Submission to the Australian Government

Discussion Paper:

Development of the retail corporate bond market –

streamlining disclosure and liability requirements

February 2012

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A. Executive Summary

The Australian Financial Markets Association (AFMA) supports the Government's policy objective to develop a vibrant domestic corporate bond market in Australia. The market machinery to support an expanding corporate bond market is in place. Australia has the advantage of well-functioning liquid derivatives markets which enable hedging and risk management, in particular via the currency and interest rate swaps market.

The major banks have a significant role in the corporate bond market and AFMA expects them, along with the global investment banks operating in Australia, to be important drivers of growth in the corporate bond market by arranging corporate issues and offering bonds as part of their complement of investment products.

Our submission outlines a number of issues that we urge the Government to consider as part of a suite of measures to encourage the development of the market, in addition to the proposed changes to the prospectus disclosure and liability regime set out in the discussion paper. Our comments on the proposals in the paper are set out in section C.

B. Background

AFMA is keenly interested in the development of a vibrant domestic corporate bond market with our overall objective of promoting efficient and competitive capital markets in Australia.

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets and provides leadership in advancing the interests of all market participants. These markets are an integral feature of the economy and perform the vital function of facilitating the efficient use of capital and management of risk. Market participants perform a range of important roles within these markets, including financial intermediation and market making.

AFMA represents over 130 members, including Australian and international banks, leading brokers, securities companies, state government treasury corporations, fund managers, traders in electricity derivatives, and other specialised markets and industry service providers.

Our members are issuers, arrangers, brokers and investors in securities, including equity raisings and corporate bonds. They are also active in corporate lending.

Within the AFMA committee framework, we have long established committees that focus on debt origination and the trading of corporate bonds in the wholesale market which bring together the major arrangers and brokers in the fixed interest market.

There is potential for growth of the corporate bond market, in both the wholesale and retail sectors (albeit that the wholesale sector may offer better prospects in the short term), but this will take time. It will depend on a number of elements including Government policy, taxation, distribution, and also the investment mentality or investment culture of Australians. It will also depend on investment objectives and on risk, cost and return relativities in the marketplace.

There are no obvious major policy blockers preventing the growth of a corporate bond market in the wholesale sector. However, there are issues that need further consideration in the retail market.

The market machinery to support an expanding corporate bond market is in place. Australia has the advantage of well-functioning liquid derivatives markets which enable hedging and risk management, in particular via the currency and interest rate swaps market.

Market growth and offshore issuance

Each year, AFMA surveys members to measure turnover in over-the-counter (OTC) markets. The *2011 Australian Financial Markets Report* shows that corporate securities had healthy growth in the financial year ended 30 June 2011, with turnover of $176 billion, up 43% on the previous year. Bank securities are a much larger market with turnover of $380 billion over the same period.

It is evident that Australian corporates and banks issue more bonds overseas than they do in Australia. Data from the Reserve Bank of Australia shows that corporates at end-October 2011 had issued $133 billion offshore, over three times as much as the $43 billion issued in Australia. Banks and other financial institutions issued $336 billion offshore, nearly twice as much as the $182 billion issued in Australia.

The reason for this preference seems to be that it is easier to raise large amounts of capital at a competitive price in the deeper and more liquid capital markets offshore, particularly in the United States.

Some changes in wholesale bond origination may occur through normal market forces – for instance, if the cost of hedging offshore bond issues in the cross currency swap market were to rise, domestic issue could begin to look more attractive.

While recognising the attractiveness of very large and liquid markets offshore, there are measures than can be taken in Australia that could encourage some of the overseas issuance back onshore, including amendment of the prospectus requirements and taxation reform.

Prospectus requirements

Prospectus requirements in Australia that take less time and expense to prepare will clearly be an advantage to the local market. The discussion paper is a helpful step in encouraging corporate issuers to consider tapping into the Australian capital pool rather than going offshore.

Tax reform

Delivery on tax reform will assist competition in the funding sector. In its submission to the Senate inquiry into banking competition, AFMA pointed out that the market for lending to large corporates in Australia is very competitive with domestic banks, foreign banks and other lenders based here as well as offshore banks. While this competitive situation remains, the relative balance is changing. APRA data shows that due to the impact of the GFC, the market share of foreign bank branches in Australia has fallen by

over 40%, from 14.6% before the GFC to 8.6% now. This reflects a lessening of competition from foreign lenders in the corporate market. Foreign bank subsidiaries have also seen their market share fall by a similar amount.

If competition is a key objective of Government policy then all reasonable steps should be taken to make it easier for foreign banks to compete in Australia's capital markets and to facilitate the smooth flow of cross-border transactions.

Role of the major banks

The major banks have a significant role in the corporate bond market and AFMA expects them, along with the global investment banks operating in Australia, to be important drivers of growth in the corporate bond market by arranging corporate issues and offering bonds as part of their suite of investment products.

