Acacia Partners Pty Ltd
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Dear Committee Secretariat,

Re Inquiry into the Development of the Australian Bond Market

Acacia Partners Pty Ltd (**Acacia**) is pleased to provide this submission which outlines our views on the potential factors which have limited the development of a deeper corporate bond market in Australia (**Submission**).

Acacia and its principals are amongst the most active and experienced advisers in Australia in bringing debt issues to the listed market, including under the vanilla bonds class order relief which preceded the Simple Corporate Bond (**SCB**) legislation, under the SCB regime itself and under the class order relief for convertibles.

We believe that investors and issuers would benefit from a more active listed market, and while we believe that legislative reform will contribute to market development in both a listed and over-the-counter context, we also believe that there is much the industry can and should do to improve the efficiency and attractiveness of issuance.

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We look forward to engaging with the inquiry to facilitate continued improvements to the bond market.

Kind regards

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Damian Pretty
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SUBMISSION: INQUIRY INTO THE DEVELOPMENT OF THE AUSTRALIAN CORPORATE BOND MARKET

1. LIMITATIONS ON REPAYMENT OPTIONS

Since the global financial crisis, understanding and taking early steps to manage the task of refinancing debt obligations has been a top priority for boards and management of Australian corporates. In most instances this means being able to extend the term of a financing arrangement prior to its stated maturity or replacing one funding source or instrument prior to its stated maturity with another.

The current SCB regime limits the ability of a corporate issuer to manage its refinancing risk because it places substantial limitations on the ability to repay SCBs prior to their stated maturity. While issuers have some alternatives, for example the consuming process of seeking a vote of holders to extend the maturity date[1] or the expensive option of leaving an existing bond with associated covenants on issue after it has effectively been refinanced[2] these are obviously undesirable and uncommercial alternatives.

Early repayment rights are a feature of the wholesale unrated market, particularly amongst the less frequent borrowers who would benefit most from reform. In contemplating what measures may assist the development of the market, flexibility to repay early may be the most important on any corporate treasurer's list.

There are three common approaches to providing repayment flexibility:

1. Issuers can repay prior to maturity, at defined dates for face value. *For example, an issuer will be able to repay up to six months prior to the maturity date at face value.*

2. Issuers can repay at a call date for face value, if they do not, the rate of interest is subject to a one time step-up. *For example, a margin of 4% applies for the first four years, if notes aren't called at four years the margin increases to 5% until notes are repaid after five years.*

3. Issuers can repay at a call date at a set premium to face value, if they do not, they are otherwise required to redeem on the maturity date at face value. *For example, an issuer can redeem a four year note for 101% of face value after three years, if they do not exercise that right the notes are redeemed at face value after four years.*

Recommendations:

Grant issuers of SCBs greater flexibility to refinance during the 12 months prior to the maturity date. This would include allowing issuers, during this period only, the right to redeem at face value or a premium to face value, or to step-up the interest rate or margin if the security isn't redeemed early.

Increase the 10% clean up call limit (s. 713A(13)(f) of the Corporations Act (2001)) *to 25%.*

[1] IMF Bentham Limited was the last issuer under the vanilla bonds class order relief which preceded the SCB regime. Its bonds (ASX: IMFHA) were scheduled to mature June 30 2019, but in December 2018 holders passed a special resolution put by the company amending the terms of the bond to extend the maturity date and vary certain other terms.
[2] Australian Unity Bonds Series B (ASX: AYUHB) were issued in 2015 in the first transaction under SCB regime. In 2019, Australian Unity refinanced via the issue of Australian Unity Bonds Series C (ASX: AYUHC) and Series D (ASX: AYUHD). A reinvestment offer was made to existing holders which received strong support with approximately $178 million opting to reinvest. While sufficient funding was raised to more than redeem the balance, Australian Unity has no right to do so as greater than 10% remain on issue (s. 713A(13)(f) of the Corporations Act (2001)).

