ASIC
Australian Securities & Investments Commission

REPORT 276

Response to submissions on CP 151 Debt securities: Modifying the naming provisions and advertising requirements

February 2012

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 151 *Debt securities: Modifying the naming provisions and advertising requirements* (CP 151).

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.

This report does not contain ASIC policy. Please see Regulatory Guide 69 *Debentures and notes: Improving disclosure for retail investors* (RG 69), Regulatory Guide 156 *Advertising of debentures and notes to retail investors* (RG 156) and Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45).

Contents

A Overview/Consultation process

Key points

We conducted two stages of consultation, with the second round targeted at initial respondents and interested parties.

We considered a number of alternative ways to describe a product that does not meet the test to be called a 'debenture' in s283BH of the *Corporations Act 2001* (Corporations Act), by either introducing a new category called 'note', or 'secured note', or expanding the definition of 'debenture' in s283BH, subject to conditions.

We have decided to modify the law by way of ASIC class order to introduce a new category called 'secured notes', which can be used by issuers who meet the conditions of Class Order [CO 12/1482] *When debentures can be called secured notes*. We have varied the risk statements that are to be included in advertisements for such products.

1 In Consultation Paper 151 *Debt securities: Modifying the naming provisions and advertising requirements* (CP 151), released in March 2011, we sought feedback on:

(a) a proposed modification of the debenture provisions of s283BH of the Corporations Act to introduce a new category, namely 'notes', for certain debt securities that must currently be described as 'unsecured notes'; and

(b) a proposal to revise our advertising standards in Regulatory Guide 156 *Advertising of debentures and unsecured notes* (RG 156) and Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45) relating to the standard concerning investors losing some or all of their principal investment.

2 This report highlights the key issues that arose out of the submissions received on CP 151 and our responses to those issues.

3 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 151. We have limited this report to the key issues.

Responses to consultation

4 We received 12 responses to CP 151 from relevant industry bodies, law firms and consumer groups. We are grateful to respondents for taking the time to send us their comments.

5 For a list of the non-confidential respondents to CP 151, see Appendix 1. Copies of these submissions are on the ASIC website at www.asic.gov.au/cp under CP 151.

6 We received two confidential submissions.

7 Overall, responses were supportive of the objectives behind the proposals in CP 151, although in some instances respondents asked ASIC to consider alternative proposals to achieve the same objective.

8 The most contentious issues raised by respondents related to:

(a) our proposal to modify the debenture naming requirements, and whether we should allow the use of the term 'secured notes', instead of the terms 'notes' or 'debentures'; and

(b) our proposal to revise the debt instrument advertising standards, and what alternative standard would achieve an appropriate outcome.

Further consultation

9 With regard to the initial responses, we conducted further consultation (including with the initial respondents to CP 151), as publicly announced in ASIC Advisory (11-172AD) *ASIC extends consultation period on debentures and advertising and extends interim no-action position* (17 August 2011).

10 We sought feedback on whether we should implement class order relief to effectively formalise the no-action position introduced in our Report 38 *High-yield debentures* (REP 38), in February 2005, subject to a number of conditions. The no-action position in REP 38 allowed issuers not offering solely tangible property as security, such as intangible property (e.g. loan receivables), to refer to their product as a debenture when it would otherwise have been described as an 'unsecured note'.

11 The proposed conditions, already canvassed in some way in CP 151, included that:

(a) the issuer (and any related body corporate), or any guarantor, provides a first ranking charge in favour of the trustee over its property (including intangible property);

(b) the issuer provides a detailed explanation of the security, as referred to in Proposal B3 of CP 151 (including a confirmation of the sufficiency of the assets supporting the security), in any quarterly report (see Proposal B4 in CP 151) or disclosure documents relating to the offer;

(c) the issuer excludes related party transactions when determining the sufficiency of the assets;

(d) the issuer prominently discloses, in documents relating to the offer, how the product is classified under the modified s283BH of the Corporations Act (see Proposal B2(c) of CP 151); and

(e) the issuer includes in advertisements relating to an offer of debentures a statement that 'this product is not a bank deposit and, accordingly, there is more risk you could lose some or all of your money' (see Proposal C1(b) of CP 151).

Responses to further consultation

12 We received 11 responses to the further consultation under CP 151. Again, we are grateful to respondents for taking the time to send us their comments.

13 For a list of the non-confidential respondents under the further consultation to CP 151, see Appendix 2. Copies of these submissions are on the ASIC website at www.asic.gov.au/cp under CP 151.

