Response to Treasury Discussion Paper:

Development of the retail corporate bond market: streamlining disclosure and liability requirements

Tony Kench
Capital Markets Professional
m: 0414 889 047
e: Tony.Kench@optusnet.com.au

Tony Kench

Experienced Capital Markets professional, having founded CommSecs Equity Capital Markets, then having primary responsibllity for the Commonwealth Bank CommSec hybrid business for 2002 to 2010.

n 2011, I worked with a boutique corporate advisory practice, advising a number of ASX listed corporates around potential retail bond issuance.

I have discussed the issues which prevent corporations from access the retail market for senior funding with a number of corporate treasurers. I , and have a understanding of the issues from a retail investors perspective from my years in working with Commonwealth Banks extensive distribution networks.

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?

There will be times where an issuer would prefer more fulsome disclosure and choose to opt out of the short form regime. This might include situations where the company has undertaken significant transactions in the prior few months which may substantially modify forward accounts and balance sheets from previous published accounts. While these may have been covered in scheme documents and the like – this may require further disclosure in the context of the bond issue.

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

Yes, particularly as described such that subsequent issues may be conducted off the back of a "term sheet". This would be significantly more appealing to companies as it facilitates the ability to top up issues – primarily via reverse enquiry when brokers are able to get a number of clients to bid the issuer for stock (particularly when that liquidity is not available on the market). This would significantly enhance the attractiveness of the market if companies believed they could facilitate new issues without the substantive documentary work required in issuing a new prospectus. The cost structure of a program that includes multiple top up issues could be lessened substantially. This is also in line with how institutional debt tap issues are completed.

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

Ideally, these should be very similar to the requirements for companies to complete an undocumented equity issue. As the risk in the securities is significantly less than for some issuers' equity, the conditions should be less rigorous for a debt issue (subject to accurate description of security features and the like). There are practical difficulties linking conditionality to issue size. Some companies may be unsure whether they could get that volume from the market, at the price they are prepared to issue. This then leads to a situation where the companies would practically need to do a full prospectus anyway to cover the prospect that they are unable to raise the $50m required, even though they will targeted the $50m threshold when launching the issue. For some – incurring additional underwriting costs to guarantee the $50m issue size will be enough of a change in cost structure to make the issue uncompetitive vs other funding sources.

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?

No. Even though companies may have listed securities, if the ordinary shares are not listed the volume of information provided to the market is practically a lot less than a company whose ordinary shares are listed provides. (This is the case with companies that have listed debt but not equity issued on the market.) There is a far greater need to ensure that these companies provide the most up-to-date description of where the business is at – to ensure that investors can assess the retail bond offering.

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?

Yes, provided the issuing subsidiary is guaranteed by the parent or part of the any guarantee group. This ensures investors are getting exposure to the known parent company, rather than a less well capitalised finance subsidiary.

Is the requirement for an unmodified auditor's report appropriate, or is it:
(a) inconsistent with audit requirements in other contexts where unmodified reports are not necessary?
(b) unnecessary, as some modifications may be positive?
(c) 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?No Comment

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?

Yes – provided that the subordination is clearly disclosed. Even a subordinated fixed income security has substantially less risk than an ordinary equity. Ordinary equity issuance is facilitated without the need for prospectuses and it is appropriate a lower threshold be adopted for these securities.

As an investor protection, consideration should be given to inclusion of information regarding subordination very early in the prospectus even within the security name. Any requirement really needs to capture structurally subordinated securities (say where the company issues prior ranking debt), just as much as those that are subordinated through legal form. To facilitate the appropriate naming there may need to be specific guidance, that if an instrument is structurally subordinated though not subordinated through the terms, that the instrument still be called subordinated, as otherwise confusion may abound.

• Should terms longer than 10 years be permitted? If so, how long should the permitted maximum be, or should there be no maximum?

There should be no maximum. In practice, let the market decide, as investors will limit the term they are prepared to invest in depending on the quality of the issuer. Very strong quality issuers may like to try 15 or 20 year terms and, as retail investors are prepared to purchase the same companies perpetual hybrids which have higher risk, there shouldn't be a limitation around the terms of the senior debt.

