



**ASIC**

Australian Securities & Investments Commission

# **Debentures – improving disclosure for retail investors Regulation Impact Statement**

**October 2007**

# What this Regulation Impact Statement is about

This Regulation Impact Statement (RIS) addresses the Australian Securities and Investments Commission's (ASIC's) proposed policy on unlisted debentures. This follows a Consultation Paper published in August 2007 setting out our proposals for change in the unlisted, unrated debenture sector as part of a 12-month plan for this sector: see Consultation Paper 89 *Unlisted, unrated debentures – improving disclosure for retail investors* (CP 89). Our overall aim is to improve disclosure to retail investors to help them understand and assess these debentures, while maintaining the flexibility of the public fundraising process.

In developing our final position, we need to consider the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

- disclosure that better informs investors about the business models and risks of unlisted debenture issuers; and
- not unduly interfering with the market and the flexibility of the public fund-raising process.

This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

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# Issues

## ***Background***

The debenture market

*What is a debenture?*

1. A debenture is a promise made by an entity to repay money that has been lent to the entity. That is, an investor provides loan funds to the issuer, and in return the person borrowing the funds (the issuer) issues a debenture with a promise to pay a rate of interest (usually fixed) for a defined term, and then repay the loan.

*The debenture market*

2. The whole retail debt securities market (bank deposits, other deposits, debentures) totals around \$523 billion. Debentures account for about \$34 billion of retail assets, which is about 6.5% of the retail debt securities market. The growth in direct retail investment (including investment in debentures) has increased significantly in recent years.
3. Those who invest in debentures tend to be individuals and small superannuation funds. (Note that ASIC's proposals relate to debentures in the retail sector, and do not include issues of debentures to wholesale investors. We have concentrated on the retail sector because of the large impact failures in the debenture sector have had on retail investors.)

*Types of debentures issued*

4. Debentures held by retail investors are used as a source of finance for a range of business models and activities and have been part of capital markets for a long time. There are 135 issuers of retail debentures (as at December 2006). The different ways of using capital raised through the issue of debentures include:
  - *Debt capital financing* – money raised and applied as working capital or transaction specific funding to further the issuer or group's business operations;
  - *Finance* – lending for personal and general commercial purposes;

- *Integrated property* – funding of property transactions and development within a group or with related parties where that amount of funds applied is greater than 10% of total assets of the debenture issuer;
- *Mortgage financing* – secured mortgage lending for residential and commercial property ownership and improvement with security over real property;
- *Structured real estate investments* – participation in ownership of commercial and residential real estate as part of a wider ownership structure; and
- *Memberships* – debentures issued to facilitate membership of clubs, groups, or franchise operations.

### Current regulation of debentures

5. The offer of debentures is regulated under the Corporations Act (all sections, chapters and parts referred to in this RIS are from the Corporations Act unless otherwise stated). A debenture is a security, so the obligations for the offer of securities in the fundraising provisions in Ch 6D apply to the offer of debentures, including the requirement to prepare a prospectus for the offer of securities, and guidance on advertising and publicity for the offer of securities.
6. Chapter 2L has requirements that are unique to the regulation of debentures, including the requirement to appoint a trustee for debenture holders.

### *Prospectus disclosure*

7. An offer of debentures will generally need to be made under a prospectus unless an exemption applies (s706). The prospectus must:
  - include all information that investors and their professional advisers would reasonably require to make an informed assessment of the issuer and the securities being offered (s710);
  - make specific disclosures (s711); and
  - word and present the prospectus in a clear, concise and effective manner (s715A).
8. The general prospectus content requirement in s710 is designed to:

- promote efficiency in the capital markets;
- promote disclosure of relevant information;
- reduce the likelihood of omitting important information;
- focus issuers on the information needs of investors; and
- be sufficiently flexible to accommodate changes in investors' information needs.

*Requirements for a trustee*

9. The Corporations Act requires that an issuer must enter into a trust deed and appoint a trustee before making an offer of debentures under a prospectus. The trustee has a duty to exercise reasonable diligence to see whether the property of the borrower and guarantors will be sufficient to repay the amount deposited under the debentures and whether there have been breaches of the terms of the debentures or the trust deed. Trustees also owe fiduciary duties to debenture holders (see Ch 2L).
10. There are civil liability consequences for trustees if a person suffers loss or damage because the trustee has contravened provisions of Ch 2L.
11. Further, if ASIC considers that the trustee is not exercising its duties in accordance with our policy, ASIC may apply to the Court to make an order to protect the interests of existing or prospective debenture holders (s283HB).

*Restrictions on advertising*

12. The Corporations Act provides restrictions on advertising and publicity for offers before and after a disclosure document is lodged with ASIC (s 734).
13. The rules on advertising an offer of securities *before* the disclosure document has been lodged are very restrictive (i.e. the advertisement can only include very minimal information about the who the offeror is, and what securities are being offered, as well as where to get the disclosure document).
14. However, the restrictions on advertising an offer of securities *after* the disclosure document has been lodged are more relaxed, and merely require that the advertisement include a statement that the offer of securities will be made in a copy of the disclosure document, and anyone wishing to acquire the securities must complete an application form in the disclosure document.

