ASIC

Australian Securities & Investments Commission

REPORT 365

Hybrid securities

August 2013

About this report

This report discusses offers of hybrid securities in the Australian market since the global financial crisis, and in particular, the extensive issuance from November 2011 to June 2013.

Hybrid securities often have very complex features and the risks they can pose are often poorly understood by investors. This report describes:

- what we have done to engage with hybrid issuers and the brokers that sell hybrid securities so that these features and risks are clearly disclosed and the products are not being mis-sold; and
- the investor warnings and education about hybrid securities we have provided through the media and on ASIC's MoneySmart website.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

Executive summary

1 Hybrid securities combine 'equity-like' and 'debt-like' characteristics and the nature and the risks of these securities can be difficult for investors to understand. As ASIC's MoneySmart website explains:

> Hybrid securities are complex products. Even experienced investors will struggle to understand the risks involved in trading them.[1]

2 In Australia, more than $18 billion has been raised by companies between November 2011 and June 2013 through the issue of ASX-listed hybrid securities.

3 There has been a retail market for hybrid securities in Australia for several decades. From an issuer perspective, hybrid securities may allow the issuer to raise capital while achieving a particular accounting, tax, credit rating or regulatory capital outcome. Following reduced activity during and immediately after the global financial crisis, hybrid securities have recently been used for significant capital raising by both banks and well-known corporate entities.

4 The terms of hybrid securities are often very complex and many involve heightened risks for retail investors, such as risks deriving from long maturities and more complex features such as interest deferral or potential conversion into ordinary shares. The overall complexity of hybrid securities makes clear, concise and effective disclosure to investors in a prospectus more difficult.

5 The sales process for hybrid securities is heavily intermediated, with offers distributed through networks of wealth management, private banking, stockbroking and financial advisory firms. Investors are also provided with a range of non-prospectus sales documents prepared by these firms, which may contain information which is in addition to, or inconsistent with, information in the prospectus.

6 When compared to direct investment in shares (34% of the adult Australian population),[2] investment in hybrid securities is concentrated among a much smaller group of approximately 75,000 investors, two-thirds of whom are self-managed superannuation funds (SMSFs).[3] These investors appear attracted to the high yield, and the brand or reputation of the issuer, with less than half of these investors saying their financial adviser played a role in their most recent investment in these securities.[4]

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[1] https://www.moneysmart.gov.au/investing/complex-investments/hybrid-securities-and-notes
[2] ASX, *Australian share ownership study 2012*, p. 4.
[3] Investment Trends, *November 2012 Investor product needs report*, March 2013, p. 212.
[4] Investment Trends, *November 2012 Investor product needs report*, March 2013, pp. 206, 213.

7 These and other factors present particular challenges in ensuring that investors are confident and informed and that there are fair and efficient markets in relation to these products.

8 We have actively engaged with the challenges posed by the increased issuance and popularity of hybrid securities. This report describes our response, which has included:

(a) providing investor warnings and education through the media and on our MoneySmart website (see Section B);

(b) working with issuers of hybrid securities and their lawyers to improve the standard of disclosure, by reviewing and providing comments on any draft prospectus before it is formally lodged (see Section C); and

(c) undertaking a targeted review of 'selling methods' to encourage the appropriate use of non-prospectus documents as part of the sales process for offers of hybrid securities (see Section D).

9 We propose to undertake further work in relation to hybrid securities, which will include:

(a) exploring whether tools might be developed so that investors can check their understanding of hybrid securities before investing in them;

(b) investigating any reports of problematic conduct by brokers (e.g. misleading promotion of hybrid securities as fixed income products);

(c) looking carefully at advertisements and other promotions of hybrid securities;

(d) considering naming conventions for hybrid instruments to ensure these are accurate; and

(e) continuing to engage with issuers of hybrid securities and their lawyers to further improve prospectus disclosure.

10 We expect issuers and those involved in the issue or sale of hybrid securities to take particular care to promote clear communication to investors about the nature of an investment in these securities. We will also continue to promote investor understanding of the risks posed by an investment in hybrid securities.

A What are hybrid securities?

Key points

The two most common legal forms of security from a retail investment perspective are debt and equity. Hybrid securities combine both ‘equity-like’ and ‘debt-like’ characteristics.

While there is enormous variation between particular hybrid securities, they typically share a number of other characteristics:

- they are issued by well-known companies, banks and insurers;
- they are actively sold to retail investors through networks of brokers and financial advisers;
- they promise regular interest payments at rates several percentage points higher than those paid on bank term deposits or vanilla corporate bonds; and
- they have complex and unique terms of issue.

Hybrid securities often involve heightened risk for retail investors when compared to other investments like vanilla bonds.

Hybrid securities and their legal form

11 The two most common legal forms of security from a retail investment perspective are debt and equity. With a debt security (e.g. a vanilla corporate bond), the investor lends money to the issuer, and the issuer agrees to make regular interest payments and repay the principal on a fixed date in the future. With an equity security (e.g. an ordinary share in a listed company), the investor becomes a member of the company and from that membership enjoys voting rights, any dividends that are declared, and the right to participate in any surplus if the company gets wound up, but only after creditors are repaid.

12 In most cases, the legal form of a security aligns with how that security is treated for accounting purposes: a debenture or bond will be recognised in a company’s accounts as a liability, while shares will be recognised as equity. Certain tax consequences, such as the deductibility of interest payments, or the ability to frank dividend payments, are usually also consistent.

13 Hybrid securities combine both ‘equity-like’ and ‘debt-like’ characteristics. While their legal form remains a debenture or a share (most often a preference share), this mix of characteristics places them on a spectrum between ‘pure’ equity and bonds: see Figure 1.

14 Hybrid securities are known by a variety of names, including subordinated notes, capital notes and convertible preference shares.

15 While there is enormous variation between particular hybrid securities, they typically share a number of characteristics:

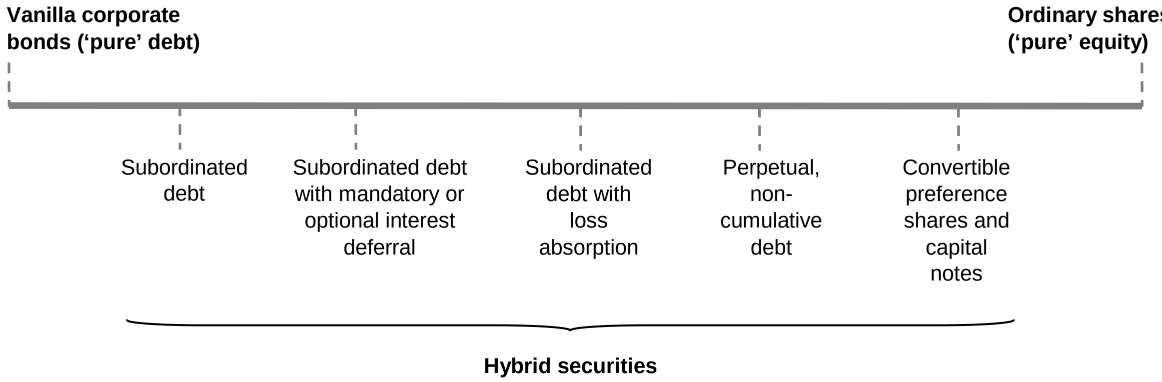
(a) they are issued by well-known companies, banks and insurers;

(b) they are actively sold to retail investors through networks of brokers and financial advisers;

(c) they promise regular interest payments at rates several percentage points higher than those paid on bank term deposits or vanilla corporate bonds; and

(d) they have complex and unique terms of issue.

Figure 1: Hybrid securities on a spectrum between 'pure' debt and 'pure' equity



The hybrid market and its drivers

16 There has been a market in Australia for hybrid securities issued by both banks and corporate entities for several decades, although issuance slowed significantly during and in the years immediately following the global financial crisis.

17 The mix of debt-like and equity-like characteristics in a hybrid security is structured to achieve one or more of the following, for the benefit of the issuer:

(a) particular treatment for accounting and tax purposes;

(b) recognition of 'equity content' or 'equity credit' under ratings methodologies used by credit rating agencies; or

(c) qualification as a particular form of 'regulatory capital' under prudential standards set by the Australian Prudential Regulation Authority (APRA).

18 Patterns of issuance, and the structures used, have varied over time in response to changes in these drivers. As discussed below, developments in equity credit criteria and prudential standards have both prompted a strong increase in issuance since November 2011 and are likely to affect the types of offer brought to market in the 2013–14 financial year.

Hybrid securities issued by banks and insurers

19 Banks and insurance companies are regular issuers of hybrid securities (referred to in this report as 'bank hybrids') because of the capital benefits which accompany an issue. Under prudential standards set by APRA, banks and insurance companies must hold a certain amount of capital to promote the stability of the institution while protecting depositors and policy holders from any losses. As discussed in Section B, these prudential standards also prescribe the criteria hybrid securities must meet to qualify as particular forms of 'regulatory capital'.

20 APRA implements the common frameworks for regulating banks and insurers developed by the Basel Committee on Banking Supervision (BCBS). As a result, the publication by the BCBS of the Basel III rules text in December 2010 prompted APRA to review its prudential standards, and as at June 2013 the updated standards applying to banks and insurers have largely been finalised.

21 While Basel III is a comprehensive set of reforms designed to strengthen the regulation, supervision and risk management of the banking sector, the updated capital requirements (and in particular, APRA's implementation of the Basel III capital reforms) have had a significant impact on the use of hybrid securities and their terms of issue.

22 For example, APRA's revised standards require that banks hold more capital. By 2016, the minimum amount of regulatory capital a bank will need to hold will be increased from 8% to 10.5%, more of which will need to be higher quality 'Common Equity Tier 1 Capital', and which includes a 2.5% 'capital conservation buffer'. APRA may also impose an additional 'countercyclical buffer' (requiring banks to hold up to a further 2.5% capital) during periods of high credit growth.

23 What qualifies for each category of capital, and indeed the categories themselves, have also changed. Bank hybrids are now required to have 'loss absorption' features, which are concerned with boosting the bank's capital position when it is in financial distress by reducing the liabilities associated with the security, requiring that the instrument be either converted or written off.

24 The requirement to hold more capital, and the terms that instruments must now include to qualify for inclusion as capital, are relevant to a bank's decision to issue hybrid securities in a number of ways.

