

## MEMORANDUM

<b>To:</b>	James Mawhinney & Rodney Watson, <i>IPO Capital Pty Ltd</i>
<b>From:</b>	Venn King & Clea Cole, <i>KHQ Lawyers</i>
<b>Date:</b>	a.m. Friday 02 February 2018
<b>Matter:</b>	IPOC - Borrowing Business (9288)
<b>Subject:</b>	<b>Overview of the Regulation of Conducting a Business of Borrowing Money from Private Investors</b>

Dear James and Rodney,

### EXECUTIVE SUMMARY

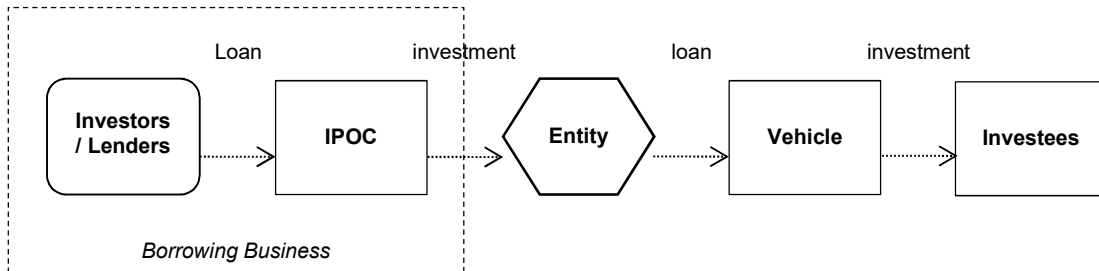
**Wholesale** - If the Borrowing Business involves 'wholesale' investors only, the following applies:

- **ACL** - The activities of the Borrowing Business (borrowing and investing the proceeds of the Loans) do not relate to a type of credit to which the Code applies, and accordingly IPOC does not require an ACL.
- **Ch 6D Disclosure**
  - **Debentures** - The Loans are "debentures" for the purposes of the Corporations Act, as none of the relevant exemptions applies.
  - **Securities** - Debentures are included in the definition of "securities", and accordingly the Loans are also securities for the purposes of the Corporations Act.
  - **Disclosure** - Therefore, IPOC (undertaking the Borrowing Business) is required to make disclosure to investors/lenders before originating the Loans, *unless* a relevant exemption applies.
  - **Exemptions** - In the case of the Borrowing Business, the exemptions most likely to apply are the "sophisticated investor" and "professional investor" exemptions – for 'wholesale' but *not* 'retail' investors/lenders.
  - **Confirmation** - IPOC will need to confirm that the investors/lenders fit within these exemption categories. If so, no disclosure will be required.
- **Ch 2L Debentures** - The provisions of CA Ch 2L which regulate debentures (i.e. the Loans) will not apply, *provided that* the Borrowing Business is exempt from the disclosure obligations in CA Ch 6D (see above).
  - **Retail** - If 'retail' investors/lenders are involved, these restrictive provisions will apply, involving the appointment of a debenture trustee.
- **Ch 7 Licensing** - The Borrowing Business is likely to require the involvement of an AFSL, as it is likely to be a financial services business which deals in (by issuing) a financial product (i.e. securities), in circumstances where the 'self-dealing' exemption will not apply.

**Retail** - If the Borrowing Business involves 'retail' investors, the above changes, as described below.

## 1. Background

- 1.1 Borrowing Business - You have told us that IPO Capital Pty Ltd (“**IPOC**”) proposes to conduct a business (the “**Borrowing Business**”) of borrowing money from private investors (qualifying as both ‘wholesale’ and ‘retail’ clients) on an unsecured basis (“**Loans**”). IPOC will invest the Loan amounts into another entity, which will use the monies to make further loans to vehicles, which will themselves use the monies for investment purposes.