In the context of Basel III, banks have increased reliance on more stable funding sources including retail deposits and term funding arrangements, including bond market financing. Apart from their business lending books, banks have a separate interest in the bond market as a source of funds and would benefit from general growth in the corporate bond market in Australia.

Corporates seeking to raise capital apart from issuing shares have the option of borrowing from banks whose lending rates are competitive with the yield that a corporate would pay on a bond it issues. Ultimately, it is a matter of competition between the rate banks offer on lending to corporates and the issue yield on a corporate bond, taking into account the time and cost involved in issuing and marketing the latter.

Investment culture

From a retail investor perspective, Australians traditionally have seen their investment options as cash, shares and property (whether the assets are held directly or through superannuation). Corporate bonds have not loomed large on their investment horizon, although there is the potential to encourage retail investment in bonds issued by well-known and trusted corporate brands.

In practice, it is likely to be self-managed superannuation funds and high net worth individuals who have the capacity to invest significantly in bonds. In time, and with appropriate incentives and structures in place, ordinary investors may develop an appetite for products beyond cash, shares and property.

Just as corporate issuers have a competitive option in borrowing from banks, retail investors have a competitive option in bank term deposits, and retail deposits have the valuable reassurance of a Government guarantee.

Corporate bonds, while relatively secure, are not risk free. Encouraging retail investors to see corporate bonds as part of a balanced portfolio will be a financial literacy and educational challenge in which investment analysts, financial advisers, retail brokers, industry associations and the media can play an important role.

The Henry review reported on the bias against retail investors taking up financial products like corporate bonds and cash deposits that generate interest income at substantial effective marginal tax rates. . In contrast, dividends carry generous tax benefits via franked dividends, albeit that they carry greater investment risk.

Tax on investment returns should operate in a more neutral way for investors and the Government has recognised this by announcing a limited tax discount for retail investors' interest income from bank deposits.

While this has recently been deferred due to fiscal constraints, in AFMA's view these sorts of initiatives are movements in the right direction to encourage greater retail participation, and more extensive measures along these lines should remain on the policy agenda.

Asset allocation

Australian pension funds have a heavy bias towards equity investment. Superannuation fund managers and trustees have a responsibility to act in the best interests of investors in taking into account the full range of investment options and the weighting given to them in a diversified portfolio. The question of whether they should be directed, through a mandate or some other mechanism, to apply a proportion of the assets they manage to corporate bonds requires careful consideration.

C. Response to Issues Raised in the Discussion Paper

C.1. Proposed entry requirements/eligibility

The proposed conditions related to the issuer as set out in the discussion paper are considered generally appropriate.

In AFMA's view, the eligibility criteria should be as wide as possible to encourage issuer participation, provided that investor protection is not adversely affected. In terms of the proposed conditions relating to the bond, overall we do not consider it appropriate for statutory rules to govern product characteristics which are commercial in nature and which affect the marketability of bonds to retail investors.

Experience in other markets suggests that retail investors align themselves with the bonds of corporates that are familiar names to them. Narrowing the characteristics of bonds able to be issued is likely to dissuade some issuers and hinder the development of a retail bond market in Australia.

In particular, subordination should not be used as a condition to distinguish vanilla bonds from more complex bonds, as this characteristic alone does not make bonds more complex, although it will affect pricing. In our view, the ability to issue subordinated debt would widen the market considerably.

'Subordination' and 'senior debt' are familiar terms in relation to debt securities that are explained in ASIC's "Investing in Corporate Bonds" publication and in other information sources available to retail investors. It is normal practice to use the word "subordination" in the title of an issue so investors are alerted to the nature of such bonds. Appropriate disclosure in plain English about the style of bond offered will ensure that investors are informed about the terms and conditions attaching to the bond. For example, a simple table showing the different characteristics between shares, bonds and subordinated bonds and their relative ranking may be sufficient to disclose the risks associated with subordination. This would not need to be overly lengthy or complicated.

The discussion paper queries whether terms longer than 10 years should be permitted. In line with our comment that statutory rules should not govern commercial characteristics that affect the marketability of bonds to retail investors, it should be left to the market to determine the maturity appetite for retail corporate bonds.

The discussion paper queries whether deferral of interest should be permitted. In our view this should be allowed where it relates to a subordinated issue and the issuer remains solvent. Under the terms of a subordination arrangement there are circumstances where interest can and must be deferred to senior creditors. Therefore in relation to a subordinated bond issue, it is necessary to allow deferred coupons in certain circumstances to enable senior debt to be repaid first.

The discussion paper also queries whether eligibility should extend to wholly-owned subsidiaries of a parent which has continuously quoted securities where the business of the subsidiary is to act as a financing company for the group. This should be allowed to ensure that companies that issue through a finance company structure (which is relatively common) are not excluded, and given that investor protection should not be compromised under this structure.