25 Hybrid securities have been part of the capital structure of major banks for over a decade, and it has been common for banks to redeem hybrid securities at the first opportunity, including in preference to allowing those securities to convert into ordinary shares. The funds to repay existing hybrid securities are often raised by issuing new hybrid securities, or 'rollover issuance'. While Basel III requires that future bank hybrids contain terms which make early redemption

less likely, the continuing need by banks to raise capital (including rollover issuance) meant that a number of hybrid securities were issued in the period leading up to 28 September 2012 (when APRA finalised the relevant prudential standard that sets out the criteria bank hybrids are required to meet).

26 Generally speaking, hybrid securities issued before that date will not meet the final criteria, and so will be eligible for 'transitional treatment' by APRA—from 1 January 2013, only 90% of the value of the security will count as regulatory capital, with a further 10% reduction occurring each year until the first date on which the bank can redeem the instrument.[5]

27 The finalisation of the revised prudential standards prompted a surge in offers of hybrid securities by banks, raising over $7 billion in the nine months to June 2013. The requirement to hold more capital, and rollover issuance associated with the need to redeem existing hybrid securities as they reach their first call date (after which they cease to be eligible for transitional treatment), is likely to mean the elevated level of bank issuance will continue in the 2013–14 financial year.

Hybrid securities issued by non-financial corporate entities

28 The changes to capital requirements noted above are part of a broader range of reforms to prudential standards and banking regulation occurring globally, with the effect that businesses face decreased access to, and an increased cost of, bank funding. When combined with the growth in superannuation assets, particularly SMSFs, business is increasingly turning to market-based financing to source their capital.[6]

29 Many listed and some unlisted companies will have a credit rating assigned to them by at least one of the major international credit rating agencies. While these agencies do not hold the required Australian financial services (AFS) licence authorisations to permit their credit ratings to be disclosed to retail investors, a company's credit rating has an impact on its cost of borrowings. Generally, funding decisions which support the company's rating will be preferred over those that place strain on that rating.

30 While the credit rating agencies each employ their own proprietary ratings methodology, at a high level, one key input is the amount of debt a company has to service. Some hybrid securities have been structured to have particular equity-like characteristics—primarily long maturities and the discretion (or obligation) to defer interest payments—which make them eligible for some degree of 'equity content' or 'equity credit' under the methodologies adopted by credit rating agencies, supporting the issuer's credit rating.

[5] For a small number of hybrid securities that were issued based on draft standards, but do not meet the final criteria, 100% of the value will count as regulatory capital until the first call date.
[6] See, for example, K Davis, *Funding Australia's future: From where do we begin?*, Australian Centre for Financial Studies, 2013.

31 Beneficial ratings treatment alone is not determinative when corporate entities raise funds through an offer of hybrid securities (referred to in this report as 'corporate hybrids'), although it is persuasive when weighing the cost of alternative funding options. While interest payments on hybrid securities are typically higher than rates available for issues of wholesale debt, access to European markets was restricted for various periods over the past three years, and offers of hybrid securities compare favourably to the dilutive effects and increased dividend burden associated with an equity offer, while still supporting the issuer's credit rating via partial equity credit.

32 Hybrid structures with 'high (100%)' equity content under the methodology used by Standard & Poor's (S&P) emerged in 2010, and can be considered one of the of the drivers of the high level of corporate issuance in the Australian retail market, and in particular, the subordinated note offers by Origin Energy (December 2011), Tabcorp (March 2012) and AGL (April 2012).

33 Following a review announced on 2 November 2012, S&P published revised criteria for assigning equity content to corporate hybrid securities on 2 April 2013. The tightened criteria resulted in the Origin Energy, Tabcorp and AGL subordinated notes now qualifying for 'intermediate (50%)' equity content, which reduced the ratings benefit and, as one commentator in the press remarked, 'turned the instruments from cheap equity into expensive debt'.[7]

34 While the ability to achieve 100% credit with S&P was not the sole driver for corporate issues,[8] the changes make fundraising through an offer of hybrid securities less attractive for many corporate entities, and is likely to lead to a reduced level of corporate issuance in the 2013–14 financial year.

Investors in the hybrid market

35 Few sales of hybrid securities in the primary market are to conventional 'institutional investors' such as fund managers, insurance companies and APRA-regulated superannuation funds. While some investors may have significant levels of investable assets[9] and/or may qualify as wholesale investors, based on our discussions with issuers of hybrid securities and their advisers, and our review of selling methods discussed in Section D, the majority of sales of hybrid securities in the primary market are to retail investors.

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[7] P Garvey, 'Santos, Origin resist equity raising route', *The Australian*, 4 April 2013.

[8] See, particularly, the other subordinated note offers featuring long maturities and interest deferral issued from November 2011 to September 2012, which qualified for a lower level of equity credit with S&P and Moody's, and more recent offers by MYOB and Healthscope ahead of anticipated re-listing of both businesses by the current private equity owners.

[9] Research conducted by Investment Trends found that, based on a sample of 965 investors in hybrid securities, 32% had investable assets of between $1 million and $2.5 million, while a further 27% had more than $2.5 million of investable assets (which includes interests in a SMSF, but excludes other superannuation, the family home and investments in their own company): Investment Trends, *2012 High net worth investor report*.

36 The lack of institutional interest, which continues to a lesser degree in the secondary market, is often attributed to hybrid securities falling outside the terms of traditional fixed income mandates. One alternate explanation is that institutional investors consider the credit and other risks of hybrid securities are not adequately priced, which if true suggests that retail investors may not be fully compensated for the risks they are assuming.

The challenges for ASIC

Popularity

37 The renewed supply-side interest in hybrid securities has been met by strong demand, with $18 billion in ASX-listed hybrid securities issued between November 2011 and June 2013. The significant size of the issues means that investors have invested in a relatively small number of offers: see the appendix for a list of offers of hybrid securities made during this period. The success of recent offers by Westpac, NAB, Suncorp and Macquarie suggest that this strong investor demand will continue.

38 The popularity of hybrid securities with retail investors appears to be a combination of the following factors:

(a) a general search for yield in a low-rate environment;

(b) the fact that the securities are issued by major banks and other corporate entities that are household names with trusted brands;

(c) the appetite of retail investors for investment alternatives, based on dissatisfaction with the returns on term deposits combined with distrust of equities, infrastructure funds, money market funds and debentures—this is especially so for SMSFs; and

(d) the promotion of offers of hybrid securities by brokers and financial advisers (noting that a 'stamping fee' was paid to many of these brokers and advisers).

Investor understanding

39 Hybrid securities (whether issued by banks or corporate entities) are often very complex and can involve heightened risk for retail investors when compared to other investments that may be offered by the same issuer, like vanilla corporate bonds or a bank term deposit. This higher risk derives from relatively simple features (such as long maturity), more complex features (such as potential interest deferral or potential conversion), and the overall complexity of the security, which makes investor understanding of the product more difficult. Like many complex products, hybrid securities test the limits of a disclosure-based regulatory regime.

40 The 'failure' of a number of hybrid securities issued between 2005 and 2007—which have operated according to their terms, but have nonetheless failed to meet the expectations of investors—suggests that many investors did not fully understand the features of these securities and the risks involved when they invested.

41 As discussed in Section D, the sales process for hybrid securities is also heavily intermediated. Generally, only a small percentage of each offer will be issued directly to the general public, with the majority being distributed through a network of investment banks acting as 'joint lead managers'. The joint lead managers in turn make the offer available through their wealth management, private banking or online brokerage businesses, appointed co-managers, and other financial services providers with whom they are affiliated, who use an investment platform they provide, or are otherwise appointed by them as a 'syndicate broker'.

42 This distribution structure introduces the potential for the sales message (in the form of non-prospectus sales documents or advice) to include information which is in addition to, or inconsistent with, the information in the prospectus, including by placing an undue emphasis on the high yield while downplaying the risks associated with the security.

43 This difficulty in providing prospectus disclosure for a complex security that can be understood by retail investors and the extensive use of non-prospectus sales documents within a broad distribution network without personal financial advice being provided present challenges for ASIC. These challenges are relevant to both our strategic priority of confident and informed investors and financial consumers, and our strategic priority of fair and efficient markets. This is particularly the case when considered in light of the recent popularity of hybrid securities and the large sums invested.

44 We have actively engaged with the challenges posed by the increased issuance and popularity of hybrid securities by:

(a) providing investor warnings and education through the media and on our MoneySmart website, focusing on the need for investors to understand the features and risks of hybrid securities;

(b) working with issuers of hybrid securities and their lawyers to improve the standard of disclosure, by reviewing and providing comments on draft prospectuses before they are formally lodged—in particular, to improve the clarity of prospectuses for hybrid securities for retail investors, and to reflect the guidance set out in Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors* (RG 228); and

(c) undertaking a targeted review of 'selling methods' for a small number of offers of hybrid securities, to encourage the appropriate use of non-prospectus documents as part of the sales process and monitoring the methods by which these securities are sold to retail investors.

B Issues for investors

Key points

ASIC has provided investor warnings and education through the media and on our MoneySmart website, focusing on the risks for retail investors in investing in hybrid securities that may have complex or risky features. We will continue to provide warnings while we remain concerned about investors being attracted to yield without fully understanding the risks involved.

We also monitor public messages around hybrid securities, including media commentary and continuous disclosure announcements by issuers.

Recent 'failures' have all involved the hybrid security operating according to its terms, suggesting that investors did not understand the features and risks of these securities when they invested.

Our warning to investors: Understand the risks

45 We have provided warnings to investors about hybrid securities (and complex products more broadly), and the need to understand the risks they involve, through:

(a) formal media releases 11-270MR *ASIC warns consumers about hybrid securities and notes* (24 November 2011) and 12-207MR *ASIC's hybrid warning: Don't be dazzled, be wary of the risks* (27 August 2012);

(b) public statements by ASIC Commission members in the press or via speeches to industry associations and other stakeholder groups;

(c) direct media comment via articles and letters to the editor; and

(d) guidance on our MoneySmart website.