- 1.2 Explanation - You have asked for a high-level overview of the relevant regulation that would apply to the Borrowing Business, including consideration of:
- Code* - whether the National Credit Code (the “**Code**”) (contained in Schedule 1 to the *National Consumer Credit Protection Act 2009* (Cth) (the “**Credit Act**”)) would apply to the conduct of the Borrowing Business; and
  - debentures* - whether the Loans would be “debentures” for the purposes of the *Corporations Act 2001* (Cth) (the “**Corporations Act**” or “**CA**”).

## 2. Australian credit licence

- 2.1 ACL - If a party engages in “credit activities” it will generally need an Australian credit licence (“**ACL**”), or an authorisation from an ACL holder, before starting business, *unless* the relevant “credit activities” are exempt from the licensing requirements.
- 2.2 Credit activities - “Credit activity” is defined in the Credit Act and includes providing credit contracts, securing payment obligations by related mortgages and guarantees, and providing credit services. To decide if a party engages in “credit activities”, it first needs to consider whether the activities relate to a type of credit to which the Code applies.<sup>1</sup>
- 2.3 Code does not apply - The activities of IPOC (undertaking the Borrowing Business) will not relate to a type of credit to which the Code applies, for the following reasons:
- Provision of credit* - The Code only applies to the provision of credit if (as set out in paragraph 5(1)(b) of the Code) the credit is provided or intended to be provided wholly or predominantly for one of the following purposes:
    - PERSONAL - for personal, domestic or household purposes;
    - RESIDENTIAL PROPERTY - to purchase, renovate or improve residential property for investment purposes; or

<sup>1</sup> See ASIC Regulatory Guide RG 203 (*Do I need a credit licence?*), paragraph 203.3.

- (iii) REFINANCING - to refinance credit that has been provided wholly or predominantly to purchase, renovate or improve residential property for investment purposes.
- (b) *Application* - The other requirements for the Code to apply (see paragraph 5 of the Code)) are:
  - (i) DEBTOR - the debtor is a natural person or a strata corporation - *likely* to be the case for many of the investors/lenders, who may be individuals;
  - (ii) CHARGE - a charge is or may be made for providing the credit - *will* apply for all of the investors/lenders, who will charge interest on the Loans; and
  - (iii) BUSINESS - the credit provider provides the credit in the course of a business of providing credit carried on in Australia or as part of or incidentally to any other business of the credit provider carried on in Australia - *unlikely* to be the case for most of the investors/lenders, who are not likely to be conducting a lending business.
- (c) *Purpose of credit for Borrowing Business* – Regardless of the other criteria, we understand that the ‘purpose’ test will not be met, as we understand that the credit to be provided by the investors (the lenders providing the Loans) for the purposes of the Borrowing Business, will be provided for *investment* purposes (as IPOC (the debtor) intends to *invest* the Loan amounts into a third entity (in return for units in that entity), which will then *lend* the relevant funds to a fourth vehicle, which will then *invest* the funds (in return for securities) into pre-initial public offering and other early stage businesses) and not wholly or predominantly for “personal, household or domestic purposes” or for “residential property investment”. If this understanding is correct, the Code will not apply, and no ACL will be required.

### 3. Debentures

- 3.1 Meaning of debenture - The Loans to be provided to IPOC (undertaking the Borrowing Business) will be regulated by the provisions of the Corporations Act if they qualify as “debentures” for the purposes of the Act, which are defined in CA s9 (*Dictionary*) as:

“**debenture** of a body means a chose in action that includes an undertaking by the body to repay as a debt money deposited with or lent to the body. The chose in action may (but need not) include a security interest over property of the body to secure repayment of the money. However, a debenture does not include:

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

[certain non-relevant specified items]” (emphasis added).

3.2 Loans are debentures

- (a) *Broad* - The above definition is very broad and includes all undertakings to repay money lent to the body, regardless of whether these undertakings are documented or not.
- (b) *No exception* - The exception given is not likely to apply to the Borrowing Business, as it is unlikely that all the investors/lenders will be conducting a *business* (being under

common law, in summary, a series of activities involving system, repetition and continuity) of lending (or even investing), regardless of whether or not IPOC conducts a business of borrowing money (which it *will*) and providing finance (which it *will not*, as it will invest the money in return for equity interests in the third entity, as opposed lending the money as debt finance to the third entity - regardless of whether the third entity itself uses the money for investment or lending purposes).