In practice, companies are seeking to extend the duration of funding, so allowing the retail market to potentially provide longer duration funding is a major positive. It also works to counterbalance one of the biggest impediments to issue. I.e. the retail issue costs – particularly brokerage – as these costs do not increase substantially with term and so can be amortised over a longer period of time hence reducing the marginal impact of the higher upfront costs in comparison to other forms of debt issuance

• Should deferral of interest be permitted, or would this be inconsistent with the notion that bonds provide a regular income stream?

There are reasons to both facilitate it and to deny it. In contrast to subordinated instruments – if an issuer has the ability to defer interest without penalty – the embedded risk of the security is magnified as the investors/ trustee are unable to pressure the company and move to appointing administrators – when the company does strike trouble. While the risk is less than in an equity issued by the same issuer, having an unencumbered right to defer interest is a significant escalation in risk vs an issue where the company defaults on non payment. See comments below.

• 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?

As a fundamental proposition, any of the fixed income style securities should require less disclosure around risks than of an equity issue by the same company. The key issue with subordinated instruments / or those having deferral features is these features need to be highlighted so investors understand they are buying something that is not a straight bond.

Investors will not make a distinction that one instrument has different features to another just because it uses the stand alone prospectus format rather than the retail bond disclosure format. As such, there needs to be a more fundamental shift in how instruments are described so that investors understand the differences.

I believe it would be a significant step forward if there was mandated description of subordination or deferral features within the security name. .

One alternative approach may be to prescribe that there be a discussion in the offer summary of how the terms of the notes differ from any bank debt or other capital markets debt the issuer (or related finance entities) have issued. This disclosure will not scare retail investors off for the right quality names; however, it will enhance their ability to make informed decisions.

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?

No, as discussed above, irrespective of the underlying issuer, the bond will always have less risk than the company's equity and as such the companies should be afforded the opportunity to issue debt securities with a less onerous disclosure framework than the ordinary equity.

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

The current asymmetry in lack of disclosure of ratings to true retail investors is a major problem where institutions and more sophisticated (and advised) retail investors will end up having access to ratings but those who most would benefit from the understanding of a independent review do not have access.

ASIC should have rethink its position with the major ratings agencies around the retail licensing requirements. In fact if a compromise cannot be reached we would recommend dropping the requirements altogether. The greater need is to protect retail investors by giving them access to the same information that institutions have. The current situation is farcical where ASIC has effectively mandated the most experienced investors in the market have the benefit of additional information that the retail investors who would benefit most do not have access. Two classes of disclosure – is not protecting retail. In contrast a suitable alternative approach may be to say that if a company has a rating that this must be published, irrespective of whether the security is rated, together with all the descriptive information around what the ratings means. Any recent ratings reports should ideally be placed on the issuers website so retail investors have access to the same commentary as institutions.

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

The concept of prescribed content is reasonable, there needs to be an overriding flexibility given to the issuer and its advisers to add more detail if desired. I have seen first hand where lawyers have looked at ASIC regulatory guides as primary focus and then have lost sight of the big picture re what needs to be disclosed in a circumstances of a particular issue.

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?

It seems that a major way of cutting the length of the document is to actually not include the detailed terms under which the security is offered. While most readers would not read these terms – it seems a backward step in not including these. There would need to be a requirement that these be made available with the prospectus and that the issue have them freely available on the website.

In a practical sense for some entities with vast business' with multiple inherent business risks the biggest practical difficultly will be ensuring risk disclosures are short enough. This may particularly be the case for business with limited operating history, or with a volatile financial footing given the extreme levels of volatility in various markets at the current time. It is very difficult in some business's to condense the risk discussion when one is concerned re disclosure obligations

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

No, as practitioners have a good understanding of the issues and should be able to use their expertise accordingly. They are likely to come up with a significantly better model than road testing a group of investors who may have little insight from past experience.

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

The headings are generally appropriate. I would question whether there is a need to have a description about the company given the reliance on continuous disclosure reporting. If one is to be included, it would be very generic/ unlikely to change between issues over a period of time. It description of core business only.

I would recommend not mandating inclusion of a tax summary, given the simplicity of taxation of retail bonds and fact this does not change between bonds, this would be better covered in an ASIC guide to investing in retail bonds that could be referred to in prospectus rather than be included each time. If the rules are to facilitate hybrids being afforded the same disclosure standards then for convertible or hybrid securities it would be appropriate to include such a discussion as there it would be relevant.