46 Examples of some of our warnings include the following:

> Hybrid securities are complex products. Even experienced investors will struggle to understand the risks involved in trading them. If you don't fully understand how they work you should not invest.
>
> ASIC's MoneySmart website

> We think retail investors too often see the household name and they see something as secure and reliable without looking at the underlying product and the risks associated with it.
>
> ASIC Commissioner Peter Kell, quoted in 'Watchdog wary of hybrid shares', *The Age*, 2 March 2012

> An expectation that at the end of a set period an issuer will definitely redeem the hybrid so that investors get repaid in full is very dangerous...
>
> [Issuers] should communicate the key features and risks of these products so retail investors can understand what they are buying.
>
> ASIC Commissioner John Price, 12-207MR

> Investors need to understand the conditions of these offers, such as the terms and conditions that allow the issuer to exit the deal or suspend interest payments, and long term maturity dates of several decades. We want to ensure consumers are fully informed before they invest.
>
> ASIC Chairman Greg Medcraft, 11-270MR

47 While our message evolves to respond to market developments and issues of particular investor interest, the focus remains on the need for investors to look past the yield and familiar brand name, to read the prospectus, and where they do not understand the features of the hybrid security and the risks they present, to seek advice or stay away.

48 Particular risks raised in these warnings include:

(a) long investment terms, circumstances which permit early redemption, and the danger in expecting issuers to redeem the instrument at the first opportunity;

(b) the ability or obligation for issuers to defer interest payments if their financial position deteriorates, and how long these can remain unpaid;

(c) the subordination of the instrument, the level of senior debt ranking ahead of hybrid investors, and the implications if the issuer fails; and

(d) the ability for investors to exit their investment prior to maturity, that market prices for hybrid securities may be volatile and experience low liquidity, and that selling their investment on market may incur a capital loss.

49 Investors are prompted to ask whether the promised returns adequately compensate for the investment risks—particularly when compared to less risky or shorter term investments—and whether a particular hybrid security will help them achieve their personal goals.

50 We will continue to provide warnings and update our guidance while we remain concerned about investors being attracted by yield without considering the features and risks attached to the investment. Our message to investors also serves to put issuers of hybrid securities, and the gatekeepers involved in the sales process for these offers, on notice about our expectations.

Our warning to investors: Hybrid securities may not be suitable

51 Investors are often attracted to hybrid securities by the promise of regular interest payments and a timely return of their capital from an investment issued by a well-known company with a trusted brand. Particularly where the security is issued by a bank, investors may assume their investment is 'safe', and see hybrid securities as an alternative to bank term deposits, or fixed income investments like 'vanilla' corporate bonds, which are held primarily to receive regular income.

52 Hybrid securities are different to traditional fixed income investments. What investors may be receiving is a product with risks that relate to the very features that first attracted their attention:

(a) the terms of many corporate hybrids mean that interest payments may be deferred for several years, and investors may not have their capital repaid for decades; and

(b) the terms of many bank hybrids mean that payments are at the discretion of the bank, and investors may be issued with shares rather than having their capital repaid, on a number of possible dates, all outside the control of the investor.

53 This mis-alignment between the expectations of investors and the features and risks of many hybrid securities prompted ASIC Commissioner Greg Tanzer to urge investors to be cautious, with the comment:

> these products may not be suitable for everyone, especially if an investor needs steady returns or capital security.[10]

54 While hybrid securities may be listed on ASX, trading is usually less liquid than the ordinary shares of the issuer, and investors wishing to exit their investment by selling on market may incur a capital loss. Investors considering whether to purchase hybrid securities on a secondary market (i.e. buying hybrid securities on ASX after they are first issued) should obtain a copy of the prospectus and familiarise themselves with the features and risks of that security, and also review any market announcements made in connection with the security to confirm whether any terms have been changed or events triggered since the date of the prospectus.

55 While true of any investment, the variety of potential outcomes for an investment in a hybrid security, which can be triggered by events which may be difficult to predict when first investing, makes diversification particularly important:

> As always, I'd remind investors that diversification of investments is important and placing too much of your personal wealth in risky products can be disastrous.
>
> ASIC Commissioner Greg Tanzer, 'Financial engineers need to build a transparent vehicle', *The Weekend Australian*, 13 July 2013

Investor expectations and hybrid 'failures'

56 Following a review by Standard & Poor's (see paragraph 33), the reclassification of the Origin Energy, Tabcorp and AGL hybrid securities potentially constituted a 'capital event' under the terms of each instrument, permitting early redemption by the issuer. While all three issuers confirmed

[10] ASIC Commissioner Greg Tanzer, 'Financial engineers need to build a transparent vehicle', *The Weekend Australian*, 13 July 2013.

that they would not seek early redemption, it is clear that events beyond the control of the issuer—and which would have been nearly impossible for the issuer or investors to predict—could result in redemption of these securities roughly a year into their very long terms. This serves as a helpful illustration of the potential impact of contingent events on the behaviour of hybrid securities, and how they can 'fail' from an investor's perspective, even when they operate according to their terms.

57 Many hybrid securities have an implied maturity often much shorter than the legal term (including where the instrument is perpetual and the issuer is never obliged to redeem the securities, even where they stop paying interest). Whether or not the security is redeemed at its implied maturity (typically the first issuer call date) can depend on a number of factors, which include:

(a) the cost at which new funding is available compared to the cost of the existing hybrid after any interest rate step-ups or resets have occurred. For a hybrid security issued with a very low margin in the years leading up to the global financial crisis, even a 2% increase in that margin may have been cheaper to maintain than seeking replacement funding in the constrained (and therefore expensive) capital markets that existed five or six years later;

(b) similar to the above, the cost of new funding compared to the cost of the existing hybrid once the potential loss of desired regulatory capital treatment (in the case of bank hybrids) or some or all equity credit (in the case of corporate hybrids) is taken into account. This is potentially a significant consideration for bank hybrids that will be eligible for 'transitional treatment' only until their first call date;

(c) in the case of bank hybrids, whether APRA will approve the redemption, and whether the alternative is to have the hybrid mandatorily convert into ordinary shares; and

(d) any expectation the market has regarding whether the issuer will call the instrument on the first call date (whether based on convention or the way in which the hybrid was originally marketed), and the reputational impact the issuer would suffer by disappointing this expectation, which may have an impact on their future cost of funding.

58 At the time a hybrid security is offered, while it may be difficult to predict the exact circumstances which will prevail in five to six years' time and their influence on the issuer's decision about whether to redeem on the first call date, it is entirely foreseeable that this redemption may not occur—and indeed did not occur with Australand ASSETS and Multiplex SITES (issued in 2005),[11] and Nufarm Step-Up Securities (issued in 2006).

[11] We note that these hybrids, and certain other instruments discussed in this section, are legally units in a trust rather than notes or preference shares.

59 These hybrid securities remain on issue, and interest payments continue to be made (based on an increased or 'stepped up' margin). However, because the terms contain no further incentive to redeem the securities (i.e. there is no secondary implied maturity), they now trade on ASX at a price that reflects their perpetual term. This means that while an investor in Multiplex SITES can continue to receive interest, if they wish to realise their investment, they would need to sell at a loss on ASX (where SITES, which have a face value of $100, have traded between roughly $70 and $90 over the past year).

60 Hybrid securities that continue to pay interest and enjoy a secondary implied maturity may be at lower risk of capital loss. One example is Goodman PLUS II (originally issued in 2007, with the terms amended following approval by investors in 2012, followed by a series of incentives to redeem beginning in 2017).

61 In the case of bank hybrids, the decision by ANZ in February 2013 to not call a retail hybrid they had issued in New Zealand five years earlier created significant market discussion about whether it would serve as a precedent for other Australian banks, particularly given the security now pays a lower interest rate. Macquarie Income Securities and National Income Securities continue to pay interest more than thirteen years after they were issued.

62 The outlook is worse for investors in two hybrid securities which remained on issue past the first call date, but where the issuers are experiencing financial distress and interest payments have not been made for some time. These are Elders Hybrids (originally Futuris Hybrids issued in 2006 with a face value of $100, and recently trading below $20) and Paperlinx SPS (issued in 2007 with a face value of $100, and recently trading below $10). Despite investors often being motivated by the promise of regular income, there is no guarantee interest payments will be made.

63 As a final example, Gunns FORESTS hybrid securities were issued in 2005 and made interest payments as scheduled until early 2012 (including at the increased margin which applied from October 2008).

64 In late August 2012, the issuer gave notice that it was exercising its right to convert the FORESTS into ordinary shares in Gunns, despite the conversion formula imposing a limit on the number of ordinary shares that could be issued, and therefore providing FORESTS investors with shares worth less than the $100 face value of the hybrid security. However, before the shares could be issued and conversion effected, Gunns was placed into voluntary administration, with receivers and managers subsequently appointed. As a result, FORESTS investors maintain their status as unsecured creditors (and therefore rank ahead of ordinary shareholders), although they are still unlikely to receive any of their capital back.[12]

[12] The Gunns Group, *Report by administrators pursuant to section 439A of the Corporations Act 2001*, 25 February 2013.

65 All of the older hybrid securities discussed above have operated according to their terms, but all may be considered to have ‘failed’ to a greater or lesser extent because they have not fulfilled the expectations of investors—whether by remaining on issue and not returning capital to investors, ceasing to make interest payments, or becoming almost worthless following the collapse of the issuer.

66 While some features of these older securities are now less common or more moderate (e.g. interest step-ups on corporate hybrids), have not been included in offers for several years (e.g. conversion of corporate hybrids into ordinary shares) or are now proscribed by prudential standards (e.g. step-ups and any other incentive to redeem in bank hybrids), the key lesson remains—investors need to ensure they understand the features and risks of hybrid securities.

67 To that end, ASIC will continue to focus on helping investors understand the features and risks associated with these securities and will continue to explore what regulatory tools we might best adopt to do so.

Other messages

Media coverage

68 Investor interest and the number of new offers brought to market have resulted in frequent coverage of hybrid securities in the business and investment media.

69 Much of this coverage has been well-informed commentary on the nature of hybrid securities and the risks they can pose for investors, market developments including what is driving the issue of hybrid securities, and ASIC’s role and activity in connection with these offers.

70 We support the measured tone many commentators have adopted, and note that they often share our concerns about both particular offers and hybrid securities generally.

