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

Minter Ellison's submission in relation to exposure draft legislation

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Introduction

Thank you for the opportunity to provide comments and submissions in relation to the exposure draft of the *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill* 2013 (**Bill**).

Minter Ellison is a full service commercial law firm which provides legal services to clients in a variety of industries and sectors, including in the debt and equity capital markets and to financial institutions, corporate issuers, underwriters and investors. As a legal adviser, we are deeply involved in the Australian debt and equity capital markets.

Background comments

The reforms contemplated by the Bill are an encouraging step towards deepening the domestic retail corporate bond market. However, we remain cautious about the likely number of corporate issuers who will avail themselves of the 'simple corporate bonds' regime proposed under the Bill given the prescribed features that a financial product must possess before it can be classified as a 'simple corporate bond' and fall within the provisions contemplated by the Bill.

The purpose of our brief submission is to provide feedback on the likely commercial impact of the Bill in its current form and highlight what we believe may be unintended anomalies in the Corporations Act created by the Bill.

In formulating our submission, we have taken into consideration:

- the *Johnson Report 'Australia as a Financial Centre: Building on our Strength'* in November 2009 and ASIC's *Consultation Paper 126 'Facilitating debt market'* in December of that year (**CP 126**), in which the issue about the relative weakness of the Australia corporate bond market rose to recent prominence;

- ASIC Class Order 10/321 *Offer of Vanilla Bonds* (**Class Order**) released on 11 May 2010, which created a streamlined disclosure regime (including a two-part prospectus regime broadly similar to the one proposed under the Bill) for a class of corporate bonds with simple features referred to as 'vanilla bonds'; and

- Treasury's December 2011 discussion paper *'Development of the retail bond market: streamlining disclosure and liability requirements'* (**Discussion Paper**) and its accompanying public submissions.

1. Narrow definition of 'simple corporate bond'

To a large extent, the Bill mirrors the conditions already set out in the Class Order.

To date, we are only aware of two corporate issuers who have elected to proceed with a bond issue under the Class Order (namely, Primary Health Care and Tatts Group). In calendar year 2012, the Australian domestic retail market witnessed a strong revival in the bonds and hybrids market. 19 deals were brought to market raising over $13 billion. Of these issues, only 3.2% were of the senior debt type covered by the reforms proposed in this Bill.[1]

We submit that the conditions (as set out in paragraph 713A of the Bill) applying to a financial product classified as a 'simple corporate bond' are too restrictive and that this is evidenced by the small take up rate from corporate issuers utilising the Class Order (which broadly has the same conditions as those set out in the Bill). These restrictive conditions are likely to in our view continue to dampen interest from corporate issuers. In our opinion, to facilitate an increase in the number of bond issues by corporate issuers utilising this regime, there needs to be a higher degree of flexibility relating to the conditions applicable to the financial product to be issued. Having consulted with corporate clients and market players such as investment banks and advisers, the resounding feedback we have received is that reforms to date in this area have tended to over-regulate the commercial characteristics of the financial product. This may arguably hinder the development of the domestic retail bonds market (for example, in respect of smaller issuers whose business/asset profile is unlikely to generate interests from retail investors sufficient to raise the minimum aggregate $50 million in funds).

We note that although a number of the primary conditions relating to simple corporate bonds have been discussed in the past few years,[2] a number of the changes previously suggested by market participants have not been adopted in the Bill. While we do not propose to recast in detail these earlier submissions, we do believe there are a number of conditions that are worthy of reconsideration.

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[1] 'Market subs Swan bond reform', Andrew White, The Australian newspaper 12 January 2013.
[2] See section B3 (conditions applying to the corporate bonds) of CP126 and paragraphs 25 to 32 (proposed entry requirement/eligibility – conditions relating to the bond, 'vanilla bond' compared to more complex products, and other requirements that could be imposed) of the Discussion Paper.

No step-down and no deferral of interest

As currently drafted, the Bill provides that an issuer can only increase the fixed margin or fixed interest rate during the term of the bond, but it cannot be decreased, nor can the issuer defer or capitalise interest payments.[3] Given bonds are often used by corporate issuers as an alternative source of debt funding, it is arguably commercially unattractive to corporate issuers if the financial product does not have an interest rate or margin structure which broadly reflects the prevailing interest rates applicable to corporate borrowings available in the open market from time to time.

We have witnessed significant volatility in the interest margins offered by corporate issuers for bonds and hybrid products over the past few years. Based on feedback we have received, an inability to lower the fixed margin or interest is commercially unattractive to corporate issuers, particularly for long dated financial products. In addition, there may be instances where a reduction or deferral of interest payment could be attractive from the perspective of both the issuer and the investor.