15. There are also general consumer protection provisions in the *Australian Securities and Investments Commission Act 2001* (ASIC Act), including prohibitions against misleading and deceptive conduct, as well as prohibitions against false or misleading representations.

#### ASIC's current policy

16. ASIC administers the law regulating debentures, within the powers granted by the Corporations Act. This includes reviewing disclosure documents, conducting surveillance and undertaking enforcement action in cases of breach of the Corporations Act (as well as the ASIC Act).
17. While ASIC does not approve prospectuses for lodgment, ASIC monitors and reviews prospectuses. ASIC has powers to make a stop order on a prospectus that has been lodged with ASIC if satisfied that:
  - information in a disclosure document lodged with ASIC is not worded and presented in a clear, concise and effective manner; or
  - an offer of securities under a disclosure document lodged with ASIC contains a misleading or deceptive statement, or omits information from the disclosure statement that is required under the Corporations Act, or a new circumstance has arisen that should be contained in the disclosure document.
18. ASIC has also alerted retail investors to the risks of debentures in the past through media releases on 'speculative debentures' or 'high yield debentures': see for example Media Release (MR 06-290) *Don't invest a cent in a fixed interest investment without using ASIC's 3-way test*. Further, ASIC has taken action against various entities for misleading advertising.

#### ***What is the issue/problem being addressed?***

##### The investment failures

19. At a hearing of the Senate Economics Committee on 30 May 2007, ASIC was asked questions on 3 investment vehicles i.e. Fincorp Investments Limited (Fincorp), Australian Capital Reserve Limited (ACR) and Westpoint Group (Westpoint), that failed after attracting significant funds from large numbers of retail investors. Investors in these vehicles face losses in their investments. Two of the entities that failed had raised funds from

retail investors by issuing debentures that were unlisted (i.e. the security is not listed on a secondary market) and unrated (i.e. the security is not rated for credit risk).

#### Unlisted, unrated debentures

20. The \$34 billion debenture market (noted above in paragraph 2) can be further sub-divided into 4 groups of debentures:

- Listed and rated (\$4 billion)
- Listed and unrated (\$8 billion)
- Unlisted and rated (\$14 billion)
- Unlisted and unrated (\$8 billion).

21. Out of the approximately 135 issuers of debentures, 92 of those issue unlisted, unrated debentures. This means that almost 70% of debenture issuers issue unlisted, unrated debentures.

22. From the types of debentures set out in paragraph 4, the majority (by number of issuers as well as value of debentures issued) fall into the debt capital funding and mortgage financing categories of unlisted, unrated debenture issues. The following table shows the split between different types of issuers and the value of the debentures issued (as at August 2007).

Category	Number of issuers	Debentures \$m (most recent)	Debentures \$m (median)	Interest rates %
Debt capital funding	21	2,682.1	12.8	2.9 – 11
Finance	15	885.3	19.2	5.23 – 11.43
Integrated property	3	72.5	26.6	8 – 9.25
Memberships	7	81.8	8.5	5.6
Mortgage financing	36	3,206.2	48.2	2.35 – 12
Structured real estate investments	10	679.9	27.3	6.45 – 9.9
<b>Total</b>	<b>92</b>	<b>7,607.8</b>	<b>24.8</b>	<b>2.35 – 12</b>



23. We note that this list excludes Fincorp and ACR due to the appointment of external administrators. They had total debentures on issue of \$201 and \$327 million respectively. Had they been included in the above table, Fincorp and ACR would have been categorised as integrated property.

Change of scope from *unlisted, unrated* debentures to *unlisted* debentures

24. The focus of ASIC's consultation paper was on unlisted, unrated debentures. After considering the nature of debentures, it appeared that the risk features of unlisted, unrated debentures were relevant to the wider category of unlisted debentures, rather than the fact that debentures were also unrated. While a credit rating provides some external scrutiny of a debenture issuer, it did not appear that the rating itself contributed to the risk features of the debenture. Rather, we considered that a credit rating was a useful tool to use for better disclosure in the prospectus.