Would an investment summary be a useful inclusion?
This is an interesting area, as industry practice has developed to include in all issues to date. This is in fact the part of a prospectus that most investors would read so by its inclusion, you facilitate easy review by a retail investor. If the desire is to try getting investors to read more of the document, you would probably not include such a section. On balance I would recommend inclusion, as this is the area that a retail investor is most likely to read and having it facilitates their simple understanding of the core investment proposition.

Are the content requirements suggested below appropriate?

Yes

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

Could section 4 be merged with section 3?

They should be merged as they otherwise there will be significant repetition.

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?

Inclusion on Information on capacity to pay is very important. It would be worthwhile changing the structure from that currently adopted in RG 213 where there is a specified methodology to calculate interest cover, gearing and working capital ratios to a method that is tied to bank covenants if any. I would suggest that the company include details of ratios calculated in the same manner as the required under the issuers existing financing covenants (wether via bank debt or capital markets). If the company's existing debt is uncovenanted, then the generic ratios could be adopted.

For companies who have equity accounted investments, I would propose that ASIC be given flexibility to review the methodology used in calculating ratios, as the current methodology does not work well where companies have numerous equity accounted investments that all have own unsupported banking arrangements – particularly where the balance sheet equity positions have not been marked to market.

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

No as stated above, it would be far better to align the disclosed covenants to the methodology the company adopts with its bankers. This gives far more reasoned ratios as they are appropriate to the company's situation rather than being generic. Different industries have different measures via which banks and credit rating agencies look at the companies/ industries underlying credit worthiness and these are the more sensible to adopt.

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?

Yes, hence the desire to tie the metrics to the Issuers banking covenants. If the Issuer doesn't have covenants it may be appropriate for the issuer to disclose the metrics the most suitable for their industry.

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;
(See comments above)
• Inclusion of a summary of the tax consequences of the bonds for investors rather than a full opinion from a tax advisory firm;

See comments above, we would recommend not including this description at all for Retail bonds but only for convertible/ hybrid securities

• 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.

Will retail investors benefit from reading these reports?

The actual 283BF style reporting is of little value, in practice you would hope any event that would be triggered for reporting via that mechanism would already be captured under continuous disclosure. Of more relevance is the half yearly reporting of updated financial ratios – in a manner consistent with the reporting in the initial offer document?

While not a question posed, the requirement to issue a 283BF report is seen as a substantial impediment by a number of corporates to issuance. This is in large part due to the requirement for a directors resolution to sign off on the report. No such report is required for institutional issuance. Even if the reporting requirement remained and senior management were able to sign off, consistently with other management obligations, there would be less concern around these requirements. I would recommend changing this rule as part of the package,

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?

There would be no additional benefit to be gained from forcing entities such as ADI's who are not required to issue under a trust arrangement to issue such reports.

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?

The prospectus and term sheet is clearly the preferable route. I have discussed this with potential issuers and they see great benefit to this approach as you could effectively just issue of the back of a new term sheet which is far simpler, As such external legal counsel may not to be involved, helping reduce cost – which is one of the major reasons the retail market has not been established (the cost differential visav a institutional issue). It will facilitate tap issuance, which is a big desire of the corporate market. Particularly, allowing a simple process for brokers to accumulate demand for an issue at a price and then contact the issuer to see if they are prepared to issue and put out a simple term sheet.

In the extreme it could facilitate an ongoing internet based offer where the company is prepared to offer to issue new securities on a different price on any day.

What should be the maximum life of a base prospectus?

There should be no reason why a prospectus actually has a multiyear shelf life (3 – 5 years say), given the company is continuously disclosing. Particularly, if the company is making semi annual announcements regarding its financial ratios.

In practice, companies will look to review whether the material within the base prospectus is current and that should drive the timing of an updated issue.

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?

While this is feasible, it is dependent on ASICs goals in terms of how much information is available within the primary document vs. the needs for short documents, simplicity that will actually facilitate development of the market. In the extreme, the term sheet style approach would simply have the terms for the new issue (particularly for large companies where the incremental issue is unlikely to change financial ratios materially if at all). The company disclosure of information previously excluded under the confidentiality carve out could be made to the exchange in the normal manner so this doesn't add to term sheet.

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?

Yes.

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

No. In practice retail investors would probably not understand the technical differences even if explained. In any event, as to what a director’s liability position is will have no bearing at all on an investors purchase decision.