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15 March 2017

Manager
Financial Services Unit
Financial Systems Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/ Madam

**Design and Distribution Obligation and Product Intervention Power
Submission: Hybrid Securities issued by APRA-regulated entities**

We refer to the invitation to comment on the Proposals Paper dated December 2016 in relation to *Design and Distribution Obligations and Product Intervention Powers*.

Set out in Annexure A are our submissions on the Proposal Paper as it relates to hybrid securities issued by entities regulated by the Australian Prudential Regulation Authority.

If there are any points arising from these comments that you would like to discuss with us, please do not hesitate to contact us.

Yours sincerely

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Annexure A

Submissions in relation to Hybrid Securities issued by APRA-regulated entities

1 Introduction

The focus of these submissions is the impact of the proposals set out in the Proposals Paper dated December 2016 in relation to *Design and Distribution Obligations and Product Intervention Powers (Proposals Paper)* on hybrid securities issued by APRA-regulated financial institutions, including authorised deposit-taking institutions (**ADIs**) and insurers. We note that this submission does not relate to corporate hybrids issued by non-ADIs.

Annexure B sets out details of hybrid issuances by APRA-regulated institutions from 1 January 1998–3 March 2017. Hybrid securities issued by ADIs and insurers generally take the form of capital notes, convertible preference shares, and subordinated debt. These instruments are typically issued to assist in satisfying regulatory capital requirements imposed by APRA in line with the frameworks developed by the Basel Committee on Banking Supervision.

2 Overview

We submit that given the regulatory landscape underpinning the issue of hybrid securities by APRA-regulated financial institutions, hybrid securities should be excluded from the operation of the design and distribution obligations for the reasons set out in section 3.

In the event that a general exemption for APRA-regulated hybrid securities is not adopted, we submit that a reasonable steps defence should be available in relation to the distribution obligations contained in the Proposals Paper in relation to these securities, for the reasons set out in section 4.

We also consider that the current regulation of hybrid securities is adequate and the extension of the intervention powers to hybrid securities is not warranted for the reasons set out in section 5.

3 Design and Distribution Obligations

The Proposals Paper notes that there will be an exemption from the design and disclosure obligations for ordinary shares as they are widely understood by consumers, and to reduce the regulatory costs associated with companies undertaking capital raisings. We submit that analogous policy considerations for exempting ordinary shares could be applied to hybrids issued by APRA-regulated institutions.¹

The reasons supporting an exemption from the design and distribution obligations for hybrids issued by APRA-regulated institutions are set out below.

(a) The prominence of ADI-issued hybrid securities in the Australian market

Hybrid securities are a prominent and well-known type of security in the Australian capital markets. In the period between 1 January 1998 to 3 March 2017, \$72.14 billion was raised through 352 hybrid security issues (of which \$42.35 billion or 59% was raised by APRA-regulated institutions through 46 issuances of hybrid securities).

In the past, some concerns have been raised about the terms of hybrids, including the complexity of certain terms relating to redemption, write-off mechanisms and risks. As a consequence, ASIC engaged in a comprehensive investor education program which has

¹ As a broader point, and beyond the scope of this submission, it is not clear to us why there should not be other exclusions, such as units in managed investment schemes, listed stapled securities and simple corporate bonds. For example, why should the issuer of units in a large, well-capitalised REIT that pays a passive income to its members be subject to more onerous regulation than the issuer of shares in (for example) a technology start-up company with no profit history and a high cash-burn?

included providing investor warnings, directions to issuers, pre-lodgment review of prospectuses, liaison meetings with corporate lawyers who act for issuers, and consumer education through the media and on its MoneySmart website.²

In particular, ASIC stated in relation to "REP 365 Hybrid Securities", released in August 2013, that its report detailed:

- "what we have done to engage with hybrid issuers and the brokers that sell hybrid securities so that these features and risks are clearly disclosed and the products are not being mis-sold; and
- the investor warnings and education about hybrid securities we have provided through the media and on ASIC's MoneySmart website."

A number of repeat issuers in the banking sector have also responded to the challenge of educating investors on the features of hybrid products by providing online quizzes and questionnaires that can be utilised by prospective investors to gauge the suitability of hybrid products for their own specific investment circumstances.

In our view, the passage of time, the considerable frequency of hybrid issuances, and information available to investors through the means outlined above, have culminated in an increased investor familiarity with hybrid structures. We think this position is also reflected in the fact that, although ASIC practice previously involved pre-lodgement review of prospectuses for hybrid issues, this is no longer the case. This change in practice reflects a recognition that appropriate standards of disclosure are being met by hybrid issuers and that there is no longer a need to subject hybrid issues by ADIs to a higher degree of scrutiny due to a lack of understanding by investors.

