displace provisions of the Act – see, for example, ss798L, 854B, 893A, 926B, 951C, 992C, 1020G and 1045A.

[200] ASIC's "Road map – financial services" webpage (http://www.asic.gov.au/asic/asic.nsf/byheadline/Road+map+financial+services?openDocument) identifies close to 200 ASIC Class Orders applicable in this area.

[201] You will also need to consider ASIC Class Order CO 04/150 *Wholly-owned subsidiaries of professional investors to be treated as wholesale clients*, although that Class Order is now probably redundant given r7.6.02AD. In addition, if you are trying to determine whether someone is a wholesale client under s761G(7)(a) (the exclusion for $500,000+ investments), you will need to have regard to the provisions in rr7.1.11, 7.1.12, 7.1.13, 7.1.14, 7.1.15, 7.1.16, 7.1.17, 7.1.17A, 7.1.17B, 7.1.17C, 7.1.18, 7.1.19, 7.1.19A, 7.1.20, 7.1.21, 7.1.21A, 7.1.22, 7.1.23, 7.1.24, 7.1.25, 7.1.26, 7.1.27 and 7.1.28 prescribing how you determine the price or value of various products for the purposes of that section.

These regulations were part of the first major round of post-implementation refinements[202] made to chapter 7 by the Corporations Amendment Regulations 2005 (No 5) SR 324/2005,[203] comprising some 70 pages of regulations mostly amending or replacing sections of the Act. In the case of s761G, there were 2 pages of amendments in 5 separate regulations to a section that only occupies a little over 3 pages of the Act.

Section 761GA was introduced as part of a second round of major post-implementation refinements to chapter 7 made by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007*.[204]

When it enacted the 2007 amending Act, Parliament had the opportunity to incorporate and consolidate into the Act all of the piecemeal amendments to chapter 7 that had been implemented in the 2005 regulations but, in an act of legislative laziness, it chose not to.[205]

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[202] There was a prior round of major pre-implementation refinements made to chapter 7 by the Financial Services Reform Amendment Act 2003.

[203] These regulations effectuated a number of sensible changes to the test whether a client is a retail or a wholesale client, including:

- providing that in determining whether a person meets the asset or income tests in s761G(7)(c), the assets and income of companies or trusts they control may be taken into account;
- deeming companies or trusts controlled by a person who is a wholesale client because they meet the asset or income tests in s761G(7)(c) also to be wholesale clients;
- extending the life of accountant certificates about assets or income under s761G(7)(c) from 6 months to 2 years;
- expanding paragraph (e) of the definition of ‘professional investor’ in s9 to cover investors who have $10 million in gross assets as well as those who control $10 million; and
- deeming related bodies corporate of wholesale clients also to be wholesale clients.

[204] That Act included not only major reforms to financial services regulation, but also significant changes to the company reporting, auditor independence, corporate governance, fundraising and takeovers provisions in the Corporations Act. In the case of s761GA, it extended the definition of ‘wholesale client’ to include so called “sophisticated investors”, applying a similar set of criteria to the corresponding provisions applicable to prospectuses in s708(10).

As an aside, it would have been preferable if the draftsperson of s761GA had tried to achieve some uniformity in terminology as well. In chapter 6D, the term “sophisticated investor” is used in the heading to s708(8) to described persons who are investing $500,000+ or who satisfy the assets and/or income test in that section (the equivalent of wholesale clients under s761G(7)(a), (c) and (ca), as affected by r7.6.02AB and 7.6.02AF). The equivalent provision in chapter 6D to the “sophisticated investor” provisions in s761GA (s708(10)) is headed “Offer through financial adviser, etc”. Investors who fall within ss708(8) and 761G(7)(a), (c) and (ca) would be better described as “wealthy investors” rather than “sophisticated investors”.

[205] Let me give another example of the same phenomenon, this time involving corrections to the Act made by an ASIC class order rather than by the regulations: the hawking provisions in ss992AA and 992A. These provisions were introduced by the FSRA to regulate, in the former case, the hawking of interests in managed investment schemes and, in the latter case, the hawking of financial products other than interests in managed investment schemes and securities (the hawking of securities being regulated by s736). In s992A(1), there is a prohibition on offering financial products in an unsolicited meeting. This is expressed in s992A(2) not to apply to an offer of securities or of managed investment products. The draftsperson of s992A(2) clearly did not appreciate that the definition of ‘managed investment product’ only captures a subset of interests in managed investment schemes, being those interests in *registered* managed investment schemes that fall within paragraph (b) of the list of financial products in s764A(1). It does not capture interests in *unregistered* managed investment schemes that fall within paragraph (ba) of the list of financial products in s764A(1). This leads to a conflict between s992A(1) and the provisions regulating the hawking of interests in unregistered managed investment schemes at an unsolicited meeting in s992AA.

In s992A(3), there is a further prohibition on offering financial products in an unsolicited telephone call. This is not qualified by any carve-out equivalent to s992A(2), so s992A(3) on its face applies to both securities and interests in managed investment schemes. This results in a conflict between s992A(3) and the provisions

B. The perils of legislative laziness

The perils of Parliament overlaying amending legislation on provisions that have been tampered with by regulation or class order can be seen in the course of s946B and related provisions. That section originally provided two exceptions to the general rule in s946A that a financial services licensee is required to give a Statement of Advice setting out or confirming any personal advice given to a retail client – one for so-called ‘further market-related advice’ and the other for advice given in relation to basic deposit products and certain other simple financial products. The section was effectively replaced in its entirety in the 2005 refinements by r7.7.10AE. The replacement section included some important substantive changes, substituting for the narrow ‘further market-related advice’ exception a much broader exception for ‘further advice’. Consequential changes were made by rr7.7.10AC and 7.7.10AD to ss942B(2)(g) and (8) and 942C(2)(h) and (8),[206] which also included references to ‘further market-related advice’, to replace them in their entirety with new provisions that instead referred to ‘further advice’.

