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Our ref KPMG submission FY12

Dear Sir

Submission - Discussion paper: Development of the retail corporate bond market: streamlining disclosure and liability requirements

We are pleased to have the opportunity to comment on Discussion paper: Development of the retail corporate bond market: streamlining disclosure and liability requirements.

Executive summary

We are supportive of the objective of better aligning disclosure for retail corporate bond issues with the process already allowed for share entitlement offers when the issuer is already subject to continuous disclosure obligations, without significantly impacting the level of protection for investors.

In our view, to more closely align the process for the issue of retail bonds with the issue of equities, retail bond issuers should (in addition to the options presented in the Discussion Paper) have the option for the provision of a cleansing statement and a brief document setting out the terms of the bonds, the existing capital structure of the issuer, and the impact of the offer on the entity where the issuing entity is listed and therefore already subject to continuous disclosure.

Despite our view that a cleansing statement and brief document as set out above should also be an option for retail corporate bond issuers, we note that with a substantial range of debt product features, and the potential for a bond's risk profile to change based on the changing capital structure of the issuing entity, debt products will be more complex for an investor to understand than equity products. Thus the desire to reduce the administrative and regulatory burden in retail corporate bond market issues must be balanced against the need to ensure that all of the information which a retail investor would reasonably require to make an informed investment decision is readily available to them.

In formulating the proposed content requirements for a short form prospectus in a retail corporate bond issue, Treasury has focused on the features of the bond to be issued. However, it is important to note that the risk profile of a debt instrument is also a function of the capital structure of the issuing entity and the ability of the issuing entity to change that capital structure. As such, a retail investor will require information not only in relation to the features of the bond to be issued, but also the features of all existing debt of the issuing entity, and any restrictions (or lack thereof) on the raising of further debt by the issuing entity after the retail bond issue has been completed.

In the institutional corporate bond market, investors have access to ratings reports which consider all material factors affecting the debt product, including the current capital structure and ability of an issuer to change that structure, and rate it accordingly. Ratings reports are not currently available to retail investors and therefore the retail investor must be able to analyse all of the information relevant to the entity and the risk profile of the debt instrument in order to make an investment decision. In our view, access to ratings reports would facilitate a more efficient and informed investment process for the retail market, and may reduce the level of disclosure required by the retail issuer.

Referring to other matters raised in the Discussion Paper, we strongly disagree with the proposal that an unmodified audit report should be a condition of a retail bond issue using the short form prospectus. Any such condition would be inconsistent with other equity and debt raising scenarios, and unnecessary given the audit report is publicly available thereby enabling an investor to consider the nature of any modification and factor it into their decision making.

Specific comments

Our comments on the specific matters raised for comment and on other issues are set out in Appendix 1.

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We would be pleased to discuss our comments with the Treasury. If you wish to do so, please contact me on (03) 9288 6748, or Jeff Cook on (02) 9335 7487.

Yours faithfully

Scott Mesley
Partner

Appendix 1

Our comments on the specific matters raised for comment and on other issues are set out below.

Should the short form prospectus be compulsory for issuers and bond issues that meet the eligibility requirements set out below, or should it be optional?

Should the use of a two-part prospectus be permitted?

In our view the disclosure requirements for bonds and equities issued by entities already listed should, as far as possible, be aligned in order that the market can benefit from a consistency in approach to debt and equity. For equities there is, in certain circumstances, currently only a requirement for the provision of a cleansing statement where the issuing entity is listed and therefore already subject to continuous disclosure. Although this is not an approach presented in this Discussion Paper, we suggest it be considered as an option. As has become common practice in relation to equities, the cleansing statement would be likely to be supplemented by issuers releasing a short document to the market outlining the terms of the bonds, the existing capital structure of the issuer, and the effect of the offer on the entity.

Consistent with the objective of facilitating a market for retail corporate bond issues in Australia, we would support a number of different disclosure options being available to issuers as this will give issuers the greatest flexibility. The options available to issuers should be:

- a cleansing statement and short document (as discussed above);
- a short form prospectus;
- a two-part prospectus;
- a full prospectus.