(b) Reducing the regulatory costs of capital raisings

Part of the rationale for the ordinary shares exemption is that companies should not be subject to additional regulatory and compliance costs for issuing ordinary shares.

Given that the issue of hybrid securities by APRA-regulated financial institutions is driven by regulatory capital requirements, and is an essential component of capital management for these institutions, we think the exemption should also extend to APRA-regulated hybrid securities. It is unclear why the issue of APRA-regulated hybrids should be subject to additional compliance costs when ordinary share issues are exempted, particularly as such products remain subject to comprehensive disclosure requirements under the Corporations Act and the oversight of each of ASIC and APRA.

(c) Product design and features of ADI-issued hybrids are driven by regulatory capital requirements

We submit that it is not practical to impose product and distribution obligations in relation to the issue of hybrid securities by APRA-regulated financial institutions. As noted above, the issue of these types of securities is driven by regulatory capital requirements. Accordingly, the product design and typical features of APRA-regulated hybrids (such as redemption events, non-viability and capital trigger events) are designed to achieve compliance with the Basel framework and capital adequacy requirements, rather than to meet the needs of particular target markets. As a result, imposing obligations to consider target markets and product suitability is not a practical consideration in the context of hybrid securities issued by APRA-regulated financial institutions. Rather, the objective of investor protection is satisfied through traditional approaches to disclosure – that is, clear, concise and effective disclosure

² <http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-365-hybrid-securities/>

of the rights and liabilities of the relevant security, and providing all information that a retail investor and his or her investment advisor would reasonably require to make an informed decision about whether or not to invest.

(d) **Freely tradable products**

Similar to ordinary shares, hybrid securities are freely tradable products on the ASX. As a result, defining target and non-target markets for these products where any subsequent purchase is outside the control of the issuer has limited practical utility. In essence, designing a product to meet a particular type of investors' criteria can quickly become an illusory objective if the product is readily transferred to a person who is entirely willing to acquire the product yet does not form part of the "target" market.

It is clear that people with identical proximity to retirement, and identical levels of income, financial literacy, and access to financial information, may still have different risk appetites and suitability for investment into hybrid products. In any case, whether suitable or not, such investors would be able to freely access such products through online trading on ASX.

In essence, there is a dichotomy between primary issuances of products that are intended to be retained by a single holder (such as an insurance policy) and those that are able to be traded freely in the anonymous secondary market. Our contention is that the regulation of the latter types of financial products is more likely to lead to greater costs and is unnecessary.

For completeness, we do not consider that restricting these products from being listed on ASX would be an appropriate course of action. To do so would reduce liquidity and may increase the cost of capital for ADIs and insurers. It would also unfairly deny retail investors the right to participate in hybrid issues which may be suitable for their risk profile and personal circumstances.

(e) **Unnecessary regulatory costs**

Section 1.2 of the Proposals Paper states that the Proposed Measures have been developed having regard to the principle that the measures should be implemented in a way that avoids unnecessary regulatory costs. The inclusion of hybrid securities within the ambit of the design and distribution obligations would involve increased regulatory costs without a corresponding benefit as:

- (i) ADIs are subject to significant regulatory capital requirements which have been amplified in recent years through Basel III. The cost of holding capital for ADIs has impacts for financial institutions, including costs that are passed on to customers. Over-regulation that increases the costs of raising capital, or limits the ability to raise capital without incurring further liability, and can have adverse consequences for the customers of ADIs and the wider economy.
- (ii) In the current environment of low interest rates and investment returns, an unintended consequence of the additional regulatory and compliance costs may be to lead investors away from APRA-regulated hybrids towards even riskier products in the hope of achieving a higher return.
- (iii) Unlike financial products that tend to be customisable to a particular individual's needs (such as loan or insurance products), hybrid securities are listed instruments and freely tradeable on ASX. As a result, they are subject to a further layer of regulatory oversight through ASX as to the appropriateness of the terms and governance of such securities. As a listed product, hybrid securities are also subject to monitoring by the media, analysts, brokers and governance groups, which means

that any serious concerns with the features, suitability, or operation of hybrid products will become quickly well-known to the market.

(f) **Existing investor protections are sufficient**

In our view, the design and distribution obligations are unnecessary in the context of hybrid securities issued by APRA-regulated institutions as most retail investors participating in such issuances:

- (i) participate through AFS licensees who are subject to strict obligations in relation to the provision of advice and recommendations (and who are exempted from the new regime in any case where providing personal advice);
- (ii) participate through a reinvestment offer, indicating a level of experience, understanding and acceptance of the risks involved with hybrid securities; or
- (iii) participate through a securityholder offer, where they are existing shareholders of, and have a degree of awareness of the risks involved in investing in that institution.