- (c) *Debentures* - Accordingly, the Loans are likely to be “debentures” for the purposes of the Corporations Act.

### 3.3 Categories of debentures

- (a) *Categories* – CA s283BH (*How debentures may be described*) of the Corporations Act (including as modified under Australian Securities and Investments Commission (“ASIC”) Class Order CO 12/1482 (*When debentures can be called secured notes*)<sup>2</sup>) sets out specific rules on how debentures can be described. The categories of debentures under CA s283BH are: (i) mortgage debentures; (ii) debentures; (iii) secured notes; and (iv) unsecured notes or unsecured deposit notes (these two terms are interchangeable under the Corporations Act).
- (b) *Use* - Whether an issuer may use one of these names depends on the type of property offered as security (if any) and, if offered, whether it is sufficient and reasonably likely to be sufficient to repay the money owed.
- (c) *Loans would be unsecured notes* – In this case, we understand that the Loans will be unsecured, and will not therefore meet the standards to be called a ‘debenture’ or ‘secured note’ for the purposes of CA s283BH. Instead, the Loans (as debentures) will fall into the category of ‘unsecured note’ or ‘unsecured deposit note’.
- (d) *Application* - Note that this descriptive categorisation *only* applies to debentures requiring formal disclosure to investors/lenders, which is *not* likely to apply here if ‘retail’ investors are not involved (see below).

- 3.4 Loans are securities - “Debentures of a body” are included in the definition of “securities” at CA s92 (*Securities*) in all circumstances, and accordingly the Loans will also be securities.

## 4. Disclosure

### 4.1 CA Ch 6D (Fundraising)

- (a) *Disclosure* - CA Ch 6D regulates the fundraising activities of entities and requires that all offers for the issue of securities (i.e. the Loans as debentures) require disclosure to investors (by way of prospectus or other disclosure document), *unless* an exemption applies (CA s706 (*Issue offers that need disclosure*)).
- (b) *Exemptions* - In the case of the Borrowing Business, the most relevant exemptions to the requirement for disclosure are the “sophisticated investor” and “professional investor” exemptions.

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<sup>2</sup> See also ASIC Regulatory Guide RG 69 (*Debentures and notes: Improving disclosure for retail investors*).

#### 4.2 Sophisticated investor exemption

- (a) *Exemption* - The sophisticated investor exemption, in CA s708(8) (*Sophisticated investors*), provides that disclosure of an offer for securities is not required if:
- (i) MINIMUM - the minimum amount payable for the securities on acceptance of the offer will be at least \$500k;
  - (ii) AGGREGATE - the investment and previous investments in securities of the same class held by the investor add up to at least \$500k (but any money lent to the investor by the person offering the securities, or an associate, is not included when calculating the \$500k);
  - (iii) CERTIFICATE - a qualified accountant certifies not more than 2 years before the offer is made that the investor has net assets of at least \$2.5m or has gross income of at least \$250k for each of the previous two financial years (an “**Accountant’s Certificate**”); or
  - (iv) ENTITY - the offer is made to a company or trust controlled by a person who meets the net assets or gross income requirements set out immediately above.
- (b) *Confirmation* - We understand that it is intended that most of the investors/lenders who will be providing the Loans to IPOC (undertaking the Borrowing Business), being ‘wholesale’ investors, will fall into this category. What this means is that, in order to take advantage of this exception:
- (i) AMOUNT - each Loan will need to be at least \$500k (as we understand that different Loans will be of different ‘classes’ with different terms, and so the aggregation provision is unlikely to apply); or
  - (ii) CERTIFICATE - an Accountant’s Certificate will need to be provided by the investor/lender to IPOC (undertaking the Borrowing Business) before the relevant offer to undertake the Loan is made to the investor/lender (and thus any information memorandum or other disclosure document relating to the Loans would need to be couched in terms of it being an invitation for potential investors/lenders to apply to receive offers from IPOC, and that it is only open to ‘wholesale’ or ‘sophisticated’ investors).