*The risk features of unlisted debentures*

25. Unlisted debentures pose particular challenges, because retail investors who hold these types of securities do not have the benefit of price discovery mechanisms and market forces to:
- help them work out the value of their securities on an ongoing basis; and
  - provide them with a reliable way to exit their investment efficiently.
26. Being unlisted means there is no liquid secondary market on which an investor can sell an investment that is no longer required, or in which the investor has lost confidence. Some debenture issuers offer early exit mechanisms, but these are likely to be unavailable if the issuer is in financial difficulty.
27. The failures noted above in paragraph 19 involved the issue of debentures whose features contribute to the risks that retail investors face. These include:
- *Minimal equity capital* – debenture issuer has little capital relative to the loan funding it relies on to operate its business, which means that if an investment runs into difficulties, there is no source of funds to tide the investment over, other than by raising further investment funds;

- *Liquidity* – liquidity is often at risk because of a mismatch between the timing of the issuer's obligations to repay debenture holders, and the timing of cash flows from the underlying businesses or assets to which funds have been on-lent;
  - *Loan assessment and diversification* – debenture issuers' loan book exposure is often not diversified;
  - *Inconsistency in valuations* – there are often differing assumptions and instructions, making it difficult to assess reliably the risk exposure associated with a loan;
  - *Related party lending* – funds raised through debenture issuers are often on-lent to companies or businesses associated with the debenture issuer, which means that there is an increased risk that lending decisions will not be made on arms' length commercial terms;
  - *Advertising* – advertising often creates unrealistic expectations about the relative safety and security of debentures.
28. As the market for debentures has grown in recent times, so too has the market in unlisted debentures. The high interest rates attract those investors who are keen for a higher return than they might get from a deposit product issued by an authorised deposit-taking institution. They are often unaware of the risks of investing in unlisted debentures.

#### *Trustees*

29. As noted above in paragraph 9, a trustee must be appointed before debentures are offered to retail investors. The trustee has the power to call meetings of the investors of debentures, and provide information and make recommendations to the investors (s283EB). This is an important protective measure, as the trustee has greater resources and experience than retail investors, and is therefore more likely to identify issues with the financial position and performance of the issuer.
30. It appears that the trustees' role has not been used to its full extent in the past. This may be because there has not been enough guidance for trustees on their obligations under the Corporations Act.

*Identifying the problem*

31. Retail investors, who are usually attracted to debentures because of the high interest rates offered, are often unaware of the risks involved, particularly for unlisted debentures. These risks can lead to debentures underperforming, and the returns being weaker than investors' expectations.
32. Given the risk features of unlisted debentures, combined with the failures that have occurred in the recent past, ASIC has identified the unlisted debentures sector as a priority for review, and possible regulatory intervention.
33. While the regulatory framework in the Corporations Act (outlined in paragraphs 7–8) is intended to provide adequate disclosure for the offer of securities, there appears to be a need for improved disclosure in the prospectus to enable investors to better assess the risks of unlisted debentures. If investors are better informed about the risks involved in the investments they are about to make, they are then better equipped to make an investment decision that suits their needs and future.
34. In addition to the gap in disclosure, and the potential for misleading advertising of debentures, it appears that the role of the trustee has not been as effective as intended by the legislation.

## Objectives

35. ASIC is seeking to balance:
  - the need to improve disclosure to allow investors to make informed decisions; and
  - the desirability of not unduly interfering with this market as a market for raising capital.
36. The need to strike an appropriate balance between protecting investors' interests and allowing markets to operate freely is part of ASIC's mandate under the ASIC Act. It is also reflected in the Government's Statement of Expectations and ASIC's Statement of Intent. These documents were published in August 2007.

# Options

## ***Option 1 – do nothing***

37. One option is that ASIC not intervene at all in the unlisted debentures sector. That is, ASIC could decide that nothing new needs to be done in this sector.
38. Under this option, ASIC would continue to administer the law under its current policy settings. For example, prospectuses would continue to be required as and when they currently are, but our proposed additional disclosures would not apply.

## ***Option 2 – additional disclosure in prospectuses, including benchmarks that apply (as appropriate), guidance on advertising, expectation of trustees, investor education***

39. This option seeks to require improved and additional disclosure, with the goal of improving risk assessment by retail investors. Under this option, we would:
- (a) establish benchmarks that help retail investors assess the risk and risk-reward prospects of unlisted debentures. Some of the benchmarks apply to all issuers, while others apply to a subset only;
  - (b) require issuers of unlisted debentures to include the relevant benchmarks in their disclosures on an 'if not, why not' basis;
  - (c) set standards for advertisements of debentures;
  - (d) require trustees to use the benchmarks and the 'if not, why not' explanations in carrying out their responsibilities; and
  - (e) provide additional education to assist investors and potential investors in the unlisted, unrated debentures sector.

## **Benchmarks**

40. We propose the following 8 benchmarks, based on significant areas of potential risk for retail investors in unlisted debentures.