14 We received three confidential submissions.

15 Overall, the proposals received greater support than our initial proposal to introduce a new category called 'notes', although the most contentious issues identified in the first round of consultation remained.

16 This report outlines the submissions received on our proposals in CP 151 and summarises our response to these submissions. We have updated our guidance in Regulatory Guide 69 *Debentures and notes: Improving disclosure for retail investors* (RG 69) and Regulatory Guide 156 *Advertising of debentures and notes to retail investors* (RG 156) to incorporate and reflect the changes made to our policy through the consultation process. We note that the wording in Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45) will be modified slightly in a future update to that guide.

B Modifying the debenture naming provisions

Key points

We received support for the introduction of a new category of debt security that could be used where the requirements to refer to a product as a 'debenture' in a document relating to an offer were not met.

We have introduced a new category called 'secured note' by way of modifying the law under [CO 12/1482] and setting out guidance in Section G of RG 69 relating to the conditions in the class order.

The new category sits between 'unsecured note' and 'debenture' in the hierarchy of how these products can be described. A 'secured note' will carry more risk than a debenture because it will not be secured entirely over tangible property. We consider it is important that investors are prominently alerted to the risk of loss when they are considering investing and we have explicitly required that advertisements about these products are accompanied by an appropriate risk statement.

Introduction of new category of debt instruments

17 In CP 151, our main proposal was to introduce a new category of debt security to be described as a 'note' for the purposes of s283BH of the Corporations Act. Other proposals related to the circumstances where issuers could use the term 'notes', including where, among other things:

(a) the issuer, or any guarantor, provides a first ranking charge in favour of the trustee over property (including intangible property—for example, loans receivable);

(b) the issuer provides a detailed explanation of the security (including a confirmation of the sufficiency of the assets supporting the security) in any disclosure document relating to the offer; and

(c) the issuer prominently discloses, in documents relating to the offer, how the product is classified under the modified s283BH of the Corporations Act.

18 All but one of the respondents agreed that we should introduce a new term for debt instruments that had the features set out in paragraph 17.

19 We then conducted further consultation by writing to the initial respondents and interested parties, as discussed in our advisory 11-172AD. The main proposal was whether we should instead expand the statutory definition of when a product can be called a debenture in a document relating to an offer beyond security over tangible property, subject to a number of conditions, including:

(a) the issuer (and any related body corporate), or any guarantor, provides a first ranking charge in favour of the trustee over its property (including intangible property);

(b) the issuer provides a detailed explanation of the security, as referred to in Proposal B3 of CP 151 (including a confirmation of the sufficiency of the assets supporting the security), in any quarterly report (see Proposal B4 in CP 151) or disclosure documents relating to the offer;

(c) the issuer excludes related party transactions when determining the sufficiency of the assets;

(d) the issuer prominently discloses, in documents relating to the offer, how the product is classified under the modified s283BH of the Corporations Act (see Proposal B2(c) of CP 151); and

(e) the issuer includes in advertisements relating to an offer of debentures a statement that 'this product is not a bank deposit and, accordingly, there is more risk you could lose some or all of your money' (see Proposal C1(b) of CP 151).

'Note', 'debenture' or 'secured note'?

20 We asked questions on whether respondents considered the term 'secured note' to be preferable to the term 'note' or 'debenture'. The majority of respondents submitted that the term 'secured note' would be more appropriate than the other terms given their belief that 'secured notes':

(a) more accurately describes the nature of the debt instruments;

(b) creates a clear distinction between 'secured' and 'unsecured' (as these debt instruments would otherwise be required to be called under s283BH of the Corporations Act);

(c) removes the negative spin associated with 'unsecured notes', which unduly places reservation in an investor's mind;

(d) has more relevance than 'notes', which may itself be considered an abbreviation of 'unsecured notes'; and

(e) immediately informs the investor that the investor has some security and that it is to be differentiated from another product that is likely to be unsecured.

21 On the other hand, some respondents expressed the following concerns with the term 'secured note':

(a) it is uncertain whether investors will fully appreciate the difference between a debenture, mortgage debenture, 'secured note' and unsecured note; and

(b) there is a risk that retail investors will invest in 'secured notes' under the misapprehension that it has a higher level of security than a debenture.

22 The preference for 'secured notes' in responses to the further consultation process was as strong as the preference in the first consultation for an expansion of the definition of 'debentures'.

