Inquiry into the Development of the Australian Corporate Bond Market

ASX Submission

22 May 2020

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Introduction

ASX is pleased to respond to the Standing Committee on Tax and Revenue's Inquiry into the Development of the Australian Corporate Bond Market. This submission is focused on impediments within the Corporations Act, which prevent the potential development of a vibrant retail corporate bond market.

In summary, the submission recommends legislative changes to:

- allow ASX 200 issuers to list $A senior bonds, either new or existing, with a term sheet and cleansing notice
- allow issuers outside the ASX 200 to list $A senior bonds with a reformed SCB prospectus for the initial offer, but to require only a term sheet and a cleansing statement for subsequent tranches
- amend the prescribed SCB terms to permit early redemption at the discretion of issuers
- remove the anomalies and inefficiencies in the existing two-part prospectus regime for SCBs.

The submission is divided into four sections:

1. The history of efforts to develop the retail corporate bond market
2. Why the reforms to date have not succeeded in developing a retail corporate bond market
3. The four key matters Parliament needs to fix to develop a vibrant retail corporate bond market
4. Conclusion.

Section 1. The history of efforts to develop the retail corporate bond market

Initiatives to develop the retail corporate bond market over the past decade or so have principally focused on removing disincentives for issuers to offer simple bonds to retail investors. In essence, the proposals have sought a gradual opening up of the retail market for the issuance of simple senior listed bonds by entities listed on the ASX market, with investor protection leveraging off the existing robust continuous disclosure regime. In ASX's view, these recommendations have been incremental, modest and non-controversial. Yet for various reasons, these recommendations have not been successful and market development has stalled.

Johnson Report – 2009

The absence of a vibrant retail corporate bond market and the imperative to develop such a market was highlighted in the Johnson Report *Australia as a Financial Centre* (November 2009). The Johnson Report proposed as a remedy to the

problem the development of a simplified two-part disclosure regime for reasonably simple debt instruments issued by listed entities.

ASIC Class Order Vanilla Bond Regime – 2010

In 2010, the Australian Securities and Investments Commission (**ASIC**) introduced a Class Order to implement the recommendations of the Johnson Report, providing for the use of a two-part "simplified" prospectus for certain "vanilla" forms of senior unsecured bonds (**Vanilla Bonds Regime**). However, this initiative was not widely used after early examples showed that the Vanilla Bonds Regime did not produce simplified disclosure. Feedback from legal firms assisting corporate bond issuers at the time made it clear that the obstacles to simplified disclosure lay more in the interpretation and implementation of the disclosure tests and regulatory policy around prospectus disclosure, rather than the disclosure tests themselves.

Reform of the Commonwealth Inscribed Stock Act enabling retail access to Government Bonds – 2013

In 2013, the Australian Government took the lead in opening up the market to retail investors by passing legislation[1] that enabled Australian Government Bonds (AGBs) to be quoted on ASX. The quotation of AGBs on ASX was a necessary pre-condition for any successful development of a retail corporate bond market for the following reasons:

- **Price transparency:** AGBs are quoted on an exchange rather than traded over the counter (OTC). This instils greater retail investor confidence in the market price signal than the search function of an OTC facility and facilitates greater liquidity in smaller traded units than is usually available OTC
- **Trading, clearing and settlement efficiency:** AGBs leverage off an exchange's standard trading, clearing and settlement services ensuring operational efficiency, cost effectiveness and investor and adviser/broker familiarity. The market structure for AGBs links the wholesale OTC and exchange traded markets, ensuring price alignment between them. In addition, there is enhanced liquidity in the exchange-traded market through the provision of market making by approved bond dealers
- **Alignment between wholesale offer and retail offers:** There is complete alignment between the terms of the OTC issued bond and the AGBs quoted on exchange
- **Seamless and highly efficient process for issuers:** The market structure for AGBs allows issuers to issue bonds in large amounts and large denominations to wholesale investors and then have the bonds transmuted to products in smaller denominations that are more suited to retail investors
- **Low cost disclosure for issuers coupled with clear and concise disclosure for investors:** AGBs rely on the provision of an information statement[2] and a single page Term Sheet[3] to provide investors with an explanation of the benefits, risks and key terms of the bond. These are supplemented with a wealth of information on AGBs provided by ASX, ASIC and market intermediaries.

The Australian Office of Financial Management (AOFM) has provided, as reference, a summary of the market structure and the considerations for its implementation. Please see Appendix A.