Benchmark	Description of benchmark
<i>Applies to all issuers</i>	
Equity capital	<p>Issuers would be required to have a minimum amount of equity capital:</p> <ul style="list-style-type: none"> <li>• Where more than a minor part of the issuer's activities is property development or lending funds directly or indirectly for property development – the issuer should maintain a minimum of 20% equity;</li> <li>• In all other cases – the issuer should maintain a minimum of 8% equity; and</li> <li>• The debenture issuer's equity ratio should be calculated as:  <math display="block">\frac{\text{equity capital}}{\text{total debt} + \text{equity capital}}</math> </li> </ul>
Liquidity	Issuers would be required to estimate their cash needs for the next 3 months and ensure that at all times they have on hand cash or cash equivalents sufficient to meet their projected cash needs over the next 3 months.
Rollovers	Issuers should clearly disclose their approach to rollovers, including whether the 'default' is that their investments are automatically rolled over.
Credit ratings	Issuers should get a rating for their debentures for the credit risk by a recognised credit rating agency. The rating should be disclosed in the prospectus, along with an explanation of what the rating means.
<i>Applies to lenders only</i>	
Loan portfolio	Issuers would be required to disclose the number, type and value of loans they have or expect to have in the coming 12 months.
Related party transactions	Issuers must disclose their policy on related party transactions such as how many loans they have made or expect to make in the coming 12 months to related parties, as well as the assessment and approval processes followed with the related party loans.

<i>Applies to issuers of property-related debentures only</i>	
Valuations	Issuers would be required to value property and assets in certain ways that are objective and independent, and to disclose the valuations correctly in the prospectus.
Lending principles – loan-to-valuation ratios	<p>Issuers would be required to maintain set loan-to-valuation ratios:</p> <ul style="list-style-type: none"> <li>• Where the loan relates to property development – 70% on the basis of the latest 'as if complete' valuation; and</li> <li>• In all other cases – 80% on the basis of the latest market valuation.</li> </ul>

### **If not, why not disclosure**

41. Issuers should disclose whether they meet the benchmarks described in the table above, and if not, why not. 'Why not' means explaining how an issuer deals with the issue underlying the benchmark.
42. Disclosure on an 'if not, why not' basis would be required:
  - Upfront in the prospectus; and
  - As material changes occur, in a replacement prospectus, supplementary prospectus or continuous disclosure notice, and at least twice a year, in quarterly reports to trustees.

### **Advertising guidance**

43. Along with the benchmarks and 'if not, why not' disclosure, we would provide guidance on advertising.
44. ASIC proposes to impose the following advertising standards on issuers of unlisted debentures:
  - Only quote interest rates if the interest rate is accompanied by equally prominent disclosure of either
    - a current credit rating of the debenture received from a recognised credit rating agency; or
    - a statement that the debenture does not have a current credit rating from a recognised credit rating agency;
  - Debenture issuers should not refer to investment ratings of the debenture or the issuers;

- Debenture advertisements should not refer to the credit ratings issued by an entity other than a recognised credit rating agency;
- Debenture advertisements should not imply that the debenture is, or is comparable to, a bank deposit;
- Debenture advertisements should not give the impression that there is little or no risk of the investor losing their principal or not being paid interest. This means that terms such as 'secure', 'secured', 'guaranteed', 'safe', and 'first ranking' should be avoided; and
- Debenture advertisements should not state or imply that the investment is suitable for a particular class of investor.

### **Expectation of trustees**

45. As part of this option, ASIC would publish our expectations of the trustee's obligations.

46. We would:

- expect trustees to actively monitor the financial position and performance of the issuer;
- expect trustees to regularly assess and form a view about the financial position and performance of the issuer; and
- expect trustees to promptly notify investors and ASIC where the trustee forms the view that the issuer is failing to meet the promises made in their disclosure documents or that there have been material adverse changes in the financial position or performance of the issuer.

### **Education of investors**

47. As a complement to the additional disclosure requirements under this option, ASIC would address investor education needs by:

- developing and publishing an investor guide to understanding the disclosure documents used in connection with unlisted debentures;
- encouraging issuers of unlisted debentures to provide investors with a copy of the investor guide with the prospectus and prior to rollover of their investments;

- conducting a broader education program directed to improving consumer understanding of the need for investment diversification;
- consulting with industry participants on ways to provide targeted seminars; and
- exploring with industry participants options for funding a broad investor program.

48. Educating investors will help them understand and use the benchmarks and the ‘if not, why not’ responses in their investment decision-making.

***Option 3 – additional disclosure in prospectuses, including benchmarks that apply to issuers of unlisted debentures (as appropriate), guidance on advertising***

49. This option would mirror the first three aspects of Option 2. That is, ASIC would require:

- additional disclosure in prospectuses of the benchmarks proposed in Option 2;
- if the issuer has not satisfied a benchmark, the issuer must explain why not; and
- give guidance on the content of advertisements of unlisted debentures.

50. The difference with Option 2 is that ASIC would not publish its expectation of trustees, nor provide any investor education programs. Option 3 can be distinguished by its focus on the obligations of issuers of unlisted debentures, whereas Option 2 is more holistic in its approach.

***Option 4 – additional disclosure in prospectuses, including mandated benchmarks, guidance on advertising, expectation of trustees, investor education***

51. This option would mirror Option 2, but there would be no option of giving an ‘if not, why not’ explanation. That is, the issuer must meet all the benchmarks, otherwise the prospectus will not comply with ASIC’s requirements (and the debenture cannot be offered without a complying prospectus).



