AFMA

15th February 2013

The Manager
Disclosure and International Unit
Retail Investor Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: SimpleBonds@treasury.gov.au

Dear Mr Fogarty

Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2013

Thank you for the opportunity to make submissions to the Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2013 (the Bill), released by the Hon Wayne Swan MP on 11th January 2013.

The Australian Financial Markets Association (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 and other specialised markets and industry service providers.

AFMA's key mandate is to promote best practice in financial markets so they can continue to maximise their contribution to the economic health of Australia.

AFMA recognises the importance of efficient regulation to inspire investor confidence in our markets, and in this regard plays a leading role in providing industry input to the government and regulators on public policy matters relevant to the financial markets.

We seek to ensure that government regulation of the financial sector is firm enough to inspire investor confidence yet flexible enough to allow the markets to grow to their full potential.

AFMA's members play a prominent role in the corporate debt market as issuers, advisers and investment managers and wish to continue to collaborate with the Government on the market's development. There are significant regulatory changes occurring on a global basis that are driving evolution of the financial markets and influencing the raising of debt capital. It is important for the Australian debt market to provide a facilitative and receptive environment to accommodate the growing needs of companies and investors. This in turn will increase the capacity of the Australian financial system to meet the financing needs of business, and broaden the range of investment opportunities for Australians to sensibly manage their growing savings.

AFMA welcomes the proposed changes to the fundraising and directors' liability regime as a step in making the Australian market more competitive and attractive to issuers. Promoting a deep and liquid domestic corporate bond market depends on a range of factors and the Government's proposals will advance this cause.

Our comments and observations about the amendments proposed in the Bill are set out below.

1. Definition of 'simple corporate bond'

'Simple corporate bonds' that are able to be offered under the proposed two-part prospectus regime are defined in draft section 713A. The proposed eligibility criteria in draft section 713A are quite restrictive, such that only very simple or 'vanilla' bonds will be offered to retail investors under this regime.

It is not clear whether corporate bond issuers will be incentivised to use this debt raising mechanism in the absence of the ability to apply any other terms and conditions to the bonds other than those prescribed by draft section 713A. We suggest that Treasury examines publicly available information about recent corporate bond issues that have been made available to retail investors in order to gauge how many of those offers would have been eligible to participate in the proposed modified regime. Our understanding is that very few recent offers would meet the definition of 'simple corporate bond' in draft section 713A.

In AFMA's view, the eligibility criteria should encourage issuer participation, provided that investor protection is not adversely affected. Experience in other markets suggests that retail investors align themselves with the bonds of corporate issuers that are familiar names to them. There are potentially a number of investment grade offers that would be appropriate for retail investor participation that will not be eligible under the definition of simple corporate bonds. While it is clearly important that retail investors are able to easily understand the product that is being offered and they receive all the information they require about the issuer, the regime also needs to be attractive to issuers in order to increase offerings of corporate bonds to retail investors.

An option that should be considered is a tiered regime under which different categories of corporate bonds can be offered to retail investors, using offer documents that are content-appropriate to the level of complexity of the product. For example, the way in which corporate bonds are defined in draft section 713A could be amended to reflect whether the product is very simple/vanilla or is slightly more complex or has features that differ (within a set of reasonable parameters, bearing in mind that the target market is retail investors) from the features of a very simple corporate bond.

AFMA has previously made submissions on several matters that we would like to reiterate, as they go to the definition of simple corporate bonds.

1.1 Subordination

The exposure draft Explanatory Memorandum (EM) says on page 10 that the holders of the securities must have a priority to unsecured creditors of the issuing body, if the issuing body is wound up. In effect this condition ensures that subordinated debt securities are not able to be considered to be simple corporate bonds.

Subordination should not be used as a condition to distinguish simple bonds from more complex bonds, as this characteristic alone does not make bonds more complex, although it will affect pricing.

'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.