Continuous disclosure

71 Issuers of hybrid securities are disclosing entities, and are subject to regular reporting and disclosure obligations under the *Corporations Act 2001* (Corporations Act) and the ASX Listing Rules.

72 Where market developments may have an impact on issuers—for example, Standard & Poor’s publication of revised equity credit criteria and subsequent reclassification of three listed hybrid securities—we consider whether disclosure by those issuers is adequate and have to date not found that regulatory action is warranted.

Analyst commentary and other 'street talk'

73 As discussed at greater length in Section D, we note a number of investment banks, wealth management businesses and independent research providers are producing regular analysis of offers of hybrid securities for their clients.

74 We have also heard anecdotal reports that some asset advisers and investment managers are recommending hybrid securities (usually acquired on the secondary market) to form part of the fixed income allocation of the investment portfolio of not-for-profit organisations and local councils. These entities may qualify as wholesale investors but do not typically have the same level of financial sophistication or resources as conventional institutional investors.

75 Given the complexity of hybrid securities compared to products generally labelled as fixed income, care needs to be taken to ensure these clients are not misled when these recommendations are given. For example, it may well be misleading to compare the return from a hybrid security with the standard return on fixed income investments as measured by a debt securities index, most of which do not contain hybrid securities.

76 As noted in Section A, there has traditionally been little institutional investment in hybrid securities, and we will continue to monitor developments for any evidence of inappropriate conduct.

C Improving prospectus disclosure for hybrid securities

Key points

ASIC has provided general prospectus guidance in Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors* (RG 228). This guidance is intended to apply to prospectuses for all offers of securities made under a prospectus, including hybrid securities.

The complexity of hybrid securities, and the different expectations of investors—that is, for repayment of principal and regular interest payments—require prospectus disclosure to place a strong emphasis on the terms of the securities, and the specific risks they introduce.

We have been working with issuers of hybrid securities and their lawyers to improve disclosure, by reviewing and providing comments on draft prospectuses before they are formally lodged.

Our current guidance

77 ASIC guidance on prospectus disclosure was most recently updated in November 2011 with the publication of Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors* (RG 228), which has been well received by the market.

78 The guidance in RG 228 focuses on equity initial public offerings (IPOs), which were the dominant retail offers requiring Ch 6D disclosure in the two years leading up to its publication. Reflecting the expectations of an IPO investor to share in the company's performance via dividends and/or capital growth, the guidance focuses on topics that are likely to be most relevant to this performance, including the company's business model, financial information, management and risks.

79 Since the publication of RG 228, prospectus disclosure has improved:

(a) a new 'Investment overview' section has replaced the previous use of multiple summary sections—which is typically more balanced and includes adequate disclosure of key risks—and photographs overlaid with slogans have been removed;

(b) prospectuses now explain the company's business model and key strategies rather than simply repeating the terms of key contracts. Company management appear to have greater input into this disclosure, and there has been improved disclosure of how the funds raised will be used; and

(c) specific risks disclosure has improved through greater prominence of these risks and a clearer distinction between specific and more general risks disclosure.

Our focus when reviewing draft prospectuses

80 RG 228 continues to work well for the vast majority of offers. As hybrid securities have comprised less than 5% of prospectuses lodged in the 12 months to June 2013, we consider it is possible to ensure that disclosure for hybrid securities is of a high standard without publishing formal supplementary guidance to RG 228. The disclosure issues that arise often depend on the type of issuer, their financial position and the terms of the security. These are better addressed on an individual basis rather than through more general guidance.

81 We have therefore engaged directly with issuers of hybrid securities and their lawyers before a prospectus is lodged, to review and provide comments on the draft document rather than attempting to provide general guidance on hybrid securities. In most cases this early engagement results in some changes being made to the document, with a particular focus on the ‘Investment overview’ and ‘About the security’ sections.

82 ASIC has limited resources, which we allocate according to risks we observe in the market and our regulated population, and based on where those resources will have the greatest impact on achieving our strategic priorities. The review process for draft prospectuses is an exception to our usual practice, and it is a decision and a process we take seriously.

83 This process relies on the cooperation of issuers and their counsel in not only providing us with sufficient time to consider and provide comments on the draft document, but also approaching the process with appropriate expectations. Our focus is on improving disclosure to retail investors, and while we endeavour to raise any comments we have in the time available, this process cannot, and is not intended to, provide any kind of ‘regulatory certainty’ about our actions after the prospectus is formally lodged.

84 Of course, in all cases, it is the issuer not ASIC who prepares the prospectus and is both best placed to ensure, and responsible for, the prospectus complying with the prospectus provisions of the Corporations Act.

85 Subject to the issue of hybrid securities remaining at or below recent levels, we expect to continue reviewing draft prospectuses for these securities in the 2013–14 financial year, with the intensity of engagement reducing as products (and market standard disclosures) become more settled.

The challenge of prospectus disclosure for hybrid securities

86 An investment in hybrid securities is different from a pure equity investment. The investor is (at least initially) a lender rather than an owner. As a general proposition, investors in hybrid securities expect to be repaid

their principal, and receive regular distributions in the nature of interest payments, but do not expect to enjoy equity upside by participating in the company's performance. Investors may perceive hybrid securities to be more stable and 'safe' than equity investments, particularly if the security is issued by a bank.

87 Hybrid securities have dominated primary fundraisings in the period since November 2011, and while our general guidance in RG 228 (including on 'clear, concise and effective' disclosure) is useful for prospectuses for these securities, the investor expectations of return, and the risks that may prevent those expectations from being met, are different from those in a pure equity IPO. In particular, before an investor can consider whether a company is likely to be able to meet its obligations under a hybrid security, they must first understand what those obligations are. Therefore, an understanding of the terms of the hybrid security, and the specific risks they introduce, becomes a greater concern for the 'Investment overview' section.

88 The security-specific risks of hybrid securities (as distinct from the business risks of the issuer) fall into three broad categories:

(a) risks that arise from simple features, which are easy for an investor to understand, such as long maturity;

(b) risks that arise from complex features, which may be more difficult for an investor to understand, such as the issuer having the discretion (or the obligation) to defer interest payments and the circumstances in which deferred payments must eventually be made, or the discretion to redeem on a given date, or earlier following the occurrence of certain events, but only where particular conditions are satisfied and approvals granted (which vary depending on the reason for redemption); and

(c) the overall complexity of the security and the way in which these features interact, which may be both difficult for investors to understand, and the likelihood of particular outcomes difficult for investors to predict (e.g. will the issuer redeem the security at the first call date, or allow it to convert some years later).

89 The balance between security-specific and issuer-specific risks in the 'Investment overview' section needs to shift based on the complexity of the instrument.

90 To the extent possible, prospectus disclosure for hybrid securities must also be informed by the way investors make decisions, including that normal thought processes can lead to investors making choices that are mistaken.

91 Recent papers by the Office of Best Practice Regulation[13] and the UK Financial Conduct Authority[14] consider behavioural economics when describing how investors can make predictable mistakes, and how regulators can use this analysis to design more effective interventions. Hybrid securities, by virtue of their complexity, can result in behavioural biases that lead to investment mistakes. In particular:

(a) investors in hybrid securities may respond to a complex and lengthy disclosure document by simplifying the investment decision to one based on yield and the brand or reputation of the issuer, without fully considering other features of the security; and

(b) where investors in hybrid securities do consider more complex features involving uncertainty—such as the various contingencies involved in early or optional redemption, optional or mandatory interest deferral, and mandatory conversion subject to conditions—their assessment of risk and likelihood may be poor and open to error.

92 Many of the protections normally available when regulating other complex products—such as AFS licence obligations—are not available when regulating hybrid securities. Accordingly, we tailor our approach and rely primarily on disclosure regulation—working with issuers of hybrid securities to improve prospectus disclosure by providing information on the features and risks in a relevant, specific way that is not likely to exacerbate investor bias or weakness.

Bank hybrids

Bank hybrid terms

93 Following APRA's finalisation of Prudential Standard APS 111 *Capital adequacy: Measurement of capital* (APS 111) with effect from 1 January 2013, which sets out 'the characteristics that an instrument must have to qualify as regulatory capital for an authorised deposit-taking institution', bank hybrids have been structured to qualify as:

(a) Additional Tier 1 Capital, which 'comprises high quality components of capital' that provides a permanent and unrestricted commitment of funds, is freely available to absorb losses, ranks behind the claims of depositors and other more senior creditors, and provides for fully discretionary capital distributions;[15] or

[13] Office of Best Practice Regulation, Department of Finance and Deregulation, *Influencing consumer behaviour: Improving regulatory design*, 2013.
[14] Financial Conduct Authority (UK), *Occasional paper No. 1: Applying behavioural economics at the Financial Conduct Authority*, April 2013.
[15] See APS 111.27. See also APS 111 Attachment E (Criteria for inclusion in Additional Tier 1 Capital), Attachment F (Loss absorption requirements: Additional Tier 1 Capital) and Attachment J (Loss absorption at the point of non-viability: Additional Tier 1 and Tier 2 Capital).

(b) Tier 2 Capital, which ‘includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital [from the perspective of the authorised deposit-taking institution (ADI)] but nonetheless contribute to the overall strength of an ADI and its capacity to absorb losses.’[16]

94 The resulting Additional Tier 1 instruments have to date been convertible preference shares or capital notes with the following features:

(a) The instruments are fully paid and perpetual, meaning that they may never be redeemed and an investor may never have the capital they have contributed returned.

(b) They offer discretionary, non-cumulative distributions, meaning that investors can expect to receive a regular payment in the nature of interest, calculated as a fixed margin to a reference rate and reduced to the extent the distribution is franked, but there is no guarantee these payments will be made and investors have no right to pursue non-payment.

(c) The instruments are unsecured and subordinated, meaning that they are not guaranteed by the bank, are not subject to the Australian Government Guarantee (they are not protected accounts under the Financial Claims Scheme), and rank above only ordinary shares in a winding up of the bank.

(d) The instruments are scheduled to convert into ordinary shares in the issuer after a fixed period (typically eight years), subject to the issuer’s ordinary share price having not fallen to less than 50% of its level at the time the hybrid securities were issued.

(e) The issuer may call the instrument (i.e. redeem or ‘resell/transfer’, which are economically the same to the investor, or in some cases convert the instrument into ordinary shares) on one or more fixed dates (typically beginning six years following issue).