**Option 5 – investor education, guidance and warnings**

52. Another approach would be to just use investor education, guidance and warnings to address the market failures (i.e. without imposing any benchmarks or further disclosure obligations on issuers): see paragraphs 47–48 for the proposal on investor education.

## Impact analysis

**Affected parties**

53. Parties affected by the proposed policy would be:

- issuers of unlisted debentures;
- trustees
- investors who receive an offer of unlisted debentures;
- ASIC and the government.

**Costs and benefits of each option**

Option 1 – do nothing

**Benefits**

54. In the short-term, the status quo (i.e. doing nothing) avoids new direct costs on industry, as there are no changes to how issuers of unlisted debentures are regulated. However, there are no *incremental* benefits of maintaining the status quo.

**Costs**

55. Maintaining the status quo is likely to involve some costs to the industry. As there have been a number of material failures, doing nothing (i.e. no changes to the regulatory settings) is likely to mean that some potential investors avoid unlisted debentures and pursue other better-regulated investment opportunities.

56. Doing nothing also means that there will be no amelioration of the risk of further failures, which may dampen general confidence in the unlisted debenture sector. The unlisted debenture market has a value of about \$22 billion (out of a \$34 billion debenture industry), with most of the failures in this unlisted debenture space. Companies that have raised almost \$1 billion have fallen

into financial difficulty. This results in both a monetary and future confidence cost. Together, these factors are likely to result in an increase in the cost of raising capital through unlisted debentures (i.e. investors may demand a greater risk premium).

57. Further, maintaining the status quo is likely to particularly affect the better-run issuers of unlisted debentures. Without any changes to the regulatory settings, the better-run issuers are likely to find it difficult to differentiate themselves from other issuers and signal their greater quality to investors. As such, they are likely to suffer the same reduction in confidence and increase in funding costs discussed above. This may result in some self-selection issues, with the better quality issuers exiting the industry.
58. Over time, the lack of a regulatory response may compound the cost for industry and investors. That is, not intervening now may mean that the cost of any eventual intervention is much higher.
59. While not changing the regulatory settings will not, of course, cause any failures, leaving the settings forgoes the opportunity of reducing the risk of failures by improving the settings. As such, leaving the settings unchanged is likely to have a significant (if difficult to quantify) cost.

Option 2 – additional disclosure in prospectuses, including benchmarks that apply (as appropriate), guidance on advertising, expectation of trustees, investor education

### **Benefits**

60. The entire package proposed in Option 2 is designed to benefit issuers of unlisted debentures as well as those who invest in unlisted debentures. This intervention is intended to promote better disclosure in prospectuses for the purposes of better enabling investors to assess the risks involved in investing in unlisted debentures.

#### *Benefits of requiring benchmarks*

61. Requiring additional disclosure about the relevant risk areas for these products will have significant benefits for industry. While additional disclosure will not directly prevent further failures, it is likely to impose some discipline on issuers (e.g. by requiring them to disclose their financial position and performance more clearly). This should encourage issuers to adopt more robust business models, as it will assist investors to price the risk associated with

riskier business models more appropriately (and demand appropriately high rates of interest rates for such debentures).

62. Better disclosure should assist individual investors to better assess whether to invest in particular unlisted debentures. This will help them to decide whether a particular debenture offer is appropriate for them, particularly in relation to its risk characteristics.

*Benefits of tailoring the benchmarks to issuers, as appropriate*

63. We have considered this approach because some benchmarks are not relevant to all issuers. For example, we have proposed exempting finance companies that enter into leasing/hire purchase agreements from the requirement to maintain a particular loan-to-valuation ratio because these entities, by their very nature, sometimes lend 100% of the value of the asset.

*Benefits of the 'if not, why not' approach*

64. An additional benefit of this particular approach is flexibility. The 'if not, why not' approach means that issuers who for good reason do not meet a particular benchmark (e.g. because their equity ratio is lower than the benchmark), can explain that they do so because they have alternate methods of ensuring stability (e.g. because their business model is more conservative, or they have a binding commitment from their parent company to supply additional capital on short notice).

*Benefits of guidance on advertising*

65. The benefits of providing guidance on advertising include the benefits of greater transparency generally as discussed above.
66. Our research suggests that those with more 'aggressive' (i.e. riskier) business models tend to make greater use of advertisements. It also suggests that many investors who have lost money in previous failures have placed undue weight on the 'information' communicated by the advertisements, as opposed to the more detailed and robust information available in the prospectus. One additional benefit is that setting standards on advertising is likely to discourage some of the higher risk products using blanket advertising to encourage investors to purchase debentures they would not otherwise be interested in.

*Benefits of giving guidance to trustees*

67. Giving trustees guidance on the trustee's role will help ensure that there is a third party to monitor the financial position and

performance of the issuer. Industry will benefit from greater certainty about ASIC's expectation of them. From consultation with some representative bodies, we understand that there is some uncertainty at present about what the law requires (and what ASIC expects).