Our view remains that the ability to issue subordinated debt will widen the market considerably, and we urge the Government to reconsider this aspect. For example, subordination may be a feature that is allowed under the tiered regime suggested above.

We would also like to raise a technical drafting point. The exposure draft EM states that the priority (to unsecured creditors) requirement has been included to ensure that "subordinated debt securities are not able to be considered to be simple corporate bonds".

However the effect of the requirement seems to be broader than intended. Specifically, if holders of simple corporate bonds must rank in priority to unsecured creditors, this would require all simple corporate bonds to be secured instruments. If the requirement is purely aimed at prohibiting subordinated instruments, then it should be sufficient to simply require that simple corporate bonds rank "at least equally with all other unsecured unsubordinated debt obligations of the issuer".

1.2 Deferral of interest

Draft paragraph 713A(12)(c) of the law says that interest payments on the securities cannot be deferred or capitalised by the issuing body.

As per our previous submissions on the deferral of interest, in AFMA's view (and on the basis that subordinated debt should qualify as simple corporate bonds), deferral 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. 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.

1.3 Maturity

Draft section 713A(7) in the Bill says that the securities must be for a fixed term of not more than 10 years.

As per our previous submissions, there is no need for the imposition of a statutory fixed term. It is more appropriate for the market and the issuer to determine the maturity of a bond, in line with the financing needs of the issuer. The maturity of a particular bond and the consequences associated with that are clearly matters that will need to be fully disclosed and explained in the prospectus. In practice, it is not likely that many corporates will issue bonds with a maturity of 10 years in any event.

2. 'Base prospectus' and 'offer specific prospectus'

Following on from the above comments about the definition of simple corporate bonds, AFMA urges the Government to consider further amendments that will allow the form and content of disclosure to be appropriately tailored to the needs of retail investors but will also give flexibility to issuers to offer products that satisfy their financing needs.

In previous submissions, AFMA said that a two-part, or a base and a 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.

We also said that on balance, AFMA sees advantages in a base prospectus and a terms sheet and cleansing notice, as this is analogous to established practices in the wholesale market, and 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 draft legislative amendments allow for a base prospectus and an offer specific prospectus.

Another option that the Government could consider, consistent with the suggestion above about a tiered approach in the definition of products, is to allow a base prospectus and terms sheet for very simple/vanilla bonds. This would more closely align the burden on the issuer that is associated with offering the product to retail investors with the very straightforward nature of the product.

Corporate bonds that are more complex or have features that differ from the features of a very simple/vanilla corporate bond (for example, subordination) could then be offered to retail investors under the base prospectus and offer specific prospectus regime proposed in the amendments.

ASIC Class Order 10/321 already allows companies to issue vanilla bonds to retail investors under a simplified two-part prospectus. However, in the two year period since the class order was introduced, only one issuer has issued retail bonds under a two-part prospectus. It has been suggested that this fact indicates that the prospectus content requirements under the class order are too onerous. We therefore encourage the Government to minimise the two-part prospectus specific content requirements under the new regime when the regulations are finally released.

3. Continuous disclosure

Paragraph 1.14 in the exposure draft EM says that "…the offer specific prospectus would have similarities with the cleansing notice regime for other offerings whereby it would include a statement outlining that the issuer has complied with their continuous disclosure obligations. Issuers would need to disclose in the second part any matters material to a consideration of an investment in the bonds which have not already been the subject of continuous disclosure".

The above commentary can be interpreted to say that information that has already been disclosed by the issuer in accordance with its continuous disclosure obligations does not need to be disclosed again in the offer specific prospectus.

However, it is not abundantly clear on the face of the drafting of the amendments that an issuer of simple corporate bonds is not obliged to disclose information that has already been disclosed in accordance with section 674 of the Corporations Act.

It would be helpful if this is clarified either in the law or the regulations.

4. Directors' liability

One of the legal impediments to retail bond issues by corporates is the lengthy due diligence process which arises because of, among other things, the deemed directors' liability provisions for prospectus content in the Corporations Act. In response to this, the Bill removes deemed civil liability of directors under section 729(1) of the Corporations Act for misleading and deceptive statements in, or omissions from, a two-part prospectus.