2. KEY FINANCIAL RATIOS

While a one size fits all approach adopted under ASIC Regulatory Guide 69 has worked well in relation to the unlisted debenture market where issuers on-lend funds raised, the current approach of reporting prescribed financial ratios set out in Regulation 6D.2.05 and 6D.2.06 doesn't sufficiently recognise the diversity of business models, funding models, and accounting standards which apply to different corporates.

Under the current regime, while complying, issuers need to contemplate whether financial ratios required to be included under the Corporations Act may be misleading to investors. While well intended, this seems to be a perverse situation in which the pursuit of consistency may potentially leave investors more confused rather than better informed.

Recommendation: *Prescribed financial ratios are removed. Issuers are instead required to explain and disclose key financial ratios which it believes are relevant to its capacity to service and repay or refinance SCBs.*

3. OFFER SPECIFIC PROSPECTUS

The SCB offer document regime is unwieldly and prolonged and acts as a disincentive to issuers. Issuers currently undertake prospectus due diligence with respect to both the offer specific prospectus and the base prospectus as required under the SCB regime. The preparation and issuance of multiple disclosure documents means more resources and time are required by issuers to produce and verify the content of those documents. This increases transaction costs and adds execution risk.

The requirement for an exposure period in relation to a first issue of SCBs compounds this and when coupled with established market practices can cause problems for issuers, advisers, investors and regulators. Current market practice in relation to listed bonds is generally:

1. Receive commitments from key institutional investors prior to lodgement of an OSP.
2. Lodge the OSP.
3. Brokers market to their clients and receive expressions of interest from retail clients.
4. Brokers and institutions bid into a bookbuild prior to the completion of the exposure period.
5. Securities are allocated to brokers and institutions.
6. Exposure period completes and offer opens.
7. Brokers syndicate their allocations to retail clients.
8. Offer settles.
9. Securities issue.

There are two sequential problems related to the exposure period. The first, that to incorporate retail requires a longer period at which the issuer is at risk of adverse market developments reducing their prospects of success. The second is that because retail cannot apply for bonds during the exposure period, there is also a material risk of adverse market movements occurring in between the allocation of securities to brokers and the advice to acquire securities which triggers sub-allocation from the broker to an individual investor. If the market has weakened, a broker may be obliged to subscribe for or procure subscriptions for securities which it can no longer justify recommending to its clients. Arguably, the investor protection which is sought by the exposure period is offset by these additional conflicts.

Recommendations:

- *For an SCB, the base prospectus should remain subject to a 7-day exposure period (which ASIC can extend to 14 days).*
- *The offer specific prospectus should be replaced by a pricing supplement.*
- *The pricing supplement should not be subject to an exposure period, including for a first issue under a base prospectus.*
- *Arrangers and issuers should then adjust their approach to allow for completion of the exposure period on the base prospectus prior to lodging a pricing supplement – which could be issued in both a preliminary and final form.*

4. REPORTING

Arrangers and key investors or channels have the capacity to require enhancements to the reporting of issuers. In particular, the terms of an instrument could require enhanced reporting such as measures for covenant purposes, and specific confirmation of compliance with specific key terms. These could be included within the 283BF quarterly reports. Requiring more specific confirmations can support the discipline of issuers in meeting their obligations. Reports should be made readily available to investors via ASX or the issuer's website.

Recommendation - market:

Arrangers should require 283BF reports be released to ASX or otherwise made readily available on the issuer's website, and that they are required to include appropriate covenant and/or financial ratio calculations, in reasonable detail, as at quarter end dates or at least as at half year and full year balance dates to facilitate comparison to lodged financial reports.

Recommendation – government:

None.

5. WHOLESALE ISSUE LISTING

In order to make it easier for ASX-listed entities which already meet continuous disclosure requirements to issue senior bonds to private investors a simpler approach may be undertaking wholesale offers which are quoted and traded on ASX and supported by CHESS (or its replacement) rather than Austraclear. The advantages are numerous:

1. Access to the CHESS system will facilitate settlement of the primary issue and secondary market trades amongst private investors, using their existing CHESS accounts, without the requirement for a custodial account.
2. Reporting for private investors will be easily integrated into existing platforms without each platform needing to make substantial additional spend.
3. There would be no requirement for a prospectus, though we would expect ASX to specify a requirement for disclosure of the terms, the trust deed, the pricing supplement, a statement of key risks and compliance certificates to facilitate the market.
4. Investors and issuers would benefit from transparency of trading and pricing.
5. The universe of investors would be materially expanded relative to an OTC wholesale note issue.