4 Safe harbour in relation to distribution arrangements if 'reasonable steps' are taken by the issuer

In the event that the need for a general exemption for APRA-regulated hybrid securities is not accepted, we submit that a reasonable steps defence should be available in relation to the distribution obligations contained in the Proposals Paper in relation to these securities.

As noted on page 22 of the Proposals Paper, some product issuers have expressed concerns about the expectation that they may be indirectly accountable for the conduct of external distributors under the reforms. While we agree that product issuers cannot be wilfully blind if distributors are acting in a manner that is inconsistent with their expectations, we submit that it is impractical for product issuers to engage in rigorous policing of distributors' compliance with appropriate selling methods.

Where an issuer has complied with its design obligations to consider the needs of identified target markets, and taken reasonable steps to comply with the distribution obligations, for example, by:

- (a) notifying distributors of the target and non-target market for the product;
- (b) providing scripts and pre-recorded messages with approved disclosures highlighting key features in relation to the product;
- (c) providing a pre-approved fact sheet or summary for provision to investors in relation to the product; and/or
- (d) providing easy access to calculators, case studies or self-assessment tools,

the issuer should not be subject to any liability for the further conduct of the distributor.

APRA-regulated financial institutions typically partner with numerous analysts, external brokerage firms or a group member who is licensed to trade in securities (who in turn work with a wide network of individual brokers and investment advisers), such that it would be impractical for such issuers to rigorously police, through regular periodic monitoring, the activities of the full network of distributors (who are already subject to existing obligations applying to the provision of advice and the sale of financial products). Accordingly, such issuers should not be subject to additional liability where they have taken reasonable steps to comply with the distribution obligations.

In addition, where a retail investor specifically and voluntarily signs a document or provides an electronic confirmation that they (i) understand the features and risks of a product, and decline further advice; or (ii) wish to acquire the product notwithstanding having been advised that it may not be suitable for their specific needs and investment profile, the issuer should have no further liability.

5 Extension of intervention powers to hybrid securities issued by APRA regulated entities

We do not consider it is necessary to extend the proposed intervention powers to hybrid products. Hybrid products are already the subject of considerable regulation that includes comprehensive disclosure requirements, potential 'stop orders', limits on advertising, market review during exposure periods, liability frameworks, APRA oversight, and a range of other regulatory guidance from ASIC that covers selling/ marketing, research, and disclosure.

We are aware of certain steps taken by offshore financial regulators to restrict hybrid issuances. These can include prohibition orders from selling such products to retail investors, or increasing the minimum denomination so as to deter retail investors from participating in the primary issue or from trading in the secondary market. We do not believe such steps to be necessary in the Australian market in light of existing safeguards and their adequacy to address investor protection concerns. As an example, most recent hybrid ADI prospectuses contain a section upfront on guidance as to the suitability of the product for retail investors and direct investors to the hybrid section of ASIC's moneysmart.gov.au website. Also, as noted earlier in relation to the design and distribution proposal, steps that make it harder for retail investors to participate in such offerings, or deter issuers from enabling retail investors to participate in particular markets, can unnecessarily limit investor choice within the Australian capital markets and, as a consequence, could have the impact of steering investors into other riskier products or offshore products. Additionally, interventionist steps by regulators to ban or prohibit investment products in the interests of investor protection can have the unintended consequence of stifling the ability of retail investors to 'grow' their knowledge in relation to the terms of products which are not vanilla and to develop a more sophisticated and liquid capital market.

6 Other Concerns

(a) Existing products in the market and grandfathering

Section 3.4 of the Proposals Paper (on page 29) notes that for products already available to consumers, it is proposed that these can continue to be offered without having to comply with the new obligations for a period of 2 years.

It is unclear how this grandfathering regime would work in the context of an existing hybrid security with a time to maturity of greater than 2 years. After the initial 2 year period, it is unclear what action an APRA-regulated issuer could take in relation to monitoring and reviewing the suitability of listed hybrid securities for holders (who may change through on-market transactions at any time). Amendment to the terms of an outstanding hybrid security is an involved process, and requires approvals from both APRA and a meeting of securityholders. Even in an extreme case, the issuer's ability to cancel or redeem the product would be extremely limited given it has already obtained, and is relying on, capital recognition from APRA. As a result, to the extent that an exemption in relation to hybrids issued by APRA-regulated entities is not adopted, we submit that the grandfathering regime should apply for the full unexpired term of such products (not just an initial 2 year period).