(f) The issuer may also call the instrument at any time following changes to tax or other laws or prudential standards that make the instrument more expensive for the bank to leave on issue or reduce the capital benefit the bank is able to recognise.

(g) The issuer must convert the instrument if the bank is subject to a successful takeover, but not if the bank undergoes an internal reorganisation.

(h) Importantly, the instrument must absorb losses where the issuer is experiencing financial distress. If this occurs, the instrument is either converted into ordinary shares in the issuer (even where the number of shares to be issued may not provide investors with equivalent value to the hybrid security) or written off.[17]

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[16] See APS 111.30. See also Attachment H (Criteria for inclusion in Tier 2 Capital) and Attachment J (Loss absorption at the point of non-viability: Additional Tier 1 and Tier 2 Capital).

[17] For convertible preference shares, this means that the terms of the instrument are changed to emulate the economic exposure an investor would experience if the hybrid security had actually converted. However, for capital notes, this means that all of the investor’s rights under the hybrid security, including to any return of capital, are immediately and irrevocably terminated.

95 Basel III-compliant Tier 2 instruments, to date structured as subordinated notes, are simpler in that they have a fixed maturity, an expectation distributions will be paid, more straight forward redemption, and no scheduled conversion. However, the complexity introduced by an issuer call date and loss absorption provisions (which may result in conversion or termination) makes even ‘simple’ bank hybrids more complex than corporate hybrids, and substantially more complex than an investor’s other potential exposures to the bank (e.g. via a deposit account or term deposit, or through holding the bank’s ordinary shares).

Our comments on bank hybrid disclosure

96 Explaining each of the features above, the way in which they interrelate, the order in which they may occur, and the conditions or qualifications to which they are subject, in a ‘clear, concise and effective’ manner is difficult.

97 Further, when the underlying terms are dozens of pages long, and the definition of, say, ‘tax event’ may run to 20 lines, explaining those terms, events or instrument mechanics requires issuers to carefully balance the desire for precision embedded in the instrument terms with the requirement to provide disclosure in a form that is useful to retail investors, necessarily involves a judgement as to the practical effect of a clause.

98 Our focus is on ensuring the ‘Investment overview’ section explains the key features in a way that retail investors can understand. This involves focusing on the question, ‘What does an investor really need to understand about this offer?’ It also involves translating complex legal terms into concepts a retail investor will understand, which in turn involves focusing on the essence of the particular term rather than the precise details. The ‘Investment overview’ section is then followed by the ‘About the security’ section, which provides further detail on individual terms.

99 While the use of plain or direct language is an important tool in achieving this, of equal importance is the structure of the ‘Investment overview’ section—features need to be ordered and grouped in a logical way. We strongly encourage issuers to make this section as short as possible. It should contain only key information and rely in part on cross-references to later sections fully explaining complex features or concepts, but at the same time should not be a list of defined terms used without context. Where a defined term cannot be summarised (or where that summary would require qualification by repeated references to ‘certain events’, ‘certain conditions’, or ‘certain exceptions’), the overview may be more readable if a representative example were used:

> ‘…following a Tax Event (for example, this would include where…’.

100 Given the complexity of the instrument terms, the usefulness of a concise ‘Investment overview’ section depends on the reader’s ability to locate a more detailed explanation of each topic, which is greatly assisted by the

'About the security' section being set out in the same order, and with the discussion grouped around the same concepts, as those used in the 'Investment overview' section. Other aids, such as summaries for each subsection and repeated subsection headings, are also helpful.

101 As set out in ASIC Media Release 12-207MR, it is important that securities be true to label, and we consider the term 'capital notes' more appropriate than 'CPS' (for 'convertible preference *securities*') or another acronym where the security is legal form debt. Investors also need to be warned that the security is not a form of bank deposit, and if the security can be converted to ordinary shares, this needs to be prominently disclosed.

102 Likewise, instrument features should be true to label. Distinguishing events which are outside the issuer's control (such as scheduled conversion, or conversion following a change of control) from events where the issuer may elect (such as redemption or resale on an issuer call date) can be achieved by prominently labelling the latter as optional. While 'exchange' can be a useful umbrella term for 'conversion, redemption or resale', issuers should carefully consider whether, given the different conditions and approvals which may be required to effect each of the exchange methods, it may be clearer to simply refer to each method separately.

103 We have observed that in many cases where the draft prospectus has been difficult to read, the 'Investment overview' and 'About the security' sections have closely followed the structure of the instrument terms. The resulting disclosure is quite 'mechanical', very technical and requires more qualification (e.g. to identify the different conditions or approvals required where conversion occurs following a tax event, a change of control event or a trigger event), and often becomes repetitive.

104 Instrument terms and their expression are a matter for issuers, their advisers and APRA. We have focused on APS 111, but note that the terms of current and future instruments have or will be structured to satisfy other prudential standards set by APRA, to qualify for inclusion in the capital base of an insurer under LPS 112 or GPS 112, or as eligible capital under 3PS 111. We also acknowledge that even between instruments meeting the same standard, the small variations are often deliberately set following extensive negotiation.

105 Despite this, many instruments share common features or behave in similar ways, and the variety of approaches in the market taken to documenting these instruments highlights that there are multiple ways to draft functionally equivalent terms. Given the impact the structure of instrument terms may have on disclosure, when structuring future instruments, we encourage issuers, and their legal and financial advisers as gatekeepers, to consider the need for the features and risks of those instruments to be disclosed to retail investors in a clear, concise and effective manner.

Corporate hybrids

Corporate hybrid terms

106 The terms of corporate hybrids are typically less complex than those of bank hybrids, but still require investors to understand features that are simply not present in more 'vanilla' corporate bonds. When compared to hybrid securities issued by banks and insurance companies (as prudentially regulated entities), the issuer's financial situation also becomes more relevant, and in particular the restrictions the issuer's existing senior debt places on their ability to deal with the hybrid securities.

107 While all recent corporate hybrids have been subordinated notes (legally 'unsecured notes' for the purposes of s283BH of the Corporations Act), there is variation between instruments, depending in part on the terms of the issuer's existing borrowings and structuring designed to have the instrument qualify for a level of equity credit. These subordinated notes have included a mix of the following common features:

(a) unsecured, meaning that no particular assets back the payments due under the notes;

(b) subordinated, meaning the notes rank behind preferred/secured creditors, ordinary bank and trade creditors, and potentially other subordinated bonds that are expressed to rank in preference (and so therefore rank ahead only of ordinary shares in a winding up);

(c) long maturity, with some notes having an investment term of 25 or even 60 years, meaning the issuer is not required to repay the principal until a date potentially beyond the life of the investor;

(d) an issuer call at around five years, permitting (but not requiring) the issuer to redeem the note early;

(e) regular interest payments typically calculated as a fixed margin above a floating rate. This margin may 'step up' if the securities are not redeemed on the issuer call date, on some other date further into the life of the bond (e.g. 25 years), or following the occurrence of change of control event;

(f) the ability for interest payments to be deferred, either at the discretion of the issuer (optional deferral) or where certain financial ratios are breached (mandatory deferral);

(g) deferred interest payments are typically cumulative and compounding, which means that investors are still entitled to receive that deferred payment at some time in the future (although this could be up to five years from the date the payment was due to be made), and interest also accrues on the deferred payment; and

(h) a 'dividend stopper', which prevents the issuer from paying dividends on ordinary shares or undertaking share buybacks and other capital transactions while an interest payment remains unpaid. This dividend stopper can be either a 'hard' stopper (where the terms of the notes prevent the issuer from paying dividends following optional deferral), or an 'intent'-based stopper (where there is no requirement in the terms, but the issuer includes a statement in the prospectus to the effect that 'where interest has been or will be mandatorily deferred, we will take particular actions, including not paying dividends or undertaking other capital transactions, until the mandatory deferral ceases to apply').

108 More recent offers of hybrid securities by unlisted issuers have adopted different terms, reflecting the different financing structures of these issuers, which involve substantial existing senior debt ranking in priority to the notes:

(a) the benefit of the same security available to the senior lenders, but on a second ranking and subordinated basis, meaning that if the issuer is wound up, any value realised for the security will go first to the senior lenders, with the real possibility nothing will be available for the subordinated note holders;

(b) relatively short maturities of five years, but may be called earlier with the consent of senior lenders, and early redemption may be at a slight premium to the issue price;

(c) either fixed interest payments, or a floating rate over a fixed margin subject to a minimum rate for the first year; and

(d) interest payments are required to be deferred if certain financial ratios under the terms are exceeded, certain 'financial covenants' (financial ratios set under the terms of the issuer's existing senior debt) are breached or there are other defaults in connection with the senior debt.

Our comments on corporate hybrid disclosure

109 While the number of complex terms present in corporate hybrids is lower than with bank hybrids, care needs to be taken to explain features like interest deferral, the circumstances in which it may occur, and the consequences for the investor. Our earlier comments on the need for direct language and thoughtful structure in the 'Investment overview' section, followed by further explanation in the 'About the security' section, which adopts the same structure and is grouped around the same concepts, applies equally to corporate hybrids.

110 Our focus is on ensuring that the company's financial situation and the implications for investors are clearly explained. At its most basic, this requires that the company show how it will be able to meet its obligations under the subordinated notes and any senior debt, and any risks to the timely payment of interest and principal on the notes (including where senior debt must be repaid or refinanced before the notes mature).

111 Where deferral on the note is tied to particular financial ratios, a brief explanation of what those ratios are intended to measure, and the current value of both those ratios and their inputs, should be included in the 'Investment overview' section.

112 Where the terms of the notes are linked to other debt facilities, investors need to understand how much senior debt ranks ahead of the notes, what rights those senior lenders have in relation to payments on the subordinated notes, and what loan covenants or other events of default exist under that senior debt which may result in interest being deferred.

113 In both cases, issuers should comment on their ability to meet those ratios or covenants (and therefore avoid deferral) in the future, particularly where the current values are close to trigger points, where the inputs to those ratios or covenants will be affected by upcoming transactions, or are exposed to specific risks or assumptions (e.g. requiring earnings growth be maintained over the life of the notes). If the issuer does not believe they have reasonable grounds to forecast compliance beyond the coming year, this should be prominently stated.