However, as directors are required to consent to the lodgement of the two-part prospectus, this means that they will still be subject, effectively, to the criminal liability provisions for these documents under sections 1308 and 1309 of the Corporations Act. These provisions are only contravened where it is determined that "reasonable steps" have not been taken. The Bill clarifies the type of conduct which will be taken to constitute "reasonable steps" for the purposes of these criminal liability provisions.

The Bill provides that a director will be considered to have taken reasonable steps to ensure a statement in, or an omission from, a disclosure document is not false or misleading where:

- that director has made all inquiries (if any) that were reasonable in the circumstances and, after doing so, the director believed on reasonable grounds that the statement was not misleading in a material particular or there was no such omission; or
- that director proves they relied on information provided to them by someone other than a director, employee or agent of the issuer and the reliance placed on the information by the director was reasonable in the circumstances.

Although the Bill clarifies the due diligence obligations under sections 1308 and 1309, the proposed amendments do not remove the need for the board of an issuer to be involved in the due diligence process. Therefore, these proposed amendments may not go far enough to satisfy some industry participants who have suggested that directors should be given the benefit of a "safe harbour" or "business judgement" rule.

5. Liability of other parties

In previous submissions AFMA has stated that while we are 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 in terms of encouraging a greater level of issuance of corporate bonds to retail investors, at a reasonable cost to the issuer.

If underwriters and lead managers to issues retain civil liability, then 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. It is incongruous that other parties have potentially more liability for a prospectus than the directors of the entity issuing the prospectus.

Retention of deemed civil liability for underwriters will also mean that the same amount of time, effort and cost will go into a due diligence process to enable the underwriter to rely on the due diligence defence. This may mean that it will be difficult to achieve a substantial reduction in the overall cost of issuing corporate bonds to retail investors. If there is no perceived or real cost reduction then issuers will not be motivated to increase their level of issuance.

It is not apparent from the exposure draft EM what, if any, consideration was given to this issue after AFMA raised it in our February 2012 submission to the Government's discussion paper on the development of the retail corporate bond market and streamlining disclosure and liability requirements. We understand that a number of market participants also made representations about this matter.

AFMA welcomes the general direction of the proposal to change the deemed civil liability of directors, but we suggest that the Government should give further consideration to the liability regime for prospectuses more generally (or at the very least, for simple corporate bond prospectuses), and particularly in relation to liability of underwriters and other parties who assume risk in relation to an offer.

AFMA is not advocating an absolution of liability for parties such as underwriters. However, it must be recognised that if an offer is underwritten, for example, it adds to the attractiveness of the offer to retail investors. Underwriting is not a guarantee about the quality of an offer but it does create a level of comfort in the minds of those investors about the process that has occurred to ensure, as far as possible, that a prospectus does not contain misleading or deceptive information. The due diligence program that an underwriter undertakes to protect itself from this risk (ie. the liability that arises in connection with making statements that are false or misleading in a material particular, or material omissions) is substantial and costly, but also benefits the issuer and potential investors.

The public interest benefit that is derived from holding a person who issues a prospectus or authorises the making of a statement in a prospectus accountable for their actions is not disputed. However, in our view the proposed changes to the liability regime do not properly recognise the role of parties other than directors who are involved in the issue of a prospectus. Those other parties should be entitled to the same level of protection from liability as is proposed for directors, provided they undertake the level of enquiries to establish a reasonable steps defence. In practice, the due diligence process undertaken by an underwriter will more than satisfy a reasonable steps obligation.

AFMA would appreciate the opportunity to have more detailed discussions with Treasury on this issue.

****

Please contact me on 02 9776 7997 or tlyons@afma.com.au if you would like to discuss any aspect of this submission.

Yours sincerely

Tracey Lyons
Director, Market Operations & Retail