For example, depending on the financial position of the issuer as at a particular payment date, it may be preferable for the issuer who has fresh capital needs, to defer the interest payment to a later date. If this was, for example, coupled with significantly advancing the interest payment date for a later period, there may be no overall material financial disadvantage to the investor. Likewise, a reduction in the fixed margin or the fixed interest rate for one period may be justifiable if it was accompanied by a similar or larger increase in the fixed margin or the fixed interest rate for another period.

We believe that issuers should be guided by market appetite in determining the interest rate or margin applicable to its bond rather than be restricted by legislation in structuring the commercial terms applicable to the bond.

Minimum aggregate issue

There is a significant risk that the minimum aggregate issue of $50 million[4], similar to the condition set out in the Class Order, will result in the exclusion of small-cap participants from accessing the retail corporate bond market. As referred to above, the business/asset profile of smaller issuers is unlikely to generate interests from retail investors sufficient to raise the minimum aggregate $50 million in funds. We suggest that a minimum aggregate issue of $20 million or $25 million would be a more appropriate condition.

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[3] Paragraphs 713A(10), (11) and (12) of the Bill.
[4] Paragraph 713A(6) of the Bill.

While we understand the need for investors to have a liquid market for the bonds, we do not believe there are compelling policy reasons to justify a difference in treatment for retail corporate bonds as compared to other financial products issued in the Australian domestic market which do not have any minimum aggregate issue amount. We consider that any liquidity risk associated with a smaller issue could be overcome by fulsome and prominent disclosure in the prospectus. Investors are accordingly given the opportunity to assess the relative merits of such risk in the context of their own investment objectives.

10 year maximum term

In our opinion, the maximum 10 year fixed term condition is unnecessary.[5] While we acknowledge that a longer term bond may potentially pose a higher risk in terms of default by the issuer, this is a hypothetical risk to be considered in conjunction with the other risks relating to the issuer and the other features of the particular bond.

We consider that if the terms of the bond are fully disclosed in the prospectus, retail investors should be given the opportunity to make their own assessment of the merits of the bond depending on their individual investment objectives. Such an assessment may necessarily include juxtaposing corporate bonds with other available fixed income products, such as long dated bank deposits, government bonds, hybrids and convertible notes, where there is either no limitation on the maximum duration of the investment term or where the term is substantially longer than 10 years.

For issuers, the length of the term of the bond will necessarily entail an element of market supply and demand. For example, when retail investors decide to invest in corporate bonds as a result of wider market fluctuation and uncertainty, they may well be more inclined to invest in a financial product that has a longer term, such as a bond, because it provides greater period of regular fixed income. This is of particular relevance to investors such as self-managed superannuation funds who represent a significant proportion of the retail bond market.

Restricted redemption

The Bill provides that redemption prior to the expiry of the term is only permitted in the following limited circumstances: [6]

(a) at the option of the bond holder;

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[5] Paragraph 713A(7) of the Bill.
[6] Paragraph 713A(14) of the Bill.

(b) as a result of the acceptance by the bond holder of a buy-back offer;

(c) a change in law which impacts on taxation liabilities of the issuer and/or any guarantor of the issuer;

(d) a change in control of the issuer; or

(e) there are fewer than 10% of the bonds remaining on issue.

In our opinion, the inability of the issuer to redeem the bonds at its option (other than in the circumstances set out above) is highly restrictive and impedes on the issuer's ability to manage its capital structure efficiently. For example, if a long dated bond with a fixed interest rate is issued during a period of high interest rates and subsequently the market interest rates drop significantly, the issuer would be encumbered with a highly inefficient form of borrowings.

Under the Bill, the issuer may introduce a buy-back program but the acceptance of the buy-back program is unlikely to generate substantial interest if the interest rates offered under the bond are in fact substantially higher than the prevailing market rates at the time of the buy-back offer. This is further exacerbated by the requirement that 'simple corporate bonds' cannot decrease its fixed margin or fixed interest rate during the term of the bond. The feedback we have received strongly indicates the need to enhance the flexibility of the issuer's capital structure and accordingly issuers should be permitted to redeem the bonds at its election or at the very least permit redemption by issuers at a specified premium (which is a common feature of bonds issued in Australia).