114 Senior debt covenants which are not terms of the notes, but which may result in deferral by triggering an event of default on the senior debt, should also be included. Where covenants tighten over time, investors should be able to assess how much headroom is available having regard to any required or voluntary repayment of senior debt over the life of the notes. Where additional debt can be raised (whether senior or equal ranking), the amounts and the impact on covenants should be shown.

115 Investors should be alerted to the deep subordination of these securities and its consequences in a winding up. We expect any references to 'security' to make clear that the notes remain 'unsecured notes' for the purposes of the Corporations Act, and to disclose that on an enforcement of that security or in a winding up, depending on the value realised for the security, there may be a shortfall in funds resulting in investors not being repaid some or all of their investment.

116 Despite the variance in terms between corporate hybrids, we have not raised concerns with the consistent use of the term 'subordinated notes' where the instruments have had a fixed maturity (albeit often with very long investment terms) and non-discretionary interest payments (although subject to deferral), provided adequate disclosure of these features and their impact on the investor is made. Where a corporate hybrid adopts more 'equity-like' features, this term may no longer be appropriate. Similarly, while the term 'subordinated notes' may be appropriate for bank hybrids with limited loss-absorbing conversion features required by the prudential standards, we will carefully consider its proposed use in connection with a corporate hybrid with conversion features or a perpetual term.

117 Investors may focus on any implied maturity, and it is important to not mislead investors by including statements in the prospectus which suggest the instrument will be redeemed on the first issuer call date. Where an instrument has a long maturity and the potential for interest payments to be deferred, it should be noted that while an investor may realise their investment by selling the instrument on ASX, the market for hybrid securities is likely to be less liquid than ordinary shares, and the market price may be less than the face value of the security, with such a sale resulting in the investor incurring a capital loss.

Conclusion

118 Due to the complexities of the security, it will always be difficult to ensure that prospectuses for hybrid securities are clear, concise and effective. Our observation is that prospectuses for hybrid securities progressively improved once we started working with issuers and their advisers prior to the formal lodgement of the prospectus.

119 In our view, issuers and their advisers should be prepared to devote considerable time and effort to striving to make the security, its features and risks as comprehensible to retail investors as possible. By doing so, issuers can enhance their reputation as a trustworthy issuer and minimise the risks to their reputation arising due to misinformed investor expectations.

D Review of selling methods

Key points

The sales process for hybrid securities is heavily intermediated, with offers distributed through networks of wealth management, private banking, stockbroking and financial advisory firms.

A number of parties within this distribution network, primarily joint lead managers and their related businesses, prepare a variety of pro forma emails, offer summaries and research reports for use as part of the sales process.

ASIC undertook a review of the selling methods used for a sample of five offers of hybrid securities made in the 12 months beginning March 2012, to encourage the appropriate use of these non-prospectus sales documents and to observe the distribution networks used.

We make a number of observations about the prominence given to yield in advertising, and the lack of balance when discussing product features and risks in shorter documents with a more promotional focus.

We consider clear, concise and effective prospectus disclosure to be of even greater importance given the extensive use of non-prospectus sales material and the low level of personal advice being provided.

The sales process

120 Because of the greater complexity and potential risks present in most hybrid securities, the disclosure provided to investors in relation to an offer (both under the prospectus for the offer and any other sales material) and the nature of the sales process are critical elements in the decision by a retail investor as to whether to invest in a hybrid.

121 Much like a traditional equity IPO, in addition to the issuer, offers of hybrid securities involve a syndicate of investment banks acting as 'joint lead managers' (one or more of whom may have also acted as 'structuring advisor' or 'arranger' to the offer), who then leverage their related wealth management or private banking businesses to distribute the offer to investors.

122 Access to this 'broker firm offer' component may also be available to clients of stockbrokers or online brokers related to the joint lead managers, other financial service providers who utilise investment platforms provided by the joint lead managers, and other co-managers or syndicate brokers appointed by the joint lead managers.

123 Hybrid ownership also appears to be relatively concentrated when compared to share ownership. According to the *Australian share ownership study 2012* published by ASX:[18]

(a) 34% of the adult Australian population directly held shares in a company listed on a securities exchange (including via an SMSF or company structure);

(b) only 4% held 'other investments listed on a stock exchange', with that group strongly biased towards a segment ASX describes as 'confident traders';19

(c) of that 4%, 29% held 'listed interest rate securities', an effective proxy for hybrid securities.[20]

124 This is consistent with separate research published by Investment Trends, which found:[21]

(a) there were a total of 75,000 investors who held hybrid securities and other 'listed interest rate securities' in November 2012, a 21% increase since December 2011; and

(b) 85% of investors in hybrid securities rated their overall understanding of these securities as 'average' or better.

125 We undertook a review of the selling methods used for a sample of five hybrid securities issued in the 12 months beginning March 2012. The purpose of the review was to encourage the appropriate use of non-prospectus documents as part of the sales process for offers of hybrid securities, and to monitor this process for the joint lead managers and the issuers themselves. The sample included both large and small corporate hybrid offers, including an unlisted corporate issuer offering ASX-listed hybrid securities, and large and small bank hybrid offers, including an offer that featured a reinvestment component (the ability for holders of an existing security approaching the first issuer call date to 'roll over' their investment into a new security).

126 The overall aim was to ensure that the appropriate actions were being taken as part of the sales process (e.g. no information is presented which is inconsistent with the prospectus), that the materials used by the joint lead managers or the issuer are appropriate, accurate and not misleading, and to gain a better understanding of the distribution networks used. The review

[18] ASX, *Australian share ownership study 2012*, pp. 4, 6, 8, 21 and 22.
[19] ASX, *Australian share ownership study* 2012, pp. 19 and 21. 'A highly knowledgeable and confident group of investors, they enjoy managing their investment portfolios and are excited about the share market challenge. This segment is strongly self-reliant (93%) and rely less on the advice of experts (41%) and more on their own gut feeling in making investment decisions (75%). They believe that investing in the long term is the key to success in the share market and tend to invest in blue chip shares (71%). They use on average, 4.8 sources of information/advice.'
[20] We note that both the ASX study and the Investment Trends research use the term 'hybrids' to refer to all listed interest rate securities, which also includes vanilla corporate bonds and (since May 2013) Exchange-traded Treasury Bonds (Commonwealth Government Securities). At the time data for the study and research was acquired (September to November 2012), hybrid securities as that term is used by this report (to describe securities which combined equity-like and debt-like characteristics) comprised the vast majority of the 'listed interest rate securities' category, by both number and size of offers.
[21] Investment Trends, *November 2012 investor product needs report*, March 2013, pp. 201 and 203.

focused on the sales process used for the initial offers of hybrid securities, and did not specifically consider acquisitions on a secondary market (i.e. buying the securities on ASX after they are first issued).

The scope of our review

Review at the issuer and joint lead manager level

127 The first stage of the review involved contacting issuers of hybrid securities and their counsel during or shortly after the completion of an offer, to ask them, together with the joint lead managers to the deal, to provide ASIC with the following information:

(a) details of the joint lead managers and their respective wealth management, private banking and broking businesses involved in the sales process;

(b) details of any co-managers or syndicate brokers appointed by the joint lead managers;

(c) a breakdown of allocations under the bookbuild, and the amounts raised under each tranche of the offer;

(d) confirmation of any selling or stamping fees paid in connection with the offer; and

(e) copies of any non-prospectus material prepared by the issuer, the joint lead managers or their related businesses for use in connection with the offer, and the circumstances in which it was provided to retail clients.

128 All issuers, joint lead managers and their counsel provided these documents to ASIC voluntarily on a confidential basis, and we thank them for their cooperation.

Review at the syndicate broker level

129 The second stage of the review involved contacting a small number of independent ‘syndicate brokers’ (i.e. AFS licensees who were invited to participate in an offer, but who were not controlled by, or formally affiliated or aligned with, a particular joint lead manager) who acted on at least two of the offers we considered as part of the first stage. We served notices requiring the following information and documents to be provided to ASIC:

(a) details of each client who invested in the relevant offers, including whether general or personal advice was provided and the amount invested;

(b) details of fees received in connection with the relevant offers;

(c) the criteria applied, and the documents considered, when assessing whether to make the relevant offers available to their clients; and

(d) the documents provided to clients in connection with the relevant offers.

Use of non-prospectus sales documents

Types of documents

130 In addition to the prospectus, each issuer prepared an 'investor presentation' containing a summary of the terms of the security, the offer, and detail on the issuer and the impact of the offer on their financial position (including financial ratios which may trigger deferral in the case of corporate hybrids, and regulatory capital levels in the case of bank hybrids). These presentations were similar in style to those used for other forms of capital raising, and as with those 'roadshow' presentations, were made available on the ASX markets announcements platform at the time the offer was announced.

131 Issuers also prepared a variety of ASX announcements, which contained a summary of the key terms of the offer (particularly the initial announcement for the offer, and when announcing the results of the bookbuild), offer websites and call centre scripts.

132 The unlisted corporate issuer prepared comparable documents, and we considered those made available to retail investors.

133 Some issuers prepared advertising material targeted at the general public (press and online advertisements) or at existing securityholders (postcards or emails alerting those eligible to participate in a shareholder or reinvestment offer). Some joint lead managers prepared short 'client alert' emails which highlighted a limited number of features, with a heavy emphasis on the interest rate payable, and which did not purport to summarise the offer.

134 A range of offer summaries were prepared by individual joint lead managers or their related businesses, including:

(a) stand-alone or email 'sales sheets' or 'briefing sheets' containing a two to three page summary of the offer and intended for distribution within their networks for broker information (i.e. not intended for client distribution, and for some offers, a common sales sheet was prepared jointly by the joint lead managers);

(b) pro forma emails containing a short (less than four pages) summary of the offer but with a narrower focus (typically on interest payments, deferral and redemption), and prepared for the express purpose of distribution to retail clients; and

(c) stand-alone offer summaries or research notes, which varied from four to 18 pages.

135 Joint lead managers also prepared Bloomberg announcements, materials for institutional investor roadshows, confirmations and other mechanical documents used as part of the sales process between the joint lead managers and syndicate brokers, but these documents were not made available to retail investors.