ASIC's response

As discussed above, we have introduced a new category called 'secured note', rather than 'note' or 'debenture'.

This description will be conditional, including the security is sufficient and reasonably likely to be sufficient to repay investors at the end of the investment terms. We have provided non-exhaustive guidance in Section G of RG 69 on matters that should be considered as part of this process.

We note that a trustee has a duty to exercise reasonable diligence to ascertain whether the property of the borrower and of each guarantor that is or should be available (whether by way of security or otherwise) will be sufficient to repay investors' money. Therefore, the trustee will need to critically assess the issuer's reliance on the class order.

In relation to a concern that there is a risk that retail investors will invest in 'secured notes' under a misapprehension of the level of security, we intend to:

- ensure that statements about the risk of loss to be included in advertisements are not buried in the fine print; and
- shortly update our investor guide, *Investing in unlisted debentures and unsecured notes?*, and MoneySmart website to clarify that the term 'secured note' is not a synonym for a safe product or low risk. The risk will depend on a range of factors, including the assets underlying the charge or security interest provided to the trustee.

Type of security

23 We proposed, through the consultation process, that issuers would only be able to refer to their debt instruments as 'notes' or 'debentures', including when:

(a) the issuer, or any guarantor, provides a first ranking charge in favour of the trustee over property (including intangible property); and

(b) the issuer provides a detailed explanation of the security (including a confirmation of the sufficiency of the assets supporting the security) in any disclosure document relating to the offer.

24 In relation to our question about whether the term 'note' or 'debenture' should be used where the issuer, or any guarantor, has provided security other than a first ranking charge in favour of the trustee over property, we initially received mixed responses, though this was less of an issue in the

further consultation process where we had indicated our preference for the relief to be available only where there was a first ranking charge.

25 On the whole, respondents agreed that the criteria outlined demonstrated a sufficient level of security to warrant being differentiated from 'unsecured notes'.

26 Most respondents confirmed their view that the term 'secured note' should be used to differentiate it from the term 'unsecured note'. It was noted that:

(a) the term 'secured note' is appropriate when the criteria outlined above are met;

(b) the term 'note' could be used where security is in the form of a second ranking charge; and

(c) the term 'unsecured note' is to be used only where there is no security.

27 Only a first ranking charge was proposed under the further consultation process.

ASIC's response

The new category called 'secured notes' will also only be available where there is a first ranking security interest (i.e. where the trustee has the highest ranking security interest). The highest priority security assists in determining whether the underlying assets are sufficient (i.e. competing or superior non-statutory claims will not need to be considered), and is beneficial in circumstances where security is, or needs to be, enforced.

For these reasons, we consider it is appropriate for the trustee to have the highest priority where an issuer relies on the class order and calls its product a 'secured note'.

We note that due to the introduction of the *Personal Property Securities Act 2009*, we refer to 'security interest', rather than continue using the word 'charge', which was the applicable terminology during the consultation period.

Disclosure of the security

28 In relation to the criterion in paragraph 23(b)—that issuers provide a detailed description of the security in any disclosure document relating to the offer—we proposed that the following information should be described:

(a) information on the nature of the first ranking charge;

(b) a description of the assets secured by the charge; and

(c) a statement that the assets that constitute the security for the charge are sufficient and are reasonably likely to be sufficient to meet the liabilities for the repayment of all such money and all other liabilities:

(i) that have been made or incurred; and

(ii) that rank in priority to, or equally with, that liability.

29 Nearly all of the respondents considered that there are no practical concerns with making these disclosures, which is in any event consistent with existing disclosure obligations, including benchmark disclosures required in accordance with our policy in RG 69.

30 Some respondents considered that additional information should be provided, including:

(a) that the issuer engage an ASIC-endorsed/approved investment grade product rating agency to assess or rate the debt instrument against specified internationally accepted criteria like, for example, the eight disclosure benchmarks in RG 69; and

(b) prominent disclosure, in disclosure documents, of how the debt instrument is classified under the modified s283BH of the Corporations Act.

31 One respondent commented that the criteria in providing a detailed explanation of the security should simply be that the issuer has 'a first ranking charge over all the assets of the company, being primarily the portfolio of first mortgage loans'.

ASIC's response

We have introduced a requirement, for those relying on [CO 12/1482] to call their product a 'secured note', to provide disclosure of their underlying security, and we have provided an example in Section G of RG 69 to assist issuers preparing such disclosure.