68. Further, investors will benefit from the higher expectations being placed on trustees and others. Trustees have the potential to provide valuable oversight of unlisted debenture issuers, and are in a better position than investors to effectively monitor issuers.

*Benefits of investor education*

69. The proposal to complement the additional disclosure with investor education materials will help investors to understand the benchmarks and explanations given by issuers of unlisted debentures.

**Costs**

*Costs of requiring compliance with benchmarks*

70. Requiring additional disclosure will have some direct cost impacts on industry. We understand that obtaining a rating is likely to cost between \$20,000-\$40,000 per issuer. However, complying with the benchmark would not necessarily be mandatory – this is because this option provides for an 'if not, why not' explanation.
71. For all issuers, there will be some ongoing costs from this approach. No additional documents are required, but our proposed policy would require that ongoing disclosure documents contain some information about performance against the benchmarks. The incremental cost is difficult to quantify, but is likely to be a material amount at least for the first preparation of these enhanced disclosure documents by each affected issuer.

*Costs of giving guidance on advertising*

72. Following the guidance on advertising for these products will have some cost to industry. Additional warnings required in advertisements might increase slightly the cost of advertisements.
73. Further, the guidance on advertising might discourage some issuers from advertising, which might have an impact on their ability to raise funds. However, we are not proposing to prohibit advertising – the guidance merely relates to better disclosure of the risks of investing in a debenture, and prevention of statements that could be misleading.

*Costs of giving guidance to trustees*

74. Trustees may find that there is a cost in following the guidance set by ASIC. Trustees might need to expand their current role in order to fulfil their statutory obligations. This may lead to an increase in the fees trustees charge, which would have an impact on issuers.

*Wider impacts on the unlisted debenture market*

75. Complying with the requirements set under Option 2 might increase the overall cost of fundraising through the issue of debentures. This is due to the increased costs associated with additional disclosure against the benchmarks, the increased cost of appointing a trustee, as well as the increased costs associated with complying with the advertising standards (see below for more detail on separate costs).
76. The overall increased cost could result in the cost of issuing debentures being too high for some debenture issuers. While this may be a disadvantage for some issuers, we think the benefit outweighs the cost because the package of additional disclosure, obligations on issuers and trustees, and advertising standards creates a transparent marketplace for investors.
77. Increased costs of issuing unlisted debentures could lead to issuers turning to other methods of raising funds – such as offering other types of securities (e.g. shares), offering interests in managed investment schemes, or offering securities to wholesale rather than retail investors. Some of these methods might be more costly than issuing unlisted debentures, and some might be cheaper. The method chosen will depend on the business structure and the aims of the business.
78. We do not think the detriment to the market of unlisted debenture issuers turning to other methods of fundraising, such as issuing shares or interests in managed investment schemes will be significant. Those who invest in shares often have a better understanding of their investment, particularly of the risks of not getting the principal back. Those who invest in managed funds benefit from other protections for retail clients, such as the requirement of a responsible entity to hold a licence.
79. Entering into the wholesale market might be an option, although again, this will depend on the goals of the business. The wholesale market has fewer rules and regulations for an offer of securities, or the provision of financial services because the clients are generally more sophisticated than retail clients. For example, the offer of

securities to sophisticated investors does not need a prospectus (s708(8)).

80. There is a risk that the cost of issuing unlisted debentures might push issuers to less regulated areas of fundraising, such as the issue of promissory notes that do not fall within the definition of 'debenture'. However, while this might be a risk, ASIC can oversee such issues under general provisions of the Corporations Act and the ASIC Act. Further, it has been the case that some substantial promissory note-based schemes can be characterised as managed investment schemes, which brings them under the more rigorous managed investment scheme regime.
81. Overall, we consider that the regulatory benefit of Option 2 – the better disclosure and additional information to help investors assess the risk of their investment – outweighs the possibility of issuers of unlisted debentures not being able to offer securities.

Option 3 – additional disclosure in prospectuses, including benchmarks that apply to issuers of unlisted debentures (as appropriate), guidance on advertising

### **Benefits**

82. The benefits of Option 3 (disclosure against benchmarks and guidance on advertising) would be the same as those outlined in paragraphs [61–66] of Option 2. Option 3, however, does not include the guidance to trustees on what is expected of them under the law, nor the investor education.
83. The benefit of not having guidance for trustees is that trustees will not incur any costs in following guidance set by ASIC. They would not be required to expand their role or increase their fees.

### **Costs**

84. The costs of Option 3 would be the same as those outlined in paragraphs [70–73] and [75–80] of Option 2.
85. In addition, as noted above, Option 3 does not include guidance on what is expected of the trustees. This could create costs for trustees because trustees may be uncertain about their expected role in monitoring and reviewing the issuers of unlisted debentures. Also, investors would miss out on the protection from trustees meeting our proposed higher expectations.
86. Further, excluding investor education from Option 3 would mean that investors would not be given guidance on understanding the

benchmarks and disclosures in prospectuses for the offer of unlisted debentures. We think such education of investors is important for the effectiveness of the proposal. If investors do not understand the additional disclosure, then there will be considerably less value in implementing the benchmarks and explanations.