We think this is a critical issue for Treasury to address since any uncertainty about how regulatory powers may be imposed or applied in this context could have a destabilising effect on current and/ or future issues. Any destabilisation of the hybrid market could have significant ramifications beyond simply investors who currently hold hybrids and ADIs and insurers who have existing programmes, to the wider economy.

(b) **Secondary market sales and post sales review**

Page 25 of the Proposals Paper notes that once a product has been released to the market, product issuers should periodically review their products with reasonable frequency to inform whether any changes are necessary to the design and distribution going forward.

As noted above, it is unclear how this obligation would operate in practice in the context of ASX-listed products where secondary market sales may occur at any time. It is also unclear what responsibility an issuer may have to anonymous prospective purchasers on the listed secondary market who may or may not find that product suitable.

Annexure

B

Details of Hybrid Issuances (APRA-regulated issuers): 1 Jan 1998 - 3 March 2017*

Source: Thomson Reuters Connect4 (New issues – hybrids)

	ASX Code	Company Name	Date Announced	Date Listed	GICS Industry	GICS Code	Not	Raising/Buyback Type	Issue Type	Issue Price	Amount Listed/Cancelled \$	
1	NCC	New Cap Reinsurance Corporation Holdings Ltd	18/11/1998	25/01/1999	GICS Applicable			Placement, raised	capital	CNotes	1.3	\$7,280,000
2	NAB	National Australia Bank Ltd	12/05/1999	8/07/1999	Banks			Placement, raised	capital	INSec	100	\$2,000,000,000
3	WBB	Wide Bay Capricorn Building Society Ltd	30/11/2001	28/12/2001	Diversified Financials			Placement, raised	capital	RESET	1	\$350,000
4	IAG	Insurance Australia Group Ltd	6/05/2002	8/06/2002	Insurance			Placement, raised	capital	RESET	100	\$350,000,000
5	BOQ	Bank of Queensland Ltd	18/07/2002	24/07/2002	Banks			Placement, raised	capital	RESET	109	\$10,000,096
6	AMK	AMP Reset Preferred Securities Trust	25/09/2002	25/10/2002	Insurance			IPO		RESET	100	\$1,150,000,000
7	WBK	Westpac First Trust	25/11/2002	20/12/2002	Diversified Financials			IPO		RESET [units]	100	\$667,114,000
8	WBB	Wide Bay Capricorn Building Society Ltd	6/12/2002	19/12/2002	Diversified Financials			Placement, raised	capital	RESET	100	\$35,000,000
9	IAG	Insurance Australia Group Ltd	20/05/2003	27/06/2003	Insurance			Placement, raised	capital	RESET	100	\$200,000,000
10	ANZ	Australia and New Zealand Banking Group Ltd	14/08/2003	2/10/2003	Banks			Placement, raised	capital	StEPS	100	\$1,000,000,000
11	PCB	PERLS II Trust	15/12/2003	7/01/2004	GICS Applicable			IPO		PERLS II	200	\$1,000,000,000
12	PMN	Promina Group Ltd	31/03/2004	6/05/2004	Insurance			Placement, raised	capital	RESET	100	\$300,000,000
13	SGB	St George Bank Ltd	2/07/2004	19/08/2004	Banks			Placement, raised	capital	SAINTS	100	\$350,000,000
14	SGB	St George Bank Ltd	19/01/2001	22/02/2001	Banks			Placement, raised	capital	PRYMES	100	\$300,000,000
15	IAN	IAG Finance (New Zealand) Ltd	26/11/2004	12/01/2005	Insurance			IPO		RES Securities	100	\$550,000,000
16	WCT	Westpac TPS Trust	30/05/2006	22/06/2006	Diversified Financials			IPO		WBC TPS	100	\$762,737,500
17	SGB	St George Bank Ltd	31/05/2006	27/06/2006	Banks			Placement, raised	capital	Step Up Prefs	100	\$150,000,000
18	CBA	Commonwealth Bank of Australia	11/06/2007	18/07/2007	Banks			Placement, raised	capital	PERLS IV	200	\$1,465,000,000
19	WBC	Westpac Banking Corporation	20/02/2009	8/04/2009	Banks			Placement, raised	capital	WBC SPS II	100	\$908,327,800
20	ANZ	Australia and New Zealand Banking	14/02/2012	21/03/2012	Banks			Placement, raised	capital	Sub Notes-	100	\$1,508,652,000