A third exception was added to s946B by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* for advice that does not recommend the acquisition or disposal of a financial product or any modification to an investment strategy or a contribution level in relation to a financial product.[207] Amendments were also made to ss942B(2)(g) and (8) and 942C(2)(h) and (8) that purported to add references to the new exception in s946B after the references to ‘further market-related advice’ in those sections, without the draftsperson appearing to appreciate that the whole notion of ‘further market-related advice’ and the various references to it had been replaced in the 2005 refinements.

The net result is that you have provisions in an Act effectively being repealed and replaced by a subsequent regulation and then later being amended in an inconsistent manner by an Act that assumes that the provisions in the Act are still in force in their original form! Goodness knows where that leaves ss946B, 942B(2)(g) and (8) and 942C(2)(h) and (8). Have the 2005 amending regulations impliedly been overridden by the 2007 amending Act and therefore those sections restored to their original pre-2005 form but with the 2007 amendments? Are the 2007 amendments that purport to add additional words after words that the 2005 regulations effectively removed from those sections simply inoperative because they have nothing to which they can attach? Will a court confronted by this muddle try to re-interpret the 2007 amendments to make them consistent with the 2005 regulations? Or will it just declare the whole lot void for uncertainty?

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regulating the hawking of securities and interests in managed investment schemes by telephone in ss736 and 992AA respectively.

ASIC corrected these self-evident drafting errors in 2002 via Class Order CO 02/641 *Hawking – securities and managed investments*, effectively declaring that s992A(1) does not apply to interests in managed investment schemes that are not managed investment products and that s992A(3) does not apply to securities or interests in managed investment schemes.

Parliament has amended ss992AA and 992A twice since ASIC issued Class Order CO 02/641 (via the Financial Services Reform Amendment Act 2003, inserting ss992AA(3) and 992A(5), and the Corporations Legislation Amendment (Simpler Regulatory System) Act 2007, amending s992AA(2) and inserting s992A(3B)) but has not seen fit to incorporate the drafting corrections in that Class Order.

[206] Sections 942B and 942C prescribe the contents to be included in a Financial Services Guides for a financial services licensee and authorised representative respectively. Sections 942B(2)(g) and (8) and 942C(2)(h) and (8) include requirements that reference the obligation of a licensee or authorised representative to provide upon request a record of any further market related advice / further advice given under s946B(1) or 946C(1) respectively.

[207] Section 946B(7)-(9).

The issue identified above with the short-form PDS provisions in schedule 10BA of the regulations is another example of the problems caused by a multiplicity of regulations amending the Act.

Regardless of the fate of these particular provisions, my point is a rather more elementary one – if Parliamentary counsel can't keep track of the current state of the law because of this hodgepodge of amending Acts and regulations piled one upon the other, what hope has the poor practitioner?

9. Conclusion

While I am hesitant to raise this, given the amount of law reform the financial services industry has had to endure over the past 10 years,[208] chapter 7 is in need of a major clean up, if only just to bring the many amendments to the Act that currently sit in the regulations and in ASIC class orders back to where they properly belong – in the Act.

For historical constitutional reasons, the law regulating financial services is buried in the middle of a body of law governing corporations and other types of business organisations. The Corporations Act and regulations now occupy 2,180 pages in the 2011 edition of CCH's Australian Corporations & Securities Legislation. Chapter 7 of the Act fills around 385, and chapter 7 of the regulations another 320, of those pages.[209]

The time must surely have come for the Corporations Act to be split into two Acts – one regulating business organisations (companies, managed investment schemes and trustee companies)[210] and the other regulating financial markets and services.

Not only would this make the law more wieldy and easier to locate and understand, it would also help to avoid some of the complications that can arise when reforms to that part of the Act which regulates business organisations have unintended consequences for that part of the Act which regulates financial markets and services – such as the CLERP 9 changes to the definition of 'officer' had on the insider trading and Chinese wall provisions, mentioned previously.

Rewriting and consolidating chapter 7 into its own Act would also afford the opportunity to address the various problems and issues identified in this paper.

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[208] In addition to the 6 amending Acts and 58 amending regulations to chapter 7 mentioned previously, the industry has also had to cope with the introduction of the unfair contract provisions in the ASIC Act and the major reforms in the NCCPA and the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth).

[209] This page count only includes the provisions directly regulating financial services and markets in chapter 7. It does not include any of the supporting definitions and interpretation provisions in chapter 1, the provisions regulating managed investment schemes and trustee companies in chapters 5C and 5D, takeovers in chapters 6-6C, continuous disclosure in chapter 6CA, or fund raisings through offers of securities in chapter 6D, all of which effectively regulate financial services or markets in some shape or form. Nor does it include the additions and modifications to chapter 7 in Schedules 10-10D of the regulations.

[210] If the Commonwealth and States were able to agree to a suitable referral of power, that law could usefully extend to partnerships and limited partnerships, so that we had a single source of law in Australia governing all of the main types of business organisations.