Option 4 – additional disclosure in prospectuses, including mandated benchmarks, guidance on advertising, expectation of trustees, investor education

### **Benefits**

87. The benefits of Option 4 would be similar to those outlined in paragraphs [61–62] and [65–69] of Option 2.
88. The difference between Options 2 and 4 is that Option 4 provides less flexibility in the application of the benchmarks. This could benefit the market by creating a level playing field for all issuers of unlisted debentures, as no issuer would be exempt from any of the benchmarks.
89. Further, the 'if not, why not' approach would require some subjective assessment of why the particular benchmark has not been met, and whether the explanation given by the issuer is adequate. Excluding the option of giving an 'if not, why not' explanation simplifies the disclosure requirements. This will enable investors to know that all prospectuses for unlisted debentures have met all benchmarks, with no exception.

### **Costs**

90. The costs of Option 4 would be similar to those outlined in paragraphs [70–80] of Option 2. However, there would be additional costs in adopting this option.
91. A major additional cost of Option 4 is that there is no flexibility for issuers of unlisted debentures. This means that issuers will be required to assess their debentures against all the benchmarks, with no exception. The cost of applying each benchmark against their debentures will be disproportionate to the benefit for some issuers.
92. Further, under Option 4, the issuer is not given the option of providing a reason for not meeting the benchmark. The 'if not, why not' approach allows issuers, who for good reason do not meet a particular benchmark (see paragraph 64 for the benefits of

the 'if not, why not' approach), the flexibility to choose the method of disclosure that works best for their business. By not allowing this flexibility, issuers of unlisted debentures would be compelled to apply a benchmark that might not give the best outcome for their business.

93. Finally, it is not certain that Option 4 would be legally available if we were to adopt this option. The reason for this is that the Corporations Act requires that issuers give adequate disclosure with an offer of securities (see paragraphs [7–8] for an outline of the requirements). Mandating the benchmarks might go beyond the ability of ASIC to provide guidance on disclosure in prospectuses. This could lead to possible test cases to ascertain the validity of the guidance, which would be a cost for everyone involved (regulator and industry alike).

#### Option 5 – investor education, guidance and warnings

##### **Benefits**

94. Education and guidance may help investors better assess unlisted debentures. Warnings by ASIC or others may also assist investors know which risks to be aware of and even which issuers to avoid (if it was sufficiently clear that a given issuer deserved such a warning).
95. Investor education will have some benefit to industry as well, to the extent that better informed investors have greater confidence in the capital market (or at least in better quality issuers) and this has a positive effect on the cost of raising capital through unlisted debentures
96. Another benefit of this option is that the additional disclosures against the proposed benchmarks of Options 2–4 would not be imposed. Rather than imposing obligations on issuers of unlisted debentures, the focus of Option 5 would be on educating the investor. Therefore, issuers of unlisted debentures would not be burdened with the cost of complying with the proposed additional disclosures.

##### **Costs**

97. Additional investor education and guidance about the relevant risk areas for these products will impose no additional cost on industry (except of course to the extent that industry directly contributes funds to investor education campaigns).



98. The main disadvantage of Option 5 is that it is an incomplete answer to the issue at hand. While it is important to educate investors on how to assess risks of unlisted debentures, and to understand the investments they make, such education programs would not be effective without adequate and meaningful disclosure of the risks attached to unlisted debentures. The education of investors is a tool for investors to better understand the proposed additional disclosures.

## Consultation

99. As outlined above, ASIC was asked at a hearing of the Senate Estimates Committee about the collapses of Westpoint, Fincorp and ACR. ASIC outlined its understanding of the common features of those failures. The analysis showed that unlisted debentures was a sector of the securities market that held some risks for investors that might not be adequately addressed by the current regulatory regime.

100. ASIC outlined to the Senate Estimates Committee its priority in examining unlisted debentures, and the proposal to implement a 3-point plan over a 12-month period addressing:

- existing debenture issuers in the retail sector;
- new debenture issues to retail investors; and
- investor education.

101. ASIC consulted with a range of industry experts on the weaknesses and risks in business models that unlisted debentures use and what mechanisms might be available to help ensure those weaknesses are fully disclosed.

102. On the basis of the work with industry experts, ASIC published CP 89 on 23 August 2007, which set out our proposed policy on unlisted, unrated debentures. ASIC invited written and oral comments on our proposed policy and asked for quantitative and qualitative information.

103. The consultation period ended on 1 October 2007. ASIC received more than 60 written submissions from stakeholders, including issuers of debentures, industry associations, ratings agencies, consumer groups and auditors. Most of the submissions recognised that there was a problem and that some action was required, although there was great divergence in the submissions.

