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10 February 2012

Manager
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Dear Sir,

Development of the Retail Corporate Bond Market: Submissions on Discussion Paper

We are pleased to provide these submissions in relation to Treasury's 13 December 2011 discussion paper, Development of the Retail Corporate Bond Market.

The submissions are provided by Baker & McKenzie Australia. Ord Minnett has also made a valuable contribution to the development of this document, and has consented to being named in connection with these submissions.

1. Introduction

We commend the work done by Treasury to critically review the legal disclosure requirements for corporate bonds, and we support an approach which seeks to replicate for retail investors in such bonds the efficiencies and investor protections that are currently part of equity capital markets practice in Australia.

Our submissions and comments in relation to selected topics from the Discussion Paper are set out below, and we hope you find them to be constructive.

2. Proposed entry requirements/eligibility – Conditions related to the issuer

We support the rationale for extending eligibility for prospectus relief to listed issuers that satisfy the conditions set out in paragraph 24 of the Discussion Paper. These criteria are similar to those applicable to an issue of equity securities by a listed issuer, and we believe that Australian market experience has shown that the continuous disclosure and financial reporting regimes have worked well as a means of informing investors in the context of such issues.

In relation to the discussion questions, our view is that:

(a) Yes, these proposed conditions are appropriate, so long as ASIC has power to modify or exempt. For example, a suspension for more than 5 days in the preceding 12 months often does not indicate a failure in the issuer's disclosure obligations, and instead is voluntarily sought by the issuer in order to prevent trading in an uninformed market.

(b) Eligibility could extend to a wholly owned subsidiary of a listed company (being a company that complies with the criteria itself), provided the listed company guarantees the subsidiary's obligations in relation to the bonds.

(c) An unmodified auditor's report is, we believe, unnecessary as investors will have access to the report and can assess the reason for the modification. In an extreme case ASIC could disqualify an issuer from using the short prospectus provisions (as is currently the case in relation to equity issues).

3. Proposed entry requirements/eligibility – Conditions related to the bond

As an overview comment, we do not believe that overly restrictive eligibility conditions on a particular bond issue are helpful to the creation of a robust corporate bond market.

The almost negligible use made of ASIC's "vanilla bonds" relief[1] has shown that detailed bond terms prescribed by regulators may well not be those desired by the market. There should, we submit, be a recognition that the bond terms that will be attractive to both issuers and investors will change over time, and so flexibility must be permitted.

Further, we note that retail investors are not necessarily protected by restricting the kinds of bond terms that may be offered to them. For example, an unsubordinated bond issued by a highly leveraged company with a large amount of first-ranking secured debt could still be a risky investment even though it is a "vanilla" bond. It could give retail investors false comfort, and is arguably misleading, to suggest that all "vanilla" bonds have "low risks" (as noted in paragraph 26 of the Discussion Paper).

The better approach, we submit, is to allow different issuers to design bond terms that suit their individual capital needs. Investor protection comes in the form of disclosure of the terms and conditions of the bond being offered, and of the effect of the offer on the issuer. This is an approach that has governed offers of shares for a considerable period of time. Accordingly, we support the proposals in the Discussion Paper to relax some of the conditions that are currently in the ASIC class order.

An alternative approach to regulating bond terms

Although we do not support legislative restriction on the range of bond terms that would qualify for prospectus relief, we do accept that retail investors may benefit

[1] ASIC Class Order 10/321

from being able to easily identify a "vanilla" corporate bond without having to closely analyse the terms and conditions. This would aid comparison, although would not necessarily be a guarantee of a low risk investment.

We suggest that a way to assist retail investors in this regard would be to regulate how a corporate bond can be described. Under this proposal, a bond could be described in the offer document as a "vanilla bond" if it meets a more restrictive set of conditions. These conditions could include some of those set out in the Discussion Paper, such as being unsubordinated, non-convertible, and the issuer having no ability to defer interest payments. Bonds that do not meet these criteria would not be able to be called a vanilla bond, but would be able to be described as a bond or note.

In the context of the above submissions, we make the following comments on specific bond terms that are mentioned in the Discussion Paper.

Convertibility

We do not believe that it is necessary to prohibit a conversion feature. If conversion is at the holder's option, this does not make the bond inherently too risky to qualify for short prospectus relief. We also note that an option to acquire a quoted share can already be offered under a short prospectus[2], and so it seems logical that an optional conversion feature should not disqualify a bond from accessing short prospectus relief either (at least where it is convertible into a quoted security).

Issue size

We do not believe it is necessary to impose a minimum issue size. Liquidity of a series of quoted bonds is determined as much by the identity of the holders as it is by the size of the issue. Imposing an arbitrary minimum issue of (say) $50 million will exclude a large number of small and medium sized issuers from the market, and it is exactly those issuers who should be facilitated into the debt capital markets as an alternative to bank funding (which, for many, is currently their only available source of debt funding).