In addition, when preparing such information, an issuer could draw upon its business model, investment overview and benchmark disclosure to assist investor understanding of the underlying security and its quality.

The existing benchmark framework provides investors with information to consider the quality of the underlying security (e.g. information about valuations, issuer security where funds are on-lent, loan-to-valuations ratios, arrears and information relating to legal proceedings).

Determining the sufficiency of the security

Related party receivables

32 We also consulted on whether the issuer should include receivables from related parties, or from transactions that are not on arm's length terms, in determining the sufficiency of the security.

33 The main reason put forward by respondents for including such receivables in determining the sufficiency of the security included that issuers are already providing detailed disclosure on related party lending in accordance with disclosure against Benchmark 6 in RG 69. It was also submitted that including such receivables is appropriate where the related parties or the transactions that are not on arm's length terms are legally bound to this additional security as a guarantor to the deed, or where the transaction is on normal commercial terms.

34 However, there was support, including from some issuers, to exclude these types of receivables in determining the sufficiency of the security. In particular, it was noted that it would have the potential to weaken investor protection by issuers using these receivables to provide a false and misleading impression of the sufficiency of the security, which is a risk not worth taking.

Intangible property under the accounting standards

35 We queried, during the further consultation process, if we should only extend the definition of 'debentures' to property that is not classified as intangible property under the Australian accounting standards. This would mean that assets classified as tangible property (e.g. land, goods) or financial instruments (e.g. cash, loan receivables) could be included in the sufficiency test.

36 We received a mixed response on this question, with one respondent noting that some property, including goodwill and other intangibles that are hard to define or quantify, had the potential for a more subjective view as to what the level of security was.

ASIC's response

Rather than requiring assets involving a related party transaction to be excluded from an issuer's calculations in determining whether the property offered as security is sufficient and reasonably likely to be sufficient, we consider that issuers should confirm whether the value of any property secured by the security interest may be affected by the financial position or performance of a related body corporate or related party of the borrower.

We note that investors can then consider such information further, including when considering information provided under Benchmark 6 of RG 69.

Similarly, rather than not permitting certain types of intangible assets from the assessment of whether the security is sufficient and reasonably likely to be sufficient, we have provided guidance in RG 69 on how issuers should approach this issue.

Finally, we do not see the sufficiency test being just a matter of whether *x* (the underlying assets) is greater than *y* (the amount owed to investors). We consider there are numerous factors that may affect whether it is or will be sufficient. A non-exhaustive list of matters for consideration is set out in Section G of RG 69.

Reporting on the security

37 We proposed that for an issuer to rely on class order relief to use the term 'note' (or any other term), it must meet the following further requirements in relation to reporting:

(a) the issuer includes in its quarterly report, required under s283BF of the Corporations Act, an update of the detailed explanation of the security; and

(b) the issuer publishes its quarterly report, with the detailed explanation of the security, on its website each time the quarterly report is due.

38 The submissions received on this proposal were generally supportive of this proposal.

39 One respondent suggested that it is unnecessary given that any material change to the security would trigger a requirement to lodge a supplementary prospectus, which would need to be issued to investors. Another respondent said that this is a good proposal because it would make the nature and underlying risks of the debt instruments clearer and more transparent to prospective investors.

40 There was also support for requiring a new quarterly report to be made available on an issuer's website (instead of only lodged with ASIC), subject to the information provided in the report not breaching the *Privacy Act 1988*. While one respondent was of the view that there might not be any clear benefit to a specific investor, providing disclosure of quarterly reports could lead to greater general confidence in debenture issuers, and thereby benefit the industry as a whole.

Email facility

41 We asked respondents whether, similar to our relief for the issue of retail bonds in Class Order [CO 10/321] *Offers of vanilla bonds*, we should make it a condition of any class order relief that issuers establish an email facility to allow investors to be notified by email when a new quarterly report (or other ongoing disclosure) is available.

42 Some respondents felt that this should not be mandatory, with some issuers who commented on CP 151 stating that they generally correspond by normal mail.

43 Other respondents commented that:

(a) the condition should not be mandatory, and emails should be sent to investors only if they have chosen to receive email notification on an 'opt-in' basis;

(b) investors should have the ability to nominate whether to receive hard or soft copies of a new quarterly report;

(c) disclosure of a new quarterly report on the issuer's website should be sufficient; and

(d) there is a risk that the use of emails to notify investors of a new quarterly report may be confused with other marketing material, or investors may become immune to its contents because of its regularity and therefore lose the benefit of any change of information disclosed in it.