6. Bonds could potentially season to be available to retail investors 12 months after issue.
7. A more transparent and contestable market would deliver more market power to issuers over arrangers, potentially reducing transaction costs.

Recommendation - market:

ASX to establish a genuine wholesale note market which clears via CHESS (or its replacement).

Recommendation – government:

Encourage the establishment of a listed wholesale note market.

6. CHAPTER 2L REFORM

There are currently only two trustees who are active in new issuance in the Australian retail market. One of these is reluctant to act other than for substantial issuers and the other requires ASIC approval to act. This situation gives rise to material uncertainty as to the availability and or timing of a trustee appointment and consequently adds uncertainty to retail issuance.

Trustees are declining appointments to potential 2L transactions because of liability concerns. We see scope for the exclusion of provisions which require the trustee to actively monitor in the case of listed issuance. We distinguish listed issuance, because transactions are infrequent and tend to be prospectus based, from unlisted debenture issuance which is often a program of continuous issuance through a prospectus which is renewed each year.

Recommendation: *Relax the monitoring requirements under 2L for listed issuance*

7. RATINGS

We are satisfied with the current regulatory settings in respect of credit ratings. We see substantial scope for emerging rating agency research to play an enhanced role in the market, particularly in relation to smaller public companies for whom the cost of traditional ratings agency services may be too high and where investors would arguably receive most value from ratings information. It is up to industry to support the uptake of credit ratings on new issues, whether retail or wholesale.

Having worked on several transactions which were rated by Australia Ratings[3] we note that such ratings information has been utilised and valued by both institutional and retail investors.

Recommendation - market:

Arrangers, key investors and intermediaries should more actively push for adoption of credit ratings for new issues, including in respect of hybrid securities.

Recommendation - government:

None.

[3] Australia Ratings was established in 2010 and is licensed by ASIC to issue credit ratings for use in the retail and wholesale financial markets. For more information visit www.australiaratings.com.

8. REGISTER TRACEABILITY

The ability to refinance via a new issue, extend the term of an instrument by passing a special resolution of bond holders, allow early repayment by passing a special resolution of bond holders, or amend or waive a covenant by passing a special resolution of bond holders, is impaired by the inability of a corporate issuer to identify the holders of its debt securities.

An equity capital raising for an ASX-listed issuer typically involves requesting a report that looks through nominee holders to identify the beneficial holders of the company's shares. In Australia, issuers lack the ability to approach refinancing and debt raisings on a similar basis as the requirements of section 672A and 672B of the *Corporations Act 2001* on which equity trace notices rely do not extend to interests in debt securities.

We see this situation as untenable and a reflection of the narrow market which has developed. We regard the modest reform recommended below as low hanging fruit, which will improve the ability of issuers to manage their funding because they will be able to identify who they are being funded by, and improve their ability to drive better competition and lower fees amongst arrangers as a result of ownership data being available to the issuer rather than an incumbent arranger. This information is valuable to <u>all</u> issuers but will be particularly valuable to issuers when under financial stress and needing to negotiate outcomes which enable them to repay and continue operating.

Recommendation: *Broaden Pt 6C.2 of the Corporations Act 2001 to enable beneficial ownership tracing of debt securities of Australian issuers.*

9. Reporting of OTC prices from clearing systems

The Australian OTC corporate bond market is fundamentally opaque, with limited price transparency available to investors. Recent observations from institutional investors underscore the risk that the carrying value of bonds may not reflect market pricing, particularly in periods of heightened volatility. A lack of reliable pricing information may reduce liquidity, diminishing the ability of investors and issuers to transact. A lack of actual pricing data may also influence the performance of benchmark indices and brings into question fairness amongst entering, exiting and continuing investors in a bond strategy.

Recommendation:

Austraclear to publish daily average price and volume figures for securities cleared through its platform.