Subordination

The Bill provides that '(i)n a winding up of the issuing body, holders of the securities must have higher priority than unsecured creditors of the issuing body'. [7] The practical effect of the wording in section 713A(15) appears to mean that a 'simple corporate bond' must be a secured instrument as it will be impossible in practice to obtain the agreement of all creditors to subordinate their claims to bond holders. Such a requirement would in our view significantly reduce the usefulness of the proposed regime as the introduction of a new secured instrument (i.e. the bond) by the issuer would require consent from an issuer's existing consortium of financiers given most financing arrangements would have restrictions on the issuer granting further security. We note that existing bonds issued in the wholesale bond market and the retail bond market (to date) typically are unsecured instruments.

[7] Paragraph 713A(15) of the Bill.

Paragraph 1.21 of the Explanatory Memorandum states that this requirement in effect '...ensures that subordinated debt securities are not able to be considered to be simple corporate bonds.' If this is the intention, we suggest that the requirement be amended to instead provide that 'simple corporate bonds' rank at least equally with all ordinary unsecured creditors of the issuer.

Emphasis of matter relating to going concern

In order to qualify as a 'simple corporate bond', the most recent auditor's report on the most recent financial statements (either the yearly or half yearly statements) for the body issuing the bond must not include, among other things, an emphasis of matter relating to going concern.[8] In our opinion, such a requirement may be an obstacle for some potential issuers.

Contrary to paragraph 1.21 of the Explanatory Memorandum, our understanding is that an emphasis of matter relating to going concern in an auditor's report does not necessarily mean that a company is not a going concern or is nearing insolvency.[9] An emphasis of matter paragraph could be included in the auditor's report, for example:

(a) when a lender is in the process of negotiating a credit facility with a borrower, and prior to the conclusion of such negotiations, is reluctant to confirm the availability of the facility with the borrower's auditor on the date the auditor's report is finalised, notwithstanding there may be not any material reason to suggest that the facility will not be available to the borrower; or

(b) where during times of uncertain economic conditions, the issuer's lenders (as matter of policy) refuse to provide a confirmation as to the continual availability of a loan facility, but without necessarily stating to the auditor that such a facility would not be available.[10]

Since neither of the scenarios above necessarily lead to a conclusion that the company is insolvent or nearing insolvency, we submit that the restriction imposed by paragraph 713A(21) is unnecessary or should be limited to where the auditor issues an adverse opinion or does not issue an opinion. In our view, it would be adequate if the emphasis of matter relating to going concern was fully disclosed in the prospectus.

[8] Paragraph 713A(21) of the Bill.
[9] According to the guidance issued by the Auditing and Assurance Standards Board (**AUASB**). See *Going concern issues in financial reporting: a guide for companies and directors: Australian Government*, Auditing and Assurance Standards Board, 2009, available at: http://www.auasb.gov.au/admin/file/content102/c3/going_concern_issues_in_financial_reporting.pdf, accessed 5 February 2013.
[10] As above, appendix 5. In particular, Treasury should note that, according to the AUASB, for an auditor to express an unqualified opinion with an emphasis of matter paragraph relating to going concern, the auditor should have answered 'no' to the question of 'is it highly improbable the entity will continue as a going concern?'. If the answer is 'yes' on the other hand, the auditor should issue an adverse opinion, meaning that a going concern basis is inappropriate for the company.

We also note that the inclusion of a going concern emphasis of matter provision in the Bill may potentially result in a significant number of companies (about one in seven according to one estimate) being automatically excluded from the operation of the Bill.[11] Furthermore, we are not aware of such a requirement for any other disclosure document, such as a transaction-specific prospectus under section 713 of the Corporations Act. We do not believe there are any compelling policy reasons to justify a difference in treatment for retail corporate bonds as compared to other financial products issued in the Australian domestic market in this respect.

2. Two-part prospectus

Compulsory usage not warranted

Leaving aside the likely effectiveness of the introduction of a two-part prospectus regime as a means to encourage the development of the Australian retail corporate bond market,[12] we submit that its compulsory adoption after the two year transition period[13] is unwarranted.

Depending on the duration, complexity and the structure of the proposed issue, we expect that not all issuers will find a two-part prospectus to be administratively cheaper or less burdensome. In fact, we believe that for single tranche bond issuers, the two-part prospectus regime may add to the cost and time burden associated with the issue.

While we are strongly supportive of the ability for issuers to use a two-part prospectus as a whole, particularly in relation to those large issuers who are contemplating a wider programme which includes multiple issues of bonds, we believe that the choice of the most appropriate form of disclosure (i.e. vis-à-vis the use of an offer-specific prospectus, as presently available under the Class Order), should be matter of judgment for each issuer.