We also note that ASX has already given consideration to minimum issue size in its Listing Rules. Where an issuer is admitted as a Debt Issuer (that is, only its debt is quoted, not its shares) the minimum issue size is a face value of $10 million[3]. Where an existing listed company wishes to quote a new issue of debt securities in addition to its shares, there is no minimum issue size[4]. We submit that where bonds are to be quoted, the size of the issue should be a matter to be determined by the exchange on which the bonds are to be issued.

[2] Corporations Act, section 713(1)(b)
[3] ASX Listing Rule 2.1 Condition 6
[4] ASX Listing Rule 2.5 Condition 5

Discussion Paper questions

In relation to the specific questions in the Discussion Paper, for the reasons set out above we do not support additional requirements for short prospectus relief such as:

- prohibition of subordination,
- prohibition of deferral of interest, or
- a maximum term (tenor).

We do agree that bonds should have a fixed term (tenor) to qualify for prospectus relief, as opposed to perpetual bonds without maturity.

4. Use and availability of credit ratings

In response to the question asked in paragraph 35 of the Discussion Paper, we do not believe that either an issuer or a bond issue should be required to have an investment grade credit rating in order to offer bonds to retail investors.

The reasons for our view include:

(a) The cost of obtaining a rating would be prohibitive for small and medium sized issuers, which could well exclude them from the market. As noted above, these are the kinds of issuers that should be facilitated to use debt capital markets.

(b) Investors should not be prevented from investing in sub-investment grade bonds, or even unrated bonds, so long as adequate disclosure is made at the time of offer. Plenty of retail investors are willing to take on riskier investments (often as part of a wider portfolio) in return for higher yields. The regulatory aim is to assure sufficient information is provided for an accurate risk assessment, rather than shift the responsibility of a risk assessment to a rating agency.

(c) Ratings for retail offers are currently difficult to obtain. Only one Australian ratings agency has the necessary licence.

We also believe that a rating would usually be useful information for a retail investor, and agree that the current information asymmetry between institutional and retail investors is undesirable. We encourage Treasury to explore ways in which ratings can more easily be made available to retail investors.

5. Prospectus content requirements and length

5.1 Prospectus length

As a general comment, we do not believe it is feasible to impose a maximum length for a retail bond prospectus. Indeed, the number of suggested topics for inclusion in such a prospectus that are listed in the Discussion Paper demonstrates the difficulty of compliance with a maximum length – the proposed headings and bullet point

descriptions of content extend to 5 or 6 pages by themselves. It would be impossible to address all of those points in just 20 pages, or potentially even 40 pages.

As with our submissions above in relation to bond terms and conditions, we believe that issuers need to be allowed to have flexibility in the preparation of a shorter prospectus. For instance, a lesser known small listed company may actually have to include more background information on it and its business compared with a household name such as Woolworths. Likewise, some issuers may have to include more information on their company-specific risks than others.

We suggest that the familiar "*clear, concise and effective*" requirement[5] should apply instead. This would allow ASIC to deal with unnecessarily long offer documents (including by way of stop order), while at the same time not unduly restricting appropriate levels of disclosure where warranted.

5.2 Content requirements

The contents suggested in the Discussion Paper seem generally reasonable, and accord with the kinds of disclosures that an issuer would normally include.

There are, however, some specific submissions we would make.

Benefits of investing

The proposed section 4 should be eliminated.

First, we do not believe it is appropriate to mandate headings or content in relation to the benefits of investing in particular bonds (Discussion Paper, paragraph 50). This should be for the issuer to determine, as different issues may have different benefits such as being highly secured, or high yield, or convertible at the holder's option (if that is permitted).

Secondly, all the points to be covered in the proposed section 4 are already covered in a more fulsome manner in the proposed Section 3. To make sure the last bullet point in paragraph 50 is sufficiently covered in Section 3, any restrictions on transfers and sales should be included in the discussion of the prescribed financial markets on which the bond will be quoted (the penultimate bullet point in paragraph 48).

Forecast information

Some of the proposed disclosures seem to involve forecasts that could conceivably extend for the life of the bond. These include:

- the ranking of the bonds in relation to the other debt *or proposed debt* of the issuer (paragraph 48),
- the amount of other debt *or proposed debt* that would need to be paid in priority to the bonds in the event of a liquidation (paragraph 48), and

[5] Corporations Act section 715A

- the capacity of the issuer to meet its obligations under the bonds, presumably including repayment of principal on maturity (paragraph 56).

The first two items above could be disclosed by an issuer provided they are limited to the date of issue of the prospectus (by removing reference to "proposed" debt). The third item is, we submit, not appropriate at all, as the issuer's main payment obligation arises on maturity and therefore unavoidably involves a long forecast.

Key financial metrics and financial ratios

We do not believe it is appropriate to require specific financial ratios to be included in a prospectus, nor would it be appropriate to prescribe the formulae to be used.