#### 4.3 Professional investor exemption

- (a) *Exemption* - The other exemption which may apply to the investors/lenders is the professional investor exemption in CA s708(11) (*Professional Investors*). Specifically, an offer of securities does not require disclosure to investors if a person (i.e. the investor/lender) has or controls gross assets of at least \$10m (including any assets held by an associate or under a trust that the person manages), or the person is a particular type of entity (listed in the Schedule to this memorandum, not generally relevant to individuals).
- (b) *Confirmation* - We understand that some of the investors/lenders may fall into this category. but most are not likely to, even though they may be ‘wholesale’ investors.

#### 4.4 Disclosure required?

- (a) *Exemption* - Assuming either the sophisticated investor exemption (likely) or the professional investor exemption (unlikely) applies, where only ‘wholesale’

investors/lenders are involved in the Borrowing Business, IPOC will *not* be required to make disclosure to investors/lenders before originating the Loans.

- (b) *No exemption* - If neither of the above exemptions applies (for example, if 'retail' investors/lenders are involved in the Borrowing Business), and no other relevant exemption applies, then the disclosure rules of CA Ch 6D (*Fundraising*) will apply, and the restrictive rules of CA Ch 2L (*Debentures*) will also apply (see below).
- (c) *Disclosure* - In those circumstances, IPOC would be required to issue a prospectus or other disclosure document.
- (d) *Conversion* - To do this, IPOC would first need to convert to a public company. (We can provide advice in relation to this process if necessary.)

## 5. CA Ch 2L (*Debentures*)

5.1 CA Ch 2L – This chapter regulates the offer and issue of debentures by a body (i.e. IPOC, undertaking the Borrowing Business) in certain circumstances. Namely, where the body is required to enter into a trust deed and appoint a trustee before making an offer/issue of debentures, in accordance with CA s283AA (*Requirement for trust deed and trustee*). The underlying policy rationale of CA Ch 2L is to protect 'retail' investors, and its provisions are relatively restrictive for debenture issuers.

5.2 Trustee / trust deed not required - IPOC (undertaking the Borrowing Business) will not be required to enter into a trust deed or appoint a trustee before making an offer/issue of debentures, and the requirements of CA Ch 2L therefore will not apply, *provided that* (CA s283AA):

- (a) *No disclosure* - the offer of debentures does not require disclosure to investors/lenders in accordance with CA Ch 6D (*Fundraising*) (assuming one of the exemptions to disclosure applies, as discussed above);
- (b) *No takeover* - the offer of debentures will not be made as consideration for the acquisition of securities under an off-market takeover bid; and
- (c) *No administration* - the issue of debentures will not be made under a compromise or arrangement due in the event of external administration.

5.3 Trustee / trust deed required

(a) *Application* - If one of the exemptions to disclosure does not apply (i.e. if the investors are not 'sophisticated' or 'professional' investors for the purposes of the Corporations Act), and the investors/lenders do not fall within another exemption category, they will be viewed as 'retail' investors, and IPOC will be required to:

- (i) **DISCLOSURE** - issue a disclosure document (a prospectus) to investors/lenders before it makes offers for the issue of the debentures, in accordance with CA Ch 6D; and
- (ii) **TRUST** - enter into a trust deed and appoint a trustee before making an offer of debentures under the disclosure document.

(b) *Trustee*

- (i) **DUTIES** - A debenture trustee has a duty to exercise reasonable diligence to see whether the property of the borrower (and any guarantors) will be sufficient to

repay the amount borrowed under the debentures, and whether there are breaches of the terms of the debentures or the trust deed. The trustee would also owe fiduciary duties to debenture holders (see CA Ch 2L).

- (ii) **POWERS** - A debenture trustee has the power to call meetings of the investors/lenders of the debentures, and provide information and make recommendations to the investors/lenders (CA s283EB (*Trustee' power to call meeting*)). This is an important protective measure, as the trustee will generally have greater resources and experience than 'retail' investors, and would therefore be more likely to identify issues with the financial position and performance of IPOC as the debenture issuer.