The discussion paper also queries whether the short form prospectus should be compulsory for issuers and bond issues which meet the eligibility criteria. In our view, an optional regime offers more flexibility without affecting investor protection.

C.2. Use and availability of credit ratings

Given the current unavailability of credit ratings to retail investors from the three major rating agencies, it is difficult to determine what should constitute an investment grade rating. Further consideration should be given to a regulatory structure that allows credit rating agencies to provide their services in a way that can be accessed by retail investors, without unduly comprising investor protection, which we also acknowledge is a significant concern for regulators.

In relation to the existing regime, AFMA remains concerned about the undesirable impact on retail investors of ASIC's decision in November 2009 to withdraw the class order relief that allowed issuers of investment products to cite credit ratings without the consent of credit rating agencies, and to require credit rating agencies to meet retail financial services licence obligations if their ratings are accessible to retail investors. AFMA's position is detailed in the submission to ASIC dated 22 October 2009 in response to ASIC Consultation Paper 117 - *Consent to quote credit ratings*.

While AFMA endorses the decision of the Government to supervise credit rating agencies, under the present law the financial services licensing regime is the only tool available to ASIC to achieve this policy objective. The AFSL regime was not designed as a regulatory tool for the purposes of institutional supervision, particularly of an entity like a credit rating agency.

A better solution is to regulate credit rating agencies under a specifically designed regime in the same way that Chapter 5D of the Corporations Act provides for trustee companies' specific supervision needs.

Since the decision to withdraw the previous class order relief, only one entity (to our knowledge) has obtained the requisite form of financial services licence that effectively allows the ratings produced by that entity to be accessed by retail investors. Putting aside the benefits to the market that would result from more vigorous competition between credit rating agencies in this space, our concern is that retail investors currently do not have access to the same information as wholesale and institutional investors. Ratings would improve investor disclosure and understanding of corporate bond products, and would help to ensure that retail investors have access to the same kind of information that is currently available to wholesale investors.

Access to credit ratings will also assist in the marketing of corporate bond issues and promotion of investor confidence in the sector as a robust investment option.

C.3. Content requirements

The discussion paper suggests that a new subdivision could be inserted into Part 6D.2 of the Corporations Act, setting out the form and content requirements for a prospectus, and the general content requirements of section 710 would be expressly taken to be satisfied where the prospectus met the prescribed content requirements of the new subdivision. This reflects previous consultations with industry on this aspect.

A degree of prescription in the headings and sections of the prospectus is likely to assist retail investors in their understanding of the offer and will enable easier comparison between offerings.

We generally agree with the headings and sections outlined in the discussion paper other than the prescription of information about the benefits of investing in bonds. This information may be misleading if not properly disclosed in conjunction with the risk factors associated with the bonds. Rather, issuers should be free to choose whether to refer to the benefits of bonds in their prospectuses.

We agree there should be sufficient flexibility for a prospectus to include other sections and information at the discretion of the issuer, in addition to the prescribed sections.

The overarching requirement in section 715A of the Corporations Act would also ensure that prospectus content remains clear and concise.

The discussion paper also raises the issue of whether the inclusion of ratios and formulae would be useful for retail investors. Whilst financial metrics may at times

reflect the issuer's capacity to meet its obligations under the bonds, the nature of these metrics is dependant upon factors such as the industry of the issuer and the markets in which they operate. These metrics may not have the same relevance across different industries. Any attempt to standardise metrics may lead to unsound comparisons and potentially confuse or mislead investors.

Consultation Paper 155 (CP 155), which ASIC released in April 2011, sets out proposals for guidance to the market in relation to preparing "clear, concise and effective" prospectuses. One of the proposals was for all issuers of shares to include their gearing ratio, interest cover ratio and working capital ratio. ASIC also proposed prescribing the formulae to be used for calculating these ratios. After receiving extensive feedback on CP 155, ASIC released Regulatory Guide 228 (RG 228) in November. The RG 228 position in relation to financial ratios was a step back from the initial position, and now states only that an issuer should consider including financial ratios that are appropriate for that particular issuer, having regard to its industry and the expectations of investors and analysts. RG 228 also recognises that a ratio can be presented in a number of ways, including by using pro-forma or prospective information.

The approach taken in RG 228 is instructive, and should be followed by Treasury.

C.4. Using a multi-part prospectus

The discussion paper describes the possible division of content under a two-part prospectus regime. A two-part, or a base and second part prospectus, is conceptually appealing on the basis that the first part would set out the information that is unlikely to change over the life of the prospectus and relates to the issuer of the bonds, and the second and subsequent parts are specific to an offer of bonds and the effect of that offer on the issuer.

The discussion paper also describes a suggested alternative in the form of a shorter bond prospectus to issue a first tranche, followed by the issue of further tranches using a term sheet and cleansing statement.