We note that the remainder of the Discussion Paper has been drafted as though the short form prospectus or two-part prospectus are the only two options under consideration. We have therefore responded to the remaining questions in that context, notwithstanding our view that a cleansing statement may be the preferred method for listed entities to issue retail bonds.

Are these proposed conditions appropriate? Are there any additional or alternative conditions that should be imposed?

Should unlisted entities with listed securities on issue be allowed to use the shorter prospectus? If so, what, if any, additional requirements would need to be imposed to ensure that investors are informed about the entity's financial position?

Should eligibility extend to a wholly-owned subsidiary of a body which has continuously quoted securities where the business of the subsidiary is to act as a financing company for the group?

Is the requirement for an unmodified auditor's report appropriate, or is it:

- **inconsistent with audit requirements in other contexts where unmodified reports are not necessary?**
- **unnecessary, as some modifications may be positive**
- **unnecessary because, if the report is modified, investors will have access to the modified report in order to make an assessment of the relevant issues.**

In our view, unlisted entities with listed securities should be permitted to issue the shorter prospectus, or any of the other options proposed above which are available to listed entities, provided that the unlisted entity is subject to the same continuous disclosure requirements and financial reporting requirements as listed entities.

In our view, where the bond issuer is a wholly-owned subsidiary of a body which has continuously quoted securities and the business of the issuer is to act as a financing company for the group, eligibility for the issue of retail corporate debt under the shorter prospectus, or any of the other options proposed above, should be extended to the subsidiary, but only if the listed parent guarantees the bonds to be issued.

KPMG does not consider it appropriate for there to be a requirement for an unmodified audit report. An unmodified audit report is not a pre-requisite in any other equity or debt raising context, and introducing it in this context would introduce an unnecessary and unjustifiable inconsistency.

Further, it is inappropriate to draw such a nexus between an audit report and the disclosure requirements that should apply to a retail corporate bond offering. The role of the auditor is to provide an independent opinion on the compliance of an entity's financial statements with the requirements of applicable legislation and accounting standards. Creating a nexus between the audit report and the disclosure requirement for a bond offering may falsely imply that the auditor has considered what disclosure requirements should apply in forming their audit opinion.

Also, an auditor's report may be modified for a variety of reasons, many of which may be of little or no relevance to the degree of risk associated with a retail bond offering by the entity to which the auditor's report relates. The auditor's report will be available to potential investors in any retail corporate bond offering and investors should refer to that report and any modifications contained within it as one of a broad range of inputs into their decision making in relation to the bonds on offer.

Are the proposed conditions set out above appropriate? Is there a case for adopting any of the alternative conditions? In particular:

- **Should subordination be allowed? If so, is disclosure of the fact of subordination sufficient to protect investors?**

- **Should terms longer than 10 years be permitted? If so, how long should the permitted maximum be, or should there be no maximum?**
- **Should deferral of interest be permitted, or would this be inconsistent with the notion that bonds provide a regular income stream?**
- **If eligibility is extended to bonds that have conditions such as subordination, very long terms or deferral of interest, will far more risk disclosure be required and would this undermine the utility of shorter disclosure for these products?**

Is there a risk that investors may confuse more complex products with vanilla bonds, if both types of investment are able to take advantage of simplified disclosure? Is it important that the bonds be correctly described? For example, if an issuer offers subordinated bonds or hybrid-type securities, should it be obligatory that the name of the securities not suggest to retail investors that vanilla bonds are being offered?

We are supportive of the proposed conditions for the issue of retail corporate bonds under a short form prospectus, or other options listed above.

In our view, subordination should be permitted, provided that the disclosure of the subordination, and the implications for the risk associated with investing in the retail corporate bond, is clear and prominent in the prospectus. Clarity of disclosure could be achieved through the use of a summary capital structure showing ranking / priority (an example is included below). The level of subordination should be clear to investors, as a retail investor should not be under the misconception that a debt product is less risky than equity if in fact it is so heavily subordinated as to be almost in the same risk category as equity.