ASX Code	Company Name	Date Announced	Date Listed	GICS Industry	Raising/Buyback Type	Issue Type	Issue Price	Amount Listed/Cancelled \$
	Group Ltd				raised	ANZ		
21	NAB	14/05/2012	19/06/2012	Banks	Placement, raised	capital Sub NAB Notes-	100	\$1,172,514,000
22	WBC	20/07/2012	24/08/2012	Banks	Placement, raised	capital Sub WBC Notes-	100	\$1,676,219,000
23	CBA	3/09/2012	22/10/2012	Banks	Placement, raised	capital PERLS VI	100	\$2,000,000,000
24	CBA	12/08/2009	15/10/2009	Banks	Placement, raised	capital PERLS V	200	\$2,000,000,000
25	WBC	30/01/2013	18/03/2013	Banks	Placement, raised	capital Cap WBC Notes-	100	\$1,383,569,000
26	WBC	10/07/2013	23/08/2013	Banks	Placement, raised	capital Sub WBC Notes-	100	\$925,285,000
27	AMP	6/11/2013	19/12/2013	Insurance	Placement, raised	capital Sub AMP Notes-	100	\$0
28	WBC	18/06/2008	31/07/2008	Banks	Placement, raised	capital WBC SPS I	100	\$1,036,267,000
29	ANZ	2/07/2013	7/08/2013	Banks	Placement, raised	capital Cap ANZ Notes-	100	\$1,120,000,000
30	ANZ	11/02/2014	1/04/2014	Banks	Placement, raised	capital Cap ANZ Notes-	100	\$1,610,000,000
31	SBK	28/10/1998	17/12/1998	Banks	Placement, raised	capital Sub SBK Notes-	100	\$200,000,000
32	SME	5/10/1998	7/01/1999	GICS Code Not Applicable	Placement, raised	capital Ords	5	\$319,487,215
33	SME	5/10/1998	7/01/1999	GICS Code Not Applicable	Placement, raised	capital CNotes	7.1	\$1,011,750,000
34	SBK	10/07/2001	16/09/2002	Diversified Financials	Placement, raised	capital RESET	100	\$25,000,000
35	WBC	7/05/2014	30/06/2014	Banks	Placement, raised	capital Cap WBC Notes-	100	\$1,310,570,500
36	CBA	18/08/2014	6/10/2014	Banks	Placement, raised	capital PERLS VII	100	\$3,000,000,000
37	ANZ	23/01/2015	10/03/2015	Banks	Placement, raised	capital Cap ANZ Notes-	100	\$970,179,100
38	NAB	17/02/2015	26/03/2015	Banks	Placement, raised	capital Cap NAB Notes-	100	\$1,342,844,400
39	WBC	27/07/2015	15/09/2015	Banks	Placement, raised	capital Cap WBC Notes-	100	\$1,324,428,000
40	AMP	26/10/2015	4/12/2015	Insurance	Placement, raised	capital Capital AM Notes-	100	\$0
41	MQG	23/11/2015	22/12/2015	Diversified Financials	Placement, raised	capital Cap MQG Notes-	100	\$530,992,100
42	CBA	16/02/2016	4/04/2016	Banks	Placement,	capital PERLS VIII	100	\$1,450,000,000

ASX Code	Company Name	Date Announced	Date Listed	GICS Industry	Raising/Buyback Type	Issue Type	Issue Price	Amount Listed/Cancelled \$
					raised			
43	NAB National Australia Bank Ltd	31/05/2016	12/07/2016	Banks	Placement, raised	capital Cap NAB Notes-	100	\$1,498,863,000
44	WBC Westpac Banking Corporation Australia and New Zealand Banking Group Ltd	17/05/2016	6/07/2016	Banks	Placement, raised	capital Cap WBC Notes-	100	\$1,702,053,400
45	ANZ Australia and New Zealand Banking Group Ltd	16/08/2016	5/10/2016	Banks	Placement, raised	capital Cap ANZ Notes-	100	\$1,622,000,000
46	IAG Insurance Australia Group Ltd	21/11/2016	30/12/2016	Insurance	Placement, raised	capital Cap IAG Notes-	100	\$404,126,500

* This table above does not represent all issues of hybrids. Additional offers, for example, of which we are aware that have subsequently been disclosed to the market (but which have not been finalised at the date of this submission) include:

- An offer by National Australian Bank of \$800 million of NAB Subordinated Notes 2 (February 2017)
- An offer by Commonwealth Bank of Australia of \$1.45 billion of PERLS IX Capital Notes (February 2017)
- An offer by Challenger Limited of \$430 million of Challenger Capital Notes 2 (February 2017)