5.4 **Benchmarks** - The following applies only if a disclosure document is required:

- (a) **Regulatory guidance** - ASIC has also published regulatory guidance for issuers of debentures (including unlisted notes) to improve disclosure by issuers and to provide for better risk assessment by 'retail' investors.<sup>3</sup>
- (b) **Benchmarks** - In the regulatory guidance, ASIC sets out eight benchmarks that apply to unlisted notes and ASIC expects issuers to disclose against the benchmarks on an 'if not, why not' basis. (We can provide further advice on what the benchmarks are, if and when required.) This means that in a prospectus or other disclosure document, IPOC as issuer must state that IPOC and/or the Loans either:
  - (i) MET - meet the benchmarks; or
  - (ii) NOT MET / EXPLANATION - do not meet the benchmarks, and explain how and why the issuer deals with the benchmark in another way, addressing that benchmark on an 'if not, why not' basis so that investors can assess its impact on their investment decision.
- (c) **Level of disclosure required** - Disclosure against the benchmarks should be:
  - (i) PROSPECTUS - addressed up-front in the disclosure document;
  - (ii) ONGOING - updated in ongoing disclosure as material changes occur, for example:
    - (A) supplementary materials - in a replacement prospectus, supplementary prospectus or continuous disclosure notice; and
    - (B) trustee reports - at least twice a year, in reports from the trustee; and
  - (iii) ADVERTISING - supported in, and not undermined by, advertising material.

## 6. Licensing

6.1 **Ch 7 (*Financial services and markets*)** - CA Ch 7 requires financial services businesses in Australia to involve an Australian financial services licence ("**AFSL**"), *unless* an exemption applies.

- (a) **External** - Note that AFSL coverage can often be 'rented' from an external licensee, if a party does not have its own AFSL.

<sup>3</sup> See ASIC Regulatory Guide RG 69 (*Debentures and notes: Improving disclosure for retail investors*). See also ASIC Regulatory Guide RG 156 (*Advertising of debentures and notes to retail investors*).



- 6.2 Dealing in a financial product - For these purposes, IPOC (undertaking the Borrowing Business) is regulated by CA Ch 7 if it provides a “financial service”, which is defined in CA s766A (*When does a person provide a financial service?*) to include “dealing” in a “financial product”.
- (a) *Financial product* - CA s764A(1) (*Financial products defined*) sets out a list of financial products, and this list includes “securities”. Accordingly, given that the Loans will be debentures for the purposes of the Corporations Act, and debentures are securities, the Loans will also be “financial products”.
  - (b) *Dealing* - CA s766C (*Meaning of dealing*) defines “dealing” in a financial product to include “issuing” a financial product. IPOC (undertaking the Borrowing Business) will originate the Loans by issuing them as debentures to investors/lenders, and accordingly will be caught by this definition, and will thus generally be required to involve an AFSL in the process, *unless* an exemption applies.
- 6.3 Self-dealing exception?
- (a) *Exception* - A debenture issuer who carries on a financial services business of dealing in debentures (i.e. the Borrowing Business) will not be required to hold an AFSL in circumstances where it is merely dealing in its own securities (CA s766C(4) (*Where certain action not dealing*)).
    - (i) EXAMPLE - For example, a company does not generally require an AFSL to issue its own shares.
  - (b) *Exception does not apply* - However, under CA s766C(5) (*Exception*), this ‘self-dealing’ exemption does not apply where a person (i.e. IPOC, undertaking the Borrowing Business):
    - (i) INVESTMENT BUSINESS - carries on a ‘business of investing’ in securities, interests in land or other investments; and
    - (ii) PUBLIC OFFER - invests the contributions of investors after an offer or invitation to the public made on terms that the funds subscribed would be invested,
 (see CA s766C(5) (*Exception*)), both of which activities we understand are the intention here (see below).
  - (c) *AFSL required* - Therefore, the ‘self-dealing’ exemption is not likely to apply, and IPOC (undertaking the Borrowing Business) will require the involvement of an AFSL (which may be held by a third party) for the issue, variation or redemption of the debentures.
- 6.4 Investment business
- (a) *Criteria* - ASIC considers that a business is likely to be a ‘business of investing’ / ‘investment business’ if a debenture issuer:
    - (i) APPLICATION - applies money to acquire shares, interests in land or some other asset;
    - (ii) RETURNS - expects to generate (or derives) a return from the assets;
    - (iii) ASSETS - obtains an interest in, ownership, or derives a benefit from the value, of the assets, and