<u>Example capital structure summary</u>

	Ranking	**Existing Primary debt obligations**
Higher ranking	Secured debt	Bank facilities (secured syndicated loan facility, secured working capital facilities A and B)
↑	Unsecured unsubordinated debt	**Bonds Example A** and other unsecured and unsubordinated debt obligations
↓	Unsecured subordinated debt	None
	Preference shares	None
Lower ranking	Ordinary equity	Primary ordinary shares

In conjunction with this capital summary (and in the absence of an investment rating), we suggest that further detail on the entity’s capital structure be a mandatory inclusion in the prospectus. Whilst it may not be necessary to prescribe the additional disclosures which need to be made, as these will vary depending on the structure and type of instruments issued by the issuing entity, examples of areas that may need to be disclosed are:

- Maturity profile (timing/quantity of other debt instruments and when they mature)
- Details on existing covenants (e.g. a covenant breach for another instrument may cause it to be repayable on demand or trigger a lock-up on distributions including to other debt instruments)
- Ability of the company to obtain other debt which could rank equally or ahead of the contemplated bond (permitted indebtedness). If this is not disclosed or not able to be disclosed then it should be prominently presented as a risk elsewhere in the prospectus
- Ability for the company to provide security over its assets to other lenders (permitted security)

In relation to the term of the new debt issue, we suggest that terms of longer than 10 years should be permitted in order to provide the most flexibility for issuers (for example issuers who are involved in infrastructure projects). However it will be necessary for there to be clear and prominent disclosure of the term of the debt, for example on the front of the short form prospectus. This would be consistent with common practice in relation to speculative equity investment offerings. Similarly, RG228 issued by ASIC requires disclosure in the investment overview section of a prospectus if the achievement of objectives is high risk.

If longer-term retail debt issues with reduced disclosure requirements are to be permitted, we suggest that guidance should be issued as to the form of disclosure of the expected returns for investors, such as a requirement for an annual equivalent rate of return on all bond issues. This would ensure that there is clarity of anticipated full term return and annual return.

In our view, deferral of interest should be permitted, but clear and prominent disclosure in the prospectus should be required, with it being made clear to investors that a deferred interest bond is less attractive to the market, and will therefore be less liquid than other bonds.

We do not expect that having one of the features listed above would require significantly more risk disclosure than if those features were not present. In order to facilitate easy comparison for investors of a number of different characteristics of bonds, we suggest a standard format be designed to address the common features of a retail bond issue which could then be used by investors as a ‘side-by-side’ comparison. For example, at the front of the prospectus it could be mandatory to include a table similar to the below:

Summary of retail bond terms	
Issuer	[Name of issuer]
Bond name	Primary Bonds Example A
Vanilla bond	YES / NO (if no, include description of why not)
Face value	$[ ] per bond
Currency	Australian Dollars

Interest	Description (e.g. fixed interest rate of X% , floating interest rate based on 90 day BBSW plus a fixed margin of 3%)
Interest payment	Quarterly in arrears
Deferred interest	Yes / No / Discretionary
Term / Principal repayment	Maturity date [X] years from the issue date
Ranking at time of issue	Description
Early redemption rights	YES / NO (if yes, include description)

It is recognised that further disclosure would be required in the prospectus in relation to some of the terms, for example if there was a floating interest rate then the base rate and floating component and associated risks would need to be separately disclosed.

If there was to be a disclosure in the negative or affirmative regarding whether a bond was vanilla (as per our first suggested table entry), we recognise that there would need to be a tight definition issued by Treasury of a vanilla bond.

With regard to additional requirements which could be imposed, we agree that a minimum issue size may be beneficial, as beneath a certain size the market will be illiquid. However the minimum issue size should be carefully considered, as in accordance with the issuer considerations set out in the policy background, small and medium sized companies do not have access to domestic wholesale debt markets, and would benefit from being able to issue debt to Australian retail investors in a cost-effective way. A minimum issue size of, say, $50 million could act as an inhibitor to small and medium sized companies accessing the retail bond market. We note that there is no minimum threshold for raising capital through issuing equity.