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[11] In a survey conducted by one auditor at the completion of the 2011 financial reporting season, it was found that 14.9% of all auditor's reports contained an emphasis of matter paragraph relating to going concern; many of these companies are in the small-cap market. This would mean that about one in seven companies would automatically be ineligible under the Bill. See *Going concern impact on audit reports*, RSM Bird Cameron, available at: http://www.rsmi.com.au/rsbcwr/_assets/main/lib90014/0912%20going%20concern%20impact_web.pdf, accessed on 5 February 2013.

[12] The ability for issuers to use a two-part prospectus, as an alternative to a shortened offer-specific prospectus, was first introduced in the Class Order. In a media release relating to the Class Order, the then Chairman of ASIC, Mr Tony D'Alosio noted that the simplified prospectus regime was 'an important change which will help build the depth and liquidity of the country's capital markets and, in the longer-term, assist in developing Australia as a global financial centre'. We note however, that in the two and half years since the release of the Class Order, only two companies, Primary Health Care and Tatts Group, have taken advantage of the Class Order; of those two companies, only Primary Health Care adopted the use of two-part prospectus.

[13] Item 2A of paragraph 705 of the Bill.

In our opinion, if Treasury's intention is to create the most simple and appropriate disclosure regime for each issuer, the requirement for all issuers to adopt the two-part prospectus regime after the two year transition period should be removed and be replaced by a provision that provides the issuer with a choice of using either an offer-specific prospectus or a two-part prospectus.

3. Directors' liability provisions

We submit that the intention behind the proposed changes to the per se civil[14] liability provisions of the Corporations Act (as set out in paragraph 1.16 of the Explanatory Memorandum) will not be achieved in respect of the way due diligence programs will be conducted by issuers.

Due diligence process

It has been noted by commentators generally[15] (and indeed in the Discussion Paper), that one of the more significant barriers to the greater prevalence of retail corporate bonds is the deemed liability provisions for directors in the Corporations Act, which forces a process of detailed due diligence to be undertaken by issuers (**Liability Barrier**). Such processes are expensive, time consuming and lower the speed at which these financial products are made available to the market and, for small cap companies, can effectively remove them from bond raising capability.

While the Bill removes the per se civil liability provisions under section 729(1) of the Corporations Act for directors in relation to misleading and deceptive statements in, and omissions from a two-part simple corporate bonds prospectus, a director of the issuer still has exposure to civil liability '...if the director is directly involved in, among other things, the misleading or deceptive statement, the omission of required material, or where new circumstances have not been reflected in the disclosure document as required by the Corporations Act...'. [16]

In addition, as the directors are required to consent to the lodgement of a two-part prospectus, this means they will still be subject to the criminal liability provisions under sections 728, 1308 and 1309 of the Corporations Act. The removal of the per se civil liability will not in our view remove the necessity to conduct a full due diligence for 'simple corporate bonds' if directors wish to avail themselves of the due

[14] Paragraphs 38 to 42 of the Bill
[15] See for example, *Streamline of retail bonds edge closer*, Australian Financial Review 7 July 2012.
[16] Paragraph 1.56 of the Explanatory Memorandum.

diligence defence under section 731 of the Corporations Act in respect of the criminal liability provisions under section 728 and the civil liability provision in 729 as it relates to '..a person who contravenes, or is involved in the contravention of, subsection 728(1)'.

Sections 1308 and 1309

We note that sections 1308 and 1309 of the Corporations Act,[17] have been amended to include the defences presently available to directors under sections 731 and 733 of the Corporations Act. However, the proposed sections 1308 and 1309 have the concept of 'materiality' included in the provisions (namely the words '...in a material particular...' have been added). We recommend that for consistency, sections 731 and 733 should also be amended to reflect the same 'materiality' qualification. There does not appear to be any compelling policy reason why there should be a distinction between the defences set out in sections 731 and 733 versus those found in sections 1308 and 1309.

4. Tax treatment of simple corporate bonds

The changes proposed by the Bill are considered to be a supply-side initiative and we query whether they will on their own be able to boost further interest in the domestic retail bond market. As many market participants have suggested, it would appear that demand-side initiatives are more likely to bring about real drivers for change.

We submit that the tax treatment of debt financial products, vis-à-vis equity, remains a significant disincentive for retail investors. Under Australia's tax laws, interest income from corporate bonds is taxed at a higher marginal rate than share dividends and geared property. This has resulted in instruments such as hybrid securities offering higher yields to compensate investors for unfavourable tax treatment and risks attached to them. Obviously higher yields increases the costs of hybrids and bonds to issuers. We therefore suggest that reforms to the tax treatment of bonds need to be examined with a view to encourage domestic retail investors to more actively participate in the corporate bond market.

[17] Paragraph 46 – 49 of the Bill.

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