- (iv) BUSINESS - engages in those activities as a business (and the extent to which the activities are repetitious or systematic is relevant to whether a person is carrying on a business).
- (b) *Application* - As IPOC (undertaking the Borrowing business) proposes to invest the Loan funds in return for equity interests in the third party entity (units, qualifying as securities), with system, repetition and continuity, the Borrowing Business is therefore likely to be classed as an investment business.

#### 6.5 Offer to the public

- (a) *Requirement* - However, even if the financial facility (i.e. the Loans) offered by IPOC (undertaking the Borrowing Business) constitutes an “investment business”, dealings in debentures will not be financial products for AFSL purposes *unless* there is an offer to the public to invest the funds raised under the debenture offering.
- (b) *Definition* - “Offer to the public” is defined in CA s82 (*Offers and invitations to the public*) to include a reference:

*“to, or to the making of, an offer to any section of the public or to, or to the issuing of, an invitation to any section of the public, as the case may be, whether selected as clients of the person making the offer or issuing the invitation or in any other manner and notwithstanding that the offer is capable of acceptance only by each person to whom it is made or that an offer or application may be made pursuant to the invitation only by a person to whom the invitation is issued [subject to certain exceptions not likely to be relevant]”.*

- (c) *Qualify* - Offers to investors/lenders by IPOC (undertaking the Borrowing Business) are therefore likely to be “offers to the public”, and accordingly the Borrowing Business is likely to be an investment business, not to qualify as ‘self-dealing’ and to require the involvement of an AFSL.
- (d) *Professionals* - Note that ASIC takes the view that where an offer is extended only to particular professionals in the business of investment, it is not to be regarded as an offer to the public. That is, where the offer is made to a person whose ordinary business is to buy or sell shares, debentures or interests in managed investment schemes, whether as principal or agent. It does not seem likely that all of the proposed investors/lenders would fit this category.

Please direct any questions to:

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**Schedule - Professional Investor**

CA s9 (*Definitions*):

"**professional investor** means a person in relation to whom one or more of the following paragraphs apply:

- (a) the person is a financial services licensee;
- (b) the person is a body regulated by APRA, other than a trustee of any of the following (within the meaning of the *Superannuation Industry (Supervision) Act 1993*):
  - (i) a superannuation fund;
  - (ii) an approved deposit fund;
  - (iii) a pooled superannuation trust;
  - (iv) a public sector superannuation scheme;
- (c) the person is a body registered under the *Financial Corporations Act 1974*;
- (d) the person is the trustee of:
  - (i) a superannuation fund; or
  - (ii) an approved deposit fund; or
  - (iii) a pooled superannuation trust; or
  - (iv) a public sector superannuation scheme;within the meaning of the *Superannuation Industry (Supervision) Act 1993* and the fund, trust or scheme has net assets of at least \$10 million;
- (e) the person controls at least \$10 million (including any amount held by an associate or under a trust that the person manages); [*Note - excluded for these purposes*]
- (f) the person is a listed entity, or a related body corporate of a listed entity;
- (g) the person is an exempt public authority;
- (h) the person is a body corporate, or an unincorporated body, that:
  - (i) carries on a business of investment in financial products, interests in land or other investments; and
  - (ii) for those purposes, invests funds received (directly or indirectly) following an offer or invitation to the public, within the meaning of section 82, the terms of which provided for the funds subscribed to be invested for those purposes;
- (i) the person is a foreign entity that, if established or incorporated in Australia, would be covered by one of the preceding paragraphs."