Should the entity or the bond issue be required to have an investment grade rating (if available)? If so, how would an investment grade rating be defined and mandated?

What other measures could the Government or ASIC take to enable the provision of credit ratings to retail investors?

As noted above, one of the objectives of the proposed policy is to enable small and medium-sized companies to have access to the retail bond market. A requirement for companies to have an investment grade rating may become an inhibitor to a large number of entities, as for example, a smaller company would not be able to obtain the same rating as very large companies, and are therefore automatically disadvantaged when being compared by retail investors.

A credit rating process is not followed for equities and given, in our view, the issuing process for debt and equity by entities already subject to continuous disclosure obligations should be aligned as far as possible, we have reservations about there being a rating requirement.

However, we acknowledge that with a substantial range of debt product features, and the potential for a bond's risk profile to change based on the changing capital structure of the issuing entity, debt products will be more complex for an investor to understand than equity products. In the institutional corporate bond market, investors have access to ratings reports which consider all such material factors affecting the debt product, and rate it accordingly. Generally, ratings reports are not currently available to retail investors and therefore the retail investor must be able to analyse all of the information relevant to the entity and the risk profile of the debt instrument in order to make an investment decision. This analysis process could be made more efficient and informed through the availability of a rating report for the retail bond issue.

Whilst we note that the cost to obtain an investment rating is currently not significant, there is an unwillingness by the ratings agencies to make ratings accessible to the retail market. If a rating was a mandatory requirement of an issue, the cost to an entity of obtaining a rating may increase commensurate with the additional risk and associated insurance cover which the agencies would then require.

In relation to other measures which ASIC or the Government may take to enable the provision of credit ratings to retail investors, we would be supportive of such measures in principle, but do not have a view on how ASIC or the Government would be able to provide such a rating.

Should the prospectus contain prescribed headings and/or prescribed content?

Should there be a maximum prospectus length (possibly with ASIC having discretion to increase this)? If so, what should be the maximum length for (a) a standalone prospectus; (b) each part of a two-part prospectus? Could a two-part prospectus be restricted to a maximum total of, say, 40 pages?

Would it be useful to consumer test one or more examples of 'model' prospectuses?

In our view, the short form prospectus, if used, should have prescribed headings to promote consistency in disclosure. However, there must still be scope for other information to be included, and the headings must be broad enough to allow for application under the varying circumstances of different issuers and issues.

It is our view that a maximum prospectus length should not be prescribed, either for a standalone prospectus or a two-part prospectus. The overarching consideration must be to provide investors with the information they require to make an informed decision on their potential investment.

Whilst we agree that it may be useful to consumer test one or more examples of model prospectuses, we note that the Australian retail investor community currently has little or no experience of assessing retail bond information and so the exercise may yield only limited value.

Assuming that headings are appropriate, are the above headings suitable? Would other headings be preferable?

Would an investment summary be a useful inclusion?

If a short form prospectus is being used for the retail bond issue, then the headings provided in the Discussion Paper are not inappropriate.

In the event that our preferred option of a cleansing statement and a short document outlining the terms of the bonds, the existing capital structure of the issuer, and the effect of the offer on the entity were adopted then several of the prescribed headings would not be necessary.

It is our view that an investment summary would not be a useful inclusion, as the short form prospectus should be concise enough not to require a summary. A relatively standardised format and the (envisaged) shorter prospectus should mean that the retail investor can locate the information they require within the full document.

Are the content requirements suggested below appropriate?

Are there alternative or additional content requirements that should be adopted?

If a short form prospectus is being used for the retail bond issue, then the content suggestions provided in the Discussion Paper are broadly appropriate.