The following are examples of some of the views expressed in the written submissions:

- There was general support for the imposition of benchmarks, although many respondents considered that some of the benchmarks should not apply to them. ASIC has responded to this issue by proposing to tailor the application of the benchmarks (see table in paragraph 40 for ASIC's proposals in relation to the application of benchmarks).
- There was a mixed response to the proposed the equity ratio for non-property development debentures. Those who did not support the proposed 10% equity argued that this ratio exceeded industry practice, and others suggested that such a ratio would put smaller companies in financial jeopardy. ASIC responded to these concerns by reducing the level of equity capital to 8%, which we understand is the current average ratio for the non-property development entities.
- There was general support for guidance on advertising unlisted debentures. However, there was disagreement about the requirement to disclose a credit rating in an advertisement, as well as the proposal to prohibit the use of terms such as 'secure' or 'no fees' when this is in fact the case. ASIC has responded to these submissions by consulting further on advertising.

Note: If we make significant changes to our guidance as a result of the feedback we receive, we will contact the Office of Best Practice Regulation to ensure that we comply with our regulatory impact analysis requirements.

- Most respondents agreed in principle to the proposals on providing guidance on the expectations of trustees. There were some concerns raised about the increase in the fees charged by trustees if their role were increased. ASIC has not changed its position on trustees, but has outlined in the guidance that the duty for trustees to monitor the financial position and performance of the issuer is part of their existing obligation to exercise reasonable diligence under the Corporations Act.

## Conclusion and recommended options

104. ASIC considers that Option 2 (*additional disclosure in prospectuses, including benchmarks that apply (as appropriate), guidance on advertising, expectation of trustees, investor education*) is the preferable option. Option 2 provides a holistic package that is designed to benefit issuers of unlisted debentures as well as those who invest in unlisted debentures. The benchmarks and the 'if not, why not' disclosure are intended to provide better information for investors to adequately assess the risks of the debentures. We have tailored the benchmarks so that some of the benchmarks apply to all issuers, while others apply to a subset only. We have separated the benchmarks in this way because some are not applicable to certain types of debenture issuers. The guidance for trustees is to give more certainty about the role of trustees, while the guidance on advertising is intended to provide greater transparency for investors to make prudent decisions. The investor education completes the package by helping investors to understand the additional disclosure proposed.
105. While Option 2 may impose costs on issuers of unlisted debentures (e.g. the cost of obtaining a credit rating for the debenture), we consider that the initial and ongoing costs are outweighed by the benefit of empowering investors with the ability to assess the merits of investing in unlisted debentures.
106. We do not recommend Options 1 (*do nothing*), 3 (*additional disclosure in prospectuses, including benchmarks that apply to issuers of unlisted debentures (as appropriate), guidance on advertising*), 4 (*additional disclosure in prospectuses, including mandated benchmarks, guidance on advertising, expectation of trustees, investor education*) and 5 (*investor education, guidance and warnings*). Option 1 does not provide any solutions to the challenges raised by the unlisted debenture market. Options 3 and 4 do not provide the rounded package for better disclosure, flexibility and investor education that Option 2 offers. Finally, Option 5 is only directed at changing investor behaviour, rather than addressing the behaviours of issuers of unlisted debentures.

# Implementation and review

## *Implementing proposals*

107. ASIC will expect that issuers comply with the additional and improved disclosure requirements for their new fundraising documents, as well as for ongoing disclosure documents.
108. The transitional period will differ for new issuers and existing issuers as follows:
- New issuers to comply with 'if not, why not' benchmarks from 1 December 2007;
  - Existing issuers to comply with 'if not, why not' benchmarks from 1 March 2008.
109. ASIC will review fundraising documents and reports against the 'if not, why not' approach from March 2008 to June 2008. This review will check that the benchmarking information is adequately disclosed to investors.
110. Over this period, we will also:
- work with issuers and trustees to ensure that the benchmarks and our disclosure expectations are understood;
  - discuss any concerns we have with an issuer's disclosure with the issuer and, where necessary, require additional disclosure (e.g. about the practical impact of not following a particular benchmark and the associated risks for investors);
  - discuss any concerns we have about the financial position and performance of an issuer with the issuer and trustee; and
  - conduct surveillance visits as needed to reinforce our disclosure expectations.
111. As outlined in paragraph 17, ASIC can use its stop order powers if it considers that a prospectus does not comply with the prospectus content requirements. Once the transition period is over, ASIC will continue to review the fundraising documents on an ongoing basis. ASIC will have recourse to the stop order powers if the documents do not comply with the benchmarks and 'if not, why not' disclosure.
112. Further, if ASIC considers that the trustee is not exercising its duties in accordance with our policy, ASIC could apply to the Court to make an order (see paragraph 11).

### ***ASIC guidance***

113. Our proposed policy will be implemented by publishing several documents setting out our expectations and reasons. These will include:

- our policy on the issuer's obligation to comply with the benchmarks and the 'if not, why not' approach, as well as the expectation of trustees;
- a Consultation Paper seeking comments on our proposed guidance on advertising, followed by a separate guide on advertising; and
- an investor guide.