The history of ASIC's development of Regulatory Guide 228 in 2011 is instructive in this regard. ASIC released Consultation Paper 155 in April 2011, which 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 suggested prescribing the formulae for these ratios.

After receiving extensive feedback on the Consultation Paper, ASIC released Regulatory Guide 228 in November 2011. Its position in relation to financial ratios changed markedly. The final Regulatory Guide says only that an issuer should consider including financial ratios in a prospectus that are appropriate for that particular issuer, and that the ratios can be legitimately calculated in a number of ways including using pro-forma or prospective information[6]. In our experience, the financial covenants applicable to an issuer's credit agreements or other debt instruments will often be the most instructive for consideration by investors.

ASIC's final position in RG228 is, we submit, sound. Companies in different industries will naturally have very different financial ratios, and these differences do not necessarily indicate any increased risk for investors. For example, the gearing ratio for a financial institution will normally be very high compared with, say, a mining exploration company. The working capital ratio for a large retailer will normally be very high compared with, say, a construction contracting company. This simply indicates a different business model, not a different risk.

We therefore submit that mandating specific financial ratios would not aid comparison between issuers. At worst, it could mislead investors by presenting a ratio that is irrelevant for a particular issuer with the implication that it can be meaningfully compared with the same ratio for a different issuer.

5.3 Incorporation by reference

The Discussion Paper presents a number of proposals for incorporation by reference that we believe are very worthwhile pursuing.

[6] ASIC RG228.103 – 228.108

In particular, being able to incorporate third party information is a commendable proposal as it will assist in shortening prospectuses. Such third party information could include:

(a) standard risk warnings or disclosures prepared by ASIC,

(b) information regarding the relevance and calculation of key financial ratios (subject to the above caveats as to comparability between issuers in different industries) prepared by ASIC, and

(c) a standard explanation of the tax treatment of interest and capital gains (or losses) prepared by ATO.

Having a standard information such as this would help shorten all bond prospectuses.

6. Other disclosures – Ongoing reporting

Ongoing reports, such as the quarterly reports made under section 283BF, are a useful addition to the initial disclosures made in the prospectus. Although any material issues should be caught under an issuer's continuous disclosure obligations, there may be matters of detail that could usefully be reported on a periodic basis. These details could include, for example, an issuer's compliance against financial covenants (such as in a senior ranking facility), and certain financial ratios. We suggest that this would be a more useful disclosure tool than requiring forecasts in the initial disclosure document (see section 5.2 above).

However, in our view it is not appropriate to legislate for a "standardised" set of financial ratios in a quarterly report, for the reasons set out in section 5.2 above. It would be better, we believe, for this kind of information to be provided on a basis that is customised for each issuer. The most practical way for this to be done is for the issuer to agree with the underwriter or lead managers to the issue as to what will be contained in the quarterly reports. These parties are closest to the market and will know best what investors want to see disclosed on a quarterly basis.

7. Multi-part prospectuses

The retail bond prospectuses issued in the last 18 months or so have generally used a "single part" prospectus, despite relief for a multi-party prospectus having been made available by ASIC since May 2010.

Part of the reason for this may have been a lack of clarity as to what information must be included in each part, and this can easily lead to duplication of information and a longer document overall.

We support the proposal outlined in the Discussion Paper for a streamlined multi-part prospectus regime, under which a bond issuer could issue further tranches by means of a term sheet and cleansing statement. This proposal would advance the policy of making debt capital markets more accessible, and making them better aligned with equity capital markets, by providing issuers with a more compelling commercial justification for undertaking the cost and effort to create the initial retail bond prospectus.

8. Liability for prospectus content

The Discussion Paper notes (correctly, in our view) that one disadvantage of offering bonds to retail investors is the increased time and expense for a due diligence process for the prospectus, as compared with institutional offers such as into the US private placement market.

However, the proposed removal of deemed personal liability for directors of the issuer of a bond prospectus does not appear to us to be a solution to this issue, for reasons including the following:

(a) the company and any underwriter to the offer would still have deemed liability for the whole prospectus[7], and therefore the normal due diligence process would still have to be undertaken in order to make the applicable defences available to those parties;

(b) as noted in paragraph 85 of the Discussion Paper, directors have other potential liabilities under the Corporations Act for a misleading document, which would not be removed. These are subject to a "reasonable steps" element, which would mean that the same due diligence and verification procedures would still be undertaken to prepare the prospectus; and

(c) the due diligence process is as much about ensuring the prospectus is complete and accurate as it is about documenting a defence to personal liability. The mandatory content rules proposed in the Discussion Paper may therefore have the unintended effect of creating an increased need for due diligence and verification.

Perhaps, an alternative approach is to ensure that the content requirements for a retail bond prospectus are kept to a minimum, which in turn would reduce the need for due diligence by all parties with potential liability for the document. Initiatives such as incorporation by reference will assist in this regard.

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Please feel free to contact either of us if you wish to discuss the above points further.

Yours sincerely,

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[7] Corporations Act section 729