In the event that our preferred option of a cleansing statement and a short document outlining the terms of the bonds, the existing capital structure of the issuer, and the effect of the offer on the entity were adopted it would be possible for the document to contain an application form for the issue, and a limited number of pages with the following content:

- disclosures about the bond (e.g. in the table format suggested above)
- timetable
- pro forma balance sheet and summary capital structure (e.g. in the format suggested above)
- links to where the company information can be found online
- links to any other pertinent information (e.g. ASIC resources).

Could section 4 be merged with section 3?

It is likely that in the event that section 3 and 4 exist separately, both will refer to benefits of investing, as it will be difficult to explain the bond's features without also highlighting benefits of such features. As such, it would be more efficient to combine the two sections.

Combining the two sections may also reduce the potential for the benefits of investing being given greater prominence than the risks of investing.

Is it appropriate to require the inclusion of information on the capacity of the issuer to meet its obligations under the bonds? Would this require the issuer to provide forecasts which should not be required for bond transactions?

If ratios are to be included, should the formulae to calculate the ratios be prescribed and, if so, what formulae should be used?

If the abovementioned metrics are not useful given the nature of the issuer or the industry they are in, could the issuer be permitted to use other metrics?

In relation to information regarding the issuer's capacity to meet obligations under the bond, historical and proforma ratios such as gearing and interest cover would be most appropriate (further details on this are discussed below). We acknowledge that forecast information may be of interest to investors, however the provision of forecasts should be optional. The forecast period covered will be an important consideration since, in line with ASIC guidance issued in RG170 *Prospective Financial Information*, there must be reasonable grounds for any forecast issued. The reasonable grounds requirement means that it would be unlikely that forecasts could span more than 12-18 months, which for most issues will not provide clarity over the capacity of the issuer to meet its obligations over the life of the bond.

In relation to the disclosure of ratios, it is our view that useful ratios should be disclosed, but we do not agree that forcing consistency by stipulating the method of calculation of each ratio, or the source of the components of each ratio, will lead to better disclosure for investors. Issuers should disclose financial ratios, and calculate those ratios, in the manner that results in the most relevant information being provided to investors. Issuers should then be required to disclose how they have calculated the ratio, and from where the components have been sourced, to enable a reader to assess the relevance and reliability of the ratio.

It is our view that, at a minimum, historical and proforma gearing and interest cover ratios should be prescribed as a mandatory inclusion in any retail bond issue document. Issuers should also be permitted to disclose any other ratios which they believe are useful to investors, but as noted above, the calculation method and source of components should also be disclosed.

Would other content requirement reforms, be desirable, for example:

- **A statement of general principles, including that the complexity of prospectuses is to be minimised, repetition is to be minimised and the focus of disclosure is on matters material to a consideration of an investment in the bonds;**
- **Inclusion of the terms of the bonds and the trust deed (if applicable) on the issuer's website rather than in the prospectus;**
- **Inclusion of a summary of the tax consequences of the bonds for investors rather than a full opinion from a tax advisory firm;**
- **Requiring issuers to refer to other sources of information about themselves such as their Annual Reports and websites; and**
- **Publication by the Government, ASIC and other relevant bodies of relevant general information for investors, including in relation to the calculation and relevance of key ratios. Issuers could be required to refer to this independent information rather than to attempt to provide this advice to investors.**

We agree that the items listed in the Discussion Paper to include within a statement of general principles are appropriate. We suggest that the statement should also make it clear that the prospectus should, for the most part, only disclose information not already disclosed to the market.

The terms of the bond and trust deed should be a mandatory inclusion in the prospectus, although if issuers also want to include them on their website and incorporate them by reference that should be permissible.

If the issuer prefers to use a summary tax opinion, the option for that rather than a full tax opinion should be available.

In order to reduce the size of the prospectus and limit repetition, we agree that the issuer should refer to other sources of information about themselves such as their Annual Reports and websites, and it is our view that these should be incorporated by reference.