On balance, AFMA sees advantages in the second option of a base prospectus plus a term sheet and cleansing notice, as it is analogous to established practices in the wholesale market. Similarity in the style of documentation required will assist in the ease and efficiency of issuance to the market (accepting that there will be differences in the content of the documents to ensure retail investors receive all the information they reasonably require to make an investment decision.)

The discussion paper raises the question of what should be the maximum life of a base prospectus. Given the continuous disclosure requirements that would apply, there is no strong case for setting a time limit on the base prospectus. The overall prospectus

requirements and liability issues would ensure that an issuer has to consider whether the base prospectus is still valid and can continue to be updated via the second part prospectus or a cleansing notice (depending on which model is adopted), or whether circumstances have changed to such an extent that a new base prospectus is required.

C.5. Incorporation of information by reference

The discussion paper suggests that in addition to the use of the incorporation by reference provisions for prospectuses, there could be scope for the prospectus to refer to other information that is available in a separate document, known as 'referencing'. Any referenced information would not be subject to the prospectus liability regime, but would still be subject to requirements such as those against misleading and deceptive conduct in the Corporations Act and the ASIC Act.

AFMA is generally supportive of this proposal, but the overriding need to ensure that investors have easy access to all the information they require to make an informed decision without the need to go to multiple places to obtain that information may limit its application in practice. Retail investors will be deterred from participating in the market if access to information is unnecessarily complicated or perceived as too burdensome.

This issue is interrelated with whether prospectuses should have a prescribed length (e.g. 20 pages). Practically speaking, a shorter prescribed length for a prospectus means that the number of materials incorporated by reference would increase. One advantage to incorporating material by reference is that the prospectus is updated much more easily. However, it is likely that a shorter prescribed length for prospectuses would have limited benefit to retail investors given that the issuer would simply move information from one document (the prospectus) to another (a document incorporated by reference). It should also be noted that not all retail investors will necessarily have access to the internet and therefore may be deprived of important information which may be incorporated by reference if it is not easily accessible.

C.6. Liability for prospectus content

The discussion paper indicates it may be appropriate to remove directors' deemed civil liability for retail corporate bonds, and that this would be consistent with Council of Australian Governments (COAG) developments, noting that COAG has agreed there is a case for reform to promote a consistent and principled approach to the imposition of personal criminal liability for corporate fault.

While AFMA is generally supportive of policy moves to relax strict liability for directors, it is important to recognise that the proposal in isolation may not bring about the

desired result. If underwriters and joint lead managers to issues retain civil liability, relieving directors of deemed liability will only change the focus to (and possibly increase the potential liability of) those other parties, which is not a desirable policy outcome.

Retention of deemed civil liability for underwriters will also mean that the same time, effort and cost will go into a due diligence process to enable the underwriter to rely on the due diligence defence, and so the intended savings outlined in the discussion paper may not eventuate.

AFMA welcomes the general direction of the proposal, but we suggest that Treasury should give further consideration to the liability regime for prospectuses, so that the overall policy objective can be achieved.

C.7. Exemption for prudentially regulated entities

AFMA does not support any change to the existing exemption in subsection 708(19) for prudentially regulated entities at this time.

Paragraphs 87 and 88 of the discussion paper raise the possible removal of the exemption in section 708(19) of the Act (which exempts ADIs and entities registered under the Life Insurance Act 1995 from the disclosure requirements under Chapter 6D) in relation to retail corporate bond issuances. One of the reasons given for removing this exemption is to ensure a level playing field between issuers.

In this regard the Corporation Act contains two explicit exemptions to facilitate fundraisings by ADIs:

(a) the definition of "debenture" in section 9 of the Act expressly carves out amounts deposited or lent to an ADI in the ordinary course of its banking business. Therefore, the disclosure requirements in Chapter 6D do not apply to these transactions; and

(b) the section 708(19) exemption provides that where an ADI enters into a transaction outside of the scope of a banking business it is nevertheless exempt from the disclosure requirement in Chapter 6D.

The policy reason underlying these exemptions is that ADIs and life insurance companies frequently raise funds in order to manage their liabilities in circumstances where it would be impossible in practice to prepare a disclosure document on every occasion.

Ford's *Principles of Corporations Law* further notes that the exemption was introduced to avoid the impracticality which would result from requiring disclosure in every

instance where a bank accepts money and issues undertakings to repay it. The removal of this exemption would place further and unnecessary pressure on banks by making it more difficult to raise money domestically. Given that banks are currently facing challenges raising money offshore, we believe that further restricting the ability of banks to raise funds would be detrimental to the banking sector in Australia, especially at this time.

C.8. Application and transitional arrangements

The prospect of a transitional period should be accommodated in the design of the regime, along with application arrangements, to create an appropriate level of flexibility for prospective bond issuers.

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