Despite record low yields for AGBs, retail investor purchases of AGBs reached an all-time high in March 2020 of approximately $114 million, illustrating the demand for secure investments, particularly in periods of stock market uncertainty.

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[1] Commonwealth Government Securities Legislation Amendment (Retail Trading) Act 2012: https://www.legislation.gov.au/Details/C2012A00155
[2] The AOFM's Information Statement is a generic document applicable to all Treasury or Treasury Indexed Bonds issued: https://www.australiangovernmentbonds.gov.au/sites/default/files/2018-12/Investor-Information-Statement-for-Exchange-traded-Treasury-Bonds-150210.pdf
[3] The AOFM issues a single page Term Sheet for each new Treasury or Treasury Indexed Bond issued. For an example, please go to:https://www.asx.com.au/documents/products/AGB_Term_Sheet_GSBG25.pdf

The Simple Corporate Bonds Regime - 2014

Making AGBs accessible to retail investors through their quotation on exchange was envisaged as a foundation on which a market for retail corporate bonds could be built. Further industry consultation ultimately led to the introduction at the end of 2014 of the Simple Corporate Bonds disclosure provisions of the Corporations Act and Regulations (**SCB Regime**).[4]

Like the Vanilla Bonds Regime, the SCB Regime featured:

- **A two-part prospectus:** comprising a base prospectus that can be used over a number of years and an offer-specific prospectus for each issue of debt
- **Strict constraints on bond terms:** the permitted terms for bonds to qualify to use the SCB Regime are tightly constrained around matters such as term, interest rate, seniority and early redemption rights
- **No fungibility with wholesale market:** as a result of the prescribed constraints on bond terms, the SCB regime cannot be used to fund usual wholesale debt issuances, as wholesale debt typically has additional early redemption rights than are permitted under the SCB Regime.

In addition, the SCB Regime introduced a highly prescriptive set of disclosure requirements for the two-part prospectus. This was intended to encourage shorter and more targeted disclosure, as well as make it easier for investors to compare the features of different bonds. The liability burden for directors was also reduced, by removing civil liability for a director who was not at fault for a defective prospectus. However, the regime retained director consent requirements which have the potential to cut across this limitation on civil liability. Civil liability for a defective prospectus was also retained for underwriters. These last two factors have limited the extent to which diligence processes can be adapted to conform more with wholesale debt issuance processes, which in turn adds cost for those seeking to take advantage of the SCB regime.

The Financial System Inquiry (FSI) - 2015

The FSI Interim Report[5] observed that "*a deeper and more liquid corporate bond market would provide diversification benefits to both issuers and investors*" and that "*since the corporate bond market in Australia is largely over-the-counter and lacks transparency, retail investors are effectively precluded from investing directly in these bonds*."

The Interim Report also acknowledged that the SCB Regime only dealt with the issues relating to public offers of listed corporate bonds "*to some degree*".

After further submissions, the Final FSI Report recommended that "*Government should amend the law to reduce disclosure requirements for large listed corporate issuers of 'simple' bonds. The disclosure regime should comprise a term sheet for a standardised product and a cleansing notice ... the proposed regime would strike the right balance between reducing issuance costs and providing potential investors with sufficient information to make a considered investment decision*."

The Government's response to the FSI recommendation was that it "***agrees** to develop legislative amendments to modernise and simplify disclosure requirements for large corporates issuing 'simple' corporate bonds to the retail market. We are working with ASIC and market participants to assess the need for further improvements to support the corporate bond market.*"[6]

However, no progress has been made in introducing the necessary legislative amendments due to competing policy priorities.

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[4] Corporations Amendment (Simple Corporate Bonds and Other Measures) Act 2014: https://www.legislation.gov.au/Details/C2014A00100
[5] Financial System Inquiry Interim Report: https://treasury.gov.au/sites/default/files/2019-03/p2014-fsi-interim-report.pdf
[6] Government response to the Financial System Inquiry, Australian Government: https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry

Section 2. Why the reforms to date have not succeeded in developing a retail corporate bond market

The current SCB Regime has failed to deliver a viable retail corporate bond market.[7] The reasons for this include in particular:

- **Issuers find the prospectus framework expensive and cumbersome**: issuers who have ready access to wholesale bond markets struggle to justify the additional management time, costs and risks of preparing a prospectus for a separate listed series of SCBs, resulting in little primary issuance of retail corporate bonds
- **The constraints on bond terms in the SCB regime:** particularly those related to early redemption, prevent existing, well-established wholesale bond programmes from being transmuted into tradeable retail debt instruments, eliminating that as a source of added depth and liquidity for the retail corporate bond market
- **As a result, there is no depth or liquidity in the market for SCBs:** which, in turn, leads to existing wholesale debt issuers being reluctant to issue retail debt that will be "trapped" in a constricted market.