ASIC's response

We consider it will be beneficial for an issuer's ongoing disclosure documents (including replacement and supplementary prospectuses, continuous disclosure documents and quarterly reports) to be posted on the issuer's website. If an issuer has a website to promote its products, the issuer will be able to post its current offer documents (including any supplementary or replacement documents), recent continuous disclosure documents, and current trustee quarterly reports to investors.

This will ensure that investors can readily access key information on their investment. If an investor is unable to access the information via a website and requests a copy, we would expect the issuer would provide a copy to the investor free of charge (e.g. by post).

We have not required issuers to set up formal email alerts, though we would encourage this if the issuer has the capacity to do so.

C Revising the advertising requirements

Key points

We have maintained our approach to require an issuer to confirm that the product is not a bank deposit and that there is a risk of loss associated with the investment.

This requirement is also a condition of [CO 12/1482] relating to when an issuer can refer to their product as a 'secured note'.

A new standard

44 In CP 151, we proposed to update RG 156 and RG 45 by revising the advertising standards for repayment of principal and comparison with bank deposits. We consulted on merging these standards and consulted on two alternatives:

(a) 'this product is not a bank deposit and, accordingly, repayment of the money you have invested is less certain'; or

(b) 'this product is not a bank deposit and, accordingly, there is more risk you could lose some or all of your money'.

45 Respondents expressed divergent views on which of the alternative standards is preferable. Generally, respondents who were issuers preferred the standard in paragraph 44(a), while consumer groups preferred the standard in paragraph 44(b). Some respondents also offered an alternative standard:

> 'This product is not a bank deposit and a risk assessment in this product is set out in the current prospectus lodged with ASIC, which should be read and understood before investing.'

46 Similarly, there were mixed views about whether we should completely remove the advertising standards for repayment of principal and comparison with bank deposits. Some respondents submitted that these standards should be removed on the basis that:

(a) the standards are discriminatory towards a limited sector of the finance industry; and

(b) disclosure against the benchmarks in RG 69 is very clear, and investor risks should be prominently disclosed in the prospectus for the offer.

47 Other respondents considered that the repayment of principal standard should be removed, but the comparison with bank deposit standard retained. Unsurprisingly, respondents with a consumer/investor focus were strongly of the view that the standards be retained in the form of one of the alternatives proposed.

48 There were no strong views expressed on whether an alternative standard should also refer to deposits with credit unions and building societies, in addition to bank deposits. Many respondents commented that an alternative standard should simply refer to bank deposits because including these deposit institutions within the standard clouds the message we are trying to impart.

49 During the further consultation process, we proposed issuers confirm, including as a condition of issuers describing their product as a debenture, that a statement that 'this product is not a bank deposit and, accordingly, there is more risk you could lose some or all of your money' be included in advertisements (as initially proposed in Section C1(b) of CP 151).

50 We received support for this proposal, with at least three responses supporting it, although we note that three of the respondents who disagreed preferred a statement that:

> 'This product is not a bank deposit and a risk assessment in this product is set out in the current prospectus lodged with ASIC, which should be read and understood before investing.'

51 These respondents then noted that, if this was not accepted, they preferred a further alternative that:

> 'This product is not a bank deposit. There may be a risk you could lose some or all of your money.'

ASIC's response

We consider that because there *is* a risk that investors could lose some or all of their money, we do not consider that it is appropriate to only say there *may be* a risk you could lose some or all of your money. The fact there is a risk is indisputable.

After considering and weighing up the responses, we decided to maintain wording very similar to the language currently used in both RG 156 and RG 45. These statements are short and use plain clear language, which is important in advertising.

We note that the wording in RG 45 will be modified slightly in a future update to that guide.

Appendix 1: List of non-confidential submissions to CP 151

- Anglesey Secured Investments Limited
- Bell Potter Capital Limited
- McCullough Robertson
- NICRI
- Provic Group Inc.
- RAC Finance Limited
- Southern Finance Limited
- The Trust Company
- Trustee Corporations Association of Australia
- Webster Dolilta Finance Limited

Appendix 2: List of non-confidential submissions to further consultation

- Anglesey Secured Investments Limited
- Bell Potter Capital Limited
- Provic Group Inc.
- RAC Finance Limited
- Sewells Finance Limited
- Southern Finance Limited
- The Trust Company
- Trustee Corporations Association of Australia