136 As discussed below, the syndicate brokers in the sample did not prepare any substantive non-prospectus sales documents for distribution to retail clients, instead forwarding documents prepared by the issuer and joint lead managers.

What is 'appropriate use'?

137 When considering whether the use of non-prospectus sales documents was appropriate, we considered:

(a) the consistency of those documents with the prospectus;

(b) the balance in disclosure of risks and benefits (e.g. whether the yield was given particular prominence or cross-references to risks disclosure in the prospectus included);

(c) whether the document made clear that the offer of hybrid securities was made in the prospectus and that investors should read the prospectus before making an investment decision;

(d) the circumstances in which the document and any attachments were provided.

138 The first three elements relate to the content and form of the sales documents, while the last is concerned with the way in which those documents are used in the sales process.

139 For completeness, we note that all offers in the sample were made using a prospectus under Ch 6D of the Corporations Act.[22] We were provided with drafts of, and provided comments on, all prospectuses in the sample before formal lodgement. In all cases, any material concerns we had with prospectus disclosure were addressed before lodgement, and the exposure period was not extended for any offer in the sample.

140 As is typical for capital raisings involving a bookbuild to determine the margin and volume, each offer involved an initial prospectus that was lodged when the offer was announced, and a replacement prospectus containing the final margin and revised volume following completion of the bookbuild and the expiry of the exposure period. Two bank hybrid offers, where the securities were convertible into ordinary shares in the issuer, were granted ASIC relief to permit a s713 'transaction-specific' prospectus to be used.

[22] While none were included in the sample, offers of bank subordinated notes with no conversion features do not require prospectus disclosure by virtue of s708(19), although the 'offer documents' or 'information memorandum' used for these offers usually contain prospectus-level disclosure.

Documents prepared by issuers

141 The investor presentations, other ASX announcements, call centre scripts and website content prepared by issuers closely tracked the language used in the prospectus, and in particular described the terms of the security in the same way adopted in the 'Investment overview' section. Given the nature of these documents, their limited content and the timing of their release relative to the prospectus, it seems unlikely that these documents would be the sole or primary document on which investors would rely.

142 Advertising material provided to existing securityholders was generally appropriate when considered in the context of the reader's existing relationship with the issuer, although press and online advertising material targeting the general public was more mixed.

143 Advertising that occurred after the lodgement of the prospectus appeared to contain the statements required to comply with the advertising restrictions in the Corporations Act. However, we were concerned with the prominence given to the yield in advertisements. For one offer, the interest payments were the only term of the security disclosed in the advertisement, and the fact the rate would vary, and that interest payments were subject to deferral, was included in substantially smaller text. The online version of the advertisement included the interest rate on one panel, with the possibility of payments being deferred appearing on the following panel, and also switched between multiple panels at short intervals, which did not allow sufficient time to read all of the text presented without repeated viewings.

Documents prepared by joint lead managers

Promotional material

144 Most 'client alert' emails could more properly be considered advertising, providing a few paragraphs or a series of bullet points setting out the key benefits of the offer, without any corresponding risks disclosure. Some examples highlighted the interest rate payable, or redemption or conversion dates, but included qualifications to these features only as footnotes, and references to the prospectus were often general. One series of alert emails included direct recommendation as to suitability of both the hybrid and the merits of participating in the reinvestment offer.

145 In a number of cases, the email did not include either a link to the prospectus or attach the prospectus, reinforcing the character of the communication as purely promotional.

146 Research by Investment Trends[23] indicates that retail investors are, among other things, particularly attracted to the interest rate (53%) and the promise of regular income (30%), and so advertisements and other sales materials which focus on the interest rate should clearly state that payments may be deferred. Where space permits, and particularly in email communications, a brief discussion of key risks (including the circumstances in which deferral may occur) should be included.

147 We observed one offer being advertised on social media by a joint lead manager, although these posts on Twitter and Facebook were limited to announcing the offer and linking to either an offer website, or a video interview with the CEO of the issuer. Some offer websites prepared by both issuers and joint lead managers contained short summaries similar to those discussed below, with the focus remaining obtaining electronic access to the prospectus.

148 'Sales sheets' prepared by the joint lead managers for use within their broker networks heavily summarised the material terms of the offers by relying on defined terms and financial ratios, and would be useful to financial service professionals or sophisticated investors already familiar with hybrid securities and the variety of terms they typically exhibit. While we did not observe these sales sheets being provided to retail investors, we encourage joint lead managers and their broker networks to remain vigilant to ensure these documents remain 'internal only'—in particular, the level of assumed knowledge around complex features like interest deferral, conditional early redemption and conversion means a retail investor accessing the document may be left with an incomplete picture of the security and its operation.

Pro forma emails

149 One group of pro-forma emails prepared by joint lead managers or their related businesses were no longer than 'sales sheets', but focused on a smaller number of terms (interest payments/circumstances where they may be deferred, and the investment term of the instrument/any early redemption rights) and often omitted the full offer timetable, rather than seeking to summarise all terms of the offer.

150 These emails were more likely to emphasise favourable features of the hybrid security, and occasionally included recommendations or predictions as to future redemption or conversion. Statements reminding the investor to consult the prospectus for full terms and conditions, and cross-references to particular risks disclosure, were generally adequate.

[23] Investment Trends, *November 2012 investor product needs report*, March 2013, p. 207.

151 The second group of pro-forma emails provided a more balanced summary of features and risks, and were also distinguished by regular, prominent and often specific cross-references to the corresponding disclosure in the prospectus.

152 Both groups of pro-forma emails included either a link to the prospectus or attached the prospectus, and for a subset of both groups also attached a more detailed stand-alone summary.

Stand-alone offer summaries

153 Stand-alone offer summaries were typically six to eight pages (and ranged from four to 18 pages), and fell into two groups along similar lines to the pro-forma emails. The first group, broadly ‘research reports’, included documents prepared by joint lead managers and their related businesses, co-managers, and also independent research providers. While not a specific focus of the review, these documents and the entities preparing them would be considered ‘research reports’ and ‘research report providers’ as those terms are used in our recently updated Regulatory Guide 79 *Research report providers: Improving the quality of investment research* (RG 79).

154 These documents included an offer summary as part of a broader analysis of the offer (and often the issuer and their financial position once the raising was taken into account), compared the features with similar hybrid securities, and included some form of recommendation or statement of opinion. While independent research reports typically made express recommendations based on the fairness of the margin given the issuer and security, joint lead manager and co-manager documents were often less direct, including prominent references to yield and maturity in the document, and in particular as part of favourable comparisons to similar hybrid securities.

155 While all documents included some level of discussion about suspension, redemption and conversion, and all included references to the prospectus, the documents prepared by joint lead managers were significantly more likely to include that discussion as part of a ‘key risks’ section and include repeated, specific cross-references to the corresponding sections of the prospectus.

156 The second group were a small number of true ‘offer summaries’ that did not include recommendations or comparisons, and were prepared for certain offers by particular joint lead managers. These documents provided a balanced summary of the features and risks of the security in language that was consistent with the prospectus—in some cases, because it largely replicated the ‘Investment overview’ section, but also where prospectus text was used as the base for a new summary drawing selectively from the ‘Investment overview’ and ‘About the security’ sections, which presented the hybrid features and accompanying disclosure in a different order.

Evaluation of non-prospectus sales documents

157 As noted above, in examining the non-prospectus documents used as part of the sales process, our aim was to ensure those documents, and the way in which they were used, were appropriate, accurate and not misleading.

158 We observed the use of some form of offer summary in almost all responses by joint lead managers, and so our view on the appropriate use of these documents is tempered by an appreciation that the provision of summaries or research to retail investors is both common, and part of the value proposition the relevant private bank, wealth management, broking or financial advisory businesses present to their clients. Likewise, while the syndicate brokers did not prepare sales material for distribution to retail clients, they did forward pro forma emails and offer summaries prepared by one joint lead manager.

159 Based on our review, disclosure of selling or stamping fees also appeared adequate. While we encourage more balanced disclosure of benefits and risks—particularly in some shorter pro forma emails—we considered the prospectus was generally referred to, attached or linked to in such a way that it remained the document on which investors would likely base their decision.

160 That said, we observed a limited number of sales documents in all categories that, if read in isolation, could be potentially misleading. As discussed below, responses from syndicate brokers accord with broader research which shows that few investors are receiving personal financial advice when investing in hybrid securities. Presented with a lengthy disclosure document for a complex financial product, and having been provided with one or more summary documents, there may be an increased likelihood that investors will place undue reliance on those summaries. We will remain alert for reports of unbalanced or misleading sales documents, and may undertake further reviews of future offers.

161 Comparisons to other securities and associated recommendations are obviously departures from the information contained in the prospectus, but appeared in a context which made clear the statements were not attributable to the issuer, and subject to the below comments, the analysis behind the recommendation was made explicit.

162 One notable inclusion in many summaries containing recommendations were statements on the likelihood the instrument would be redeemed on the first issuer call date.

163 When structuring instruments, issuers consider the effect implied maturity will have on the pricing of the instrument (rather than being priced as a perpetual security, or based on a decades-long legal maturity), but are prevented from making any indication about their intentions at the first call date by the prudential standards or equity credit criteria they are seeking to satisfy.

164 As discussed in Section B, the expectation that hybrid securities will be redeemed at the first call can be disappointed, and it may be appropriate to present comparisons or recommendations (including calculations of 'yield to issuer call') alongside more balanced discussion of any conditions to this call being exercised, factors which may be relevant to the issuer's decision whether to exercise the call, and the potential for the instrument to remain on issue.

Distribution and advice

Distribution networks

165 Responses from issuers and joint lead managers confirmed that the sales process for offers of hybrid securities is heavily intermediated, with a very small proportion (in some cases less than 1%) of the securities offered being subscribed for as part of the 'general offer' made directly by the issuer. Instead, investors will typically participate as part of a 'broker firm offer', where their 'allocation' will be received from:

(a) the wealth management, private banking or brokerage businesses of the individual joint lead managers (and co-managers if relevant);

(b) AFS licensees who are affiliated with, aligned with, or use investment platforms provided by, the joint lead managers;

(c) other AFS licensees who are invited to participate directly by the joint lead managers; and

(d) a further layer of AFS licensees who obtain their allocation from one of the entities described above.