We agree with the proposal of the Government, ASIC and other relevant bodies publishing general information for investors, and issuers referring to this in the prospectus. We suggest that if a set of prescribed ratios was to be published, then issuers should refer investors to these ratios and then discuss any variations between the calculations prescribed and the calculations that the issuer has used.

Will retail investors benefit from reading these reports?

Also, should account be taken of the fact that not all bonds require a trustee and therefore not all bonds are subject to section 283BF?

We do not believe that there should be a quarterly reporting requirement, since the issuer will already be subject to continuous disclosure. We suggest that there could instead be a requirement to disclose the occurrence of any of the events listed in 283BF(4) *Content of quarterly report* when they occur. This will ensure that the market/investor is informed immediately of such events, but will remove the requirement of additional reporting for those issuers which have not had any such events occur.

Do you agree with a two-part prospectus approach, or do you consider it would be preferable to have a prospectus followed by a term sheet and cleansing statement? What is the basis for your view?

What should be the maximum life of a base prospectus?

Is it feasible and/or appropriate to specify what information should be included in each part of a two-part prospectus, or alternatively in a short prospectus, term sheet and cleansing statement? If so, what should that content be?

As discussed above, our preferred approach to a retail corporate bond issue by a listed entity is to have a cleansing statement, a short document outlining the terms of the bonds, the existing capital structure of the issuer and the effect of the offer, and application form. We consider this to be consistent with Treasury's objective to have a process which facilitates efficient disclosure. However, if a prospectus approach is being used, then flexibility should be retained with options for a short form, or a two-part, prospectus.

If a prospectus approach is pursued, the maximum life of a base prospectus should be unlimited, as is the case for equities, since the entity is subject to continuous disclosure requirements. An exception to this could be that a new prospectus be required if a change in the capital structure of the issuer has occurred with implications for the risk profile of the bonds.

We consider it feasible to specify the information which should be included in each part of a two-part prospectus, or alternatively in a short prospectus, term sheet and cleansing statement.

Should there be scope to have information that is 'otherwise referred to', for example the issuer's annual and half-yearly reports, or information such as ASIC's MoneySmart website?

Should it be made clear what the effect of referring to such information will be since it does not form part of the prospectus (for example, could it satisfy prospectus content requirements even though there is no prospectus liability for this information)?

There should be scope to include information that is 'otherwise referred to', however for annual and half-yearly reports we would anticipate that the information would be incorporated by reference, as discussed above. Only information which is not prepared by the issuer (e.g. ASIC-prepared information) would be 'otherwise referred to'.

We would appreciate further clarity as to why it is proposed that information prepared by the issuer would be 'otherwise referred to', and not subject to prospectus liability, as this would seem inconsistent with the requirements on issuers raising equity.

We agree that for non issuer-prepared information which is 'otherwise referred to', disclosure that there is no prospectus liability for that content may be appropriate.

Should directors' deemed civil liability for prospectus content be removed?

In our view, directors' deemed civil liability for prospectus content should not be removed entirely. Directors are appointed by an entity's members to oversee the operations of the entity of their behalf. As such, directors must owe a duty to the members and, in our view, that duty should extend to ensuring that members and others are not misled or deceived and are provided with appropriate and sufficient information on which to base decisions relating to the entity, including whether or not to invest in the entity via the acquisition of equity or debt instruments.

We acknowledge this is a complex matter and there is scope for considering alternative approaches to the existing position, but would be concerned by any proposal to remove directors' deemed civil liability for prospectus content entirely.

Should subsection 708(19) be amended in the context of these proposed reforms?

KPMG has no comment on this point.

Is there a need for a transitional period and, if so, what should that period be?

We do not perceive that there is any requirement for a transitional period.

Other matters

KPMG also makes the following observations in relation to other matters which do not fall within the specified questions.

It is our view that other private non-listed corporates should be able to issue a short-form prospectus, but only if the instrument has a credit rating and the ratings report is made available to retail investors

In relation to paragraph 59 (which deals with the summary of the interests of advisers and of any fees relating to the bonds), if a ratings agent will be required, then they should also be a specified person in this disclosure.