166 As the term is used in connection with most offers, 'syndicate broker' typically includes all entities described in paragraph 165(a)–165(c) (with all syndicate brokers contacted in the second stage of our review falling within the third category).

167 Investors may also subscribe through:

(a) a security holder offer, under which existing holders of the issuer's securities (including other hybrid securities) can apply for a preferential allocation of hybrid securities under the new offer;

(b) a reinvestment offer, under which holders of existing hybrid securities that are approaching their first issuer call date may elect to have those securities redeemed, and the proceeds reinvested in new hybrid securities; or

(c) an institutional offer.

168 The above summary is necessarily general, and a number of factors make providing precise figures difficult, including:

(a) variations in the terms of each offer;

(b) the structure of bookbuild allocations (or the way in which they were reported to ASIC);

(c) the treatment of subscriptions under any security holder and reinvestment offers; and

(d) the need to preserve the confidentiality of the information provided to ASIC by issuers, joint lead managers and syndicate brokers.

169 However, based on the offers included in our review, and publicly available information for other recent offers of hybrid securities, we can form a number of broad conclusions:

(a) for most offers, the majority of investors (and often more than 80% by value) will subscribe through a syndicate broker as part of the broker firm offer;

(b) for offers with a security holder or reinvestment component, investors are still likely to participate through a syndicate broker rather than deal directly with the issuer; and

(c) depending on the size of the offer and the particular joint lead managers appointed, the number of syndicate brokers involved in the sales process may range from several dozen to several hundred.

Investor engagement with syndicate brokers

170 As part of our review at the syndicate broker level, in addition to the documents being provided to retail investors, we also sought details of how independent syndicate brokers considered whether to make the relevant offers available to their clients, and details of those clients, including whether they had received personal advice when investing in hybrid securities.

171 We received responses relating to 174 investments totalling approximately $10 million, with the majority of investments being made by SMSFs. The average amount invested was approximately $55,000, although individual investments ranged from $5,000 (the minimum subscription amount for the relevant offers) through to $500,000.

172 One syndicate broker arranged investments on an execution-only basis as intermediary for other AFS licensees, and therefore could not provide details of the advice or documents provided to the end client.

173 For the remaining syndicate brokers, individual advisers assessed the relevant offers based on the prospectus, investor presentation, the pro forma email and offer summary prepared by the particular joint lead manager inviting them to participate, and in some cases research reports prepared by independent research houses.

174 Advisers would then forward these materials to selected clients on a general advice basis. In particular, the pro forma email prepared by the joint lead manager was used as the primary means of communication, with little if any additional text included by the adviser.

175 Fewer than 10% of investments in this sample involved the provision of personal advice, with yield the primary reason recorded for the recommendation.

Other research and further action

Investment Trends research

176 Since undertaking our review, we have obtained access to research conducted by Investment Trends based on a larger sample of investors in hybrid securities, which found:[24]

(a) of the 75,000 current direct investors in hybrid securities, SMSFs account for 67%;

(b) the average total investment in hybrid securities was $97,000, and the most recent investment an average of $47,000;

(c) investors were substantially more likely to invest in hybrid securities because of the high yield (53%) and brand or reputation of the issuer (43%) compared to a recommendation from a financial adviser (24%); and

(d) financial advisers were involved in 40% of investors' most recent investments in hybrid securities.

Implications and further action

177 The importance of clear, concise and effective prospectus disclosure, and our continuing focus on improving prospectus disclosure for hybrid securities through engaging with issuers to review draft documents, is supported by three separate findings of the review of selling methods:

(a) The extensive use of pro forma emails and stand-alone offer summaries at all levels of the sales process requires that investors have access to more detailed disclosure of the features and risks of the security, and the ability of the investor to locate and understand that disclosure depends on the prospectus being clearly expressed and thoughtfully structured.

(b) The low levels of personal advice being provided, and a majority of investors reporting no involvement by a financial adviser, suggest that most investors are assessing potential investments in hybrid securities without professional assistance, emphasising the need for the 'Investment overview' section of the prospectus to provide a short, easy-to-read explanation of the key features and risks of the security.

[24] Investment Trends, *November 2012 Investor product needs report*, March 2013, pp. 202, 206, 212 and 213.

(c) Based on the large sums invested and the majority of investors being SMSFs, it is likely that a significant number of investments in hybrid securities are retirement savings. When investing substantial savings for the purpose of obtaining a regular income stream, it is critical that investors understand that—unlike bank accounts or fixed term deposits—hybrid securities are not ‘government guaranteed’, involve the risk of capital loss, and may have their interest payments deferred for long periods.

178 Given the extensive distribution networks and large number of syndicate brokers that may be involved in selling a particular offer, issuers (with the assistance of joint lead managers) have a responsibility to ensure that members of that network act appropriately in the selling messages they deliver and the documents they provide, and manage any risks introduced by (or take steps to address) their limited visibility over that network.

179 Based on our review, we found no further regulatory action was warranted in connection with the content of the offer summaries, or the way in which the pro forma emails and stand-alone summaries were used, although we encourage more balanced disclosure of benefits and risks. We will continue to monitor the selling methods used for offers of hybrid securities, and may undertake further targeted reviews to ensure standards are maintained. We will also investigate any reports of brokers promoting hybrid securities as fixed income products in a misleading fashion.

180 We note that the conduct of the broker firm offer can require syndicate brokers to estimate demand from their clients to inform any bid into the bookbuild. We would be concerned if syndicate brokers or individual advisers were contacting retail clients to solicit firm commitments before the offer opens.

181 Syndicate brokers or other AFS licensees should act responsibly if they recommend clients acquire hybrid securities on a secondary market, and at a minimum, we consider it appropriate for clients to be provided with access to the prospectus.

182 Because yield and the brand or reputation of the issuer are the most commonly cited triggers to investing in hybrid securities, we plan to engage further with issuers about any advertising proposed in connection with an offer. In our view, it is important that this advertising is balanced and encourages investors to understand the investment proposition. It is also important that joint lead managers ensure any promotional material they prepare (including client alert emails with minimal summary content) is consistent with the tone adopted in material prepared by the issuer.

183 We will explore whether tools can be developed so investors can check their understanding of hybrid securities before investing in them. We will also consider further naming conventions in relation to hybrid securities, to ensure hybrid instruments are not named in a way that might confuse investors.

Appendix: Offers of ASX-listed hybrid securities from November 2011 to June 2013

Issuer/product	Instrument	Issue date	Offer size
Woolworths Notes II	Subordinated notes	Nov 11	700
Origin Energy Subordinated Notes	Subordinated notes	Dec 11	900
Tabcorp Limited	Subordinated notes	Mar 12	250
ANZ Subordinated Notes	Subordinated notes	Mar 12	1,509
Westpac CPS	Convertible preference shares (Basel II)	Mar 12	1,189
Colonial Group Subordinated Notes	Subordinated notes (Basel II)	Mar 12	1,000
AGL Energy Subordinated Notes	Subordinated notes	Apr 12	650
NAB Subordinated Notes	Subordinated notes (Basel II)	Apr 12	1,173
IAG CPS	Convertible preference shares (Basel III transitional)	May 12	377
Westpac Subordinated Notes	Subordinated notes (Basel II)	Aug 12	1,500
Crown Subordinated Notes	Subordinated notes	Sep 12	525
APA Group Subordinated Notes	Subordinated notes	Sep 12	350
Caltex Subordinated Notes	Subordinated notes	Sep 12	525
Commonwealth PERLS VI	Capital notes (Basel III)	Oct 12	2,000
Suncorp CPS2	Convertible preference shares (Basel III)	Nov 12	500
Bendigo and Adelaide Bank CPS	Convertible preference shares (Basel III)	Nov 12	210
Bank of Queensland CPS	Convertible preference shares (Basel III)	Dec 12	200
MYOB Subordinated Notes	Subordinated notes	Dec 12	175
Westpac Capital Notes	Capital notes (Basel III)	Mar 13	1,380
NAB CPS	Convertible preference shares (Basel III)	Mar 13	1,500
Healthscope Notes II	Subordinated notes	Mar 13	300
Suncorp Subordinated Notes	Subordinated notes (Basel III)	May 13	770
Macquarie Capital Notes	Capital notes (Basel III)	Jun 13	600
Total of 23 offers			**18,283**

Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	ASX Limited or the exchange market operated by ASX Limited
bank hybrids	Hybrid securities issued by banks, insurance companies or other prudentially regulated entities
Basel III reforms	The comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector
BCBS	Basel Committee on Banking Supervision
corporate hybrids	Hybrid securities issued by corporate entities that are not prudentially regulated
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
hybrid security	Securities that combine 'equity-like' and 'debt-like' characteristics
IPO	Initial public offering
joint lead managers	The syndicate of investment banks appointed by the issuer to lead manage an offer of hybrid securities
S&P	Standard & Poor's
SMSF	Self-managed superannuation fund

Related information

Headnotes

Bank hybrids, capital notes, convertible preference shares, corporate hybrids, debt, disclosure, equity, hybrid securities, joint lead managers, non-prospectus sales documents, prospectuses, retail investors, subordinated notes

Regulatory guides

RG 79 *Research report providers: Improving the quality of investment research*

RG 228 *Prospectuses: Effective disclosure for retail investors*

Legislation

Corporations Act, Ch 6D, s283BH, s708(19), 439, 713, 715A, 761A, 913B

Media releases

11-270MR *ASIC warns consumers about hybrid securities and notes*, 24 November 2011

12-207MR *ASIC's hybrid warning: Don't be dazzled, be wary of the risks*, 27 August 2012

Other documents

APRA, Prudential Standards APS 111, 3PS 111, GPS 112 and LPS 112 *Capital adequacy: Measurement of capital*

ASX, ASX Listing Rules

ASX, *Australian share ownership study 2012*

Financial Conduct Authority (UK), *Occasional paper No. 1: Applying behavioural economics at the Financial Conduct Authority*, April 2013

Investment Trends, *November 2012 Investor product needs report*, March 2013

Investment Trends, *2012 High net worth investor report*

Office of Best Practice Regulation, Department of Finance and Deregulation, *Influencing consumer behaviour: Improving regulatory design*, 2013

The Gunns Group, *Report by administrators pursuant to section 439A of the Corporations Act 2001*, 25 February 2013