These factors feed upon each other and, as a result, there has been a negligible uptake of direct issuance under the SCB regime,[8] notwithstanding interest from potential issuers in simplified disclosure.

Other issues with the SCG Regime include:

- **Prescribed ratios are not suitable:** the strict prescription of the method for calculating relevant prescribed ratios overlooks that these ratios are not relevant to all issuers. It also assumes a standard formula for all issuers, which is not consistent with corporate practice. As a result, some irrelevant disclosures have to be included solely for compliance purposes, which is potentially confusing for investors and has to be explained. Other more relevant ratios also have to be included and explained. This has increased the length of the base prospectus
- **Repetition and separation:** the requirement for prescribed "explanations" and initial figures to be included in the base prospectus, with updated figures and explanations in the offer-specific prospectus, leads to separation of information, which did not support "readability" and navigation of the two-part prospectus
- **Two-part format does not work well:** ultimately, the updates that are required to the information in the base prospectus at the time of each issue tend to increase the length of the offer-specific prospectus. This tends to disrupt the logical flow of the document and increases the need for repetition of explanations, for context purposes, in each of the two documents, making the two-part format unwieldy
- **Need for replacement offer-specific prospectus:** the unwieldy nature of the two-part format is compounded by the fact that most debt issuances are priced after release of the initial prospectus, requiring a replacement "offer-specific prospectus" to be issued for each tranche
- **Limitations of incorporation by reference:** the two-part prospectus makes significant use of incorporation by reference and involves establishing a web page that references all key materials. However, this mechanism is unwieldy in a two-part format:
  - Different documents had to be incorporated into each part of the prospectus (including any replacement offer-specific prospectus)
  - ASIC policy encourages significant summaries to be included where documents are incorporated by reference. This increases the length of the two-part prospectus.

Realistically, without broad reforms it is unlikely that a viable listed bond market will be established relying on the SCB Regime. As discussed below, the critical mass needed to establish a listed bond market in the short to medium-term is likely to come from allowing existing senior wholesale bonds to be transmuted to the listed market.

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[7] There have been only four issuers of SCBs and a total of seven bonds issued. The major issuer to take advantage of the regime has been Australian Unity.
[8] See note 7 above.

Section 3. The four key matters Parliament needs to fix to develop a vibrant retail corporate debt market

In ASX's view, the four key reforms needed to improve the SCB regime and deliver a vibrant retail corporate debt market are:

- **ASX 200 issuers[9] should be able to list $A senior bonds, either new or existing, with a term sheet and cleansing notice (i.e. without a prospectus)**, adopting the FSI recommendation. Australia's robust continuous disclosure regime is considered sufficient for investors to trade shares on the ASX market on an informed basis. It should also be sufficient for investors to trade simple corporate bonds issued by ASX 200 companies, which have substantially less risk attached than shares
- **Issuers outside the ASX 200[10] should be able to list $A senior bonds with a reformed SCB prospectus** (see below) for the initial offer, but should be able to list subsequent tranches with a term sheet and a cleansing statement (i.e. no prospectus)
- **The prescribed SCB terms must permit early redemption** at the discretion of issuers, which is one of the main practical barriers to use of the SCB regime. This will allow existing, well-established wholesale bond programmes to be transmuted into tradeable retail debt instruments in the same way as AGBs, adding extra depth and liquidity to the retail corporate bond market
- **For issuers outside the ASX 200, the anomalies and inefficiencies in the existing two-part prospectus regime for SCBs should be addressed**, including:
  - since it will only be required for the first issue of a bond series, issuers should have flexibility to elect to combine the base prospectus with the offer-specific prospectus to produce one blended document, if it provides more effective and less disjointed disclosure
  - issuers should be able to nominate the ratios and formulae that are relevant to them in their prospectus – strictly prescribed ratios and formulae create inflexible outcomes and lead to meaningless and confusing disclosure
  - the prospectus should be able to be issued with blanks for pricing and updated on the ASX Market Announcements Platform and the issuer's website with the pricing information, rather than requiring the lodgement of a supplementary or replacement prospectus.

Why differentiate between issuers in and those outside the ASX 200?

Differentiating between issuers in the ASX 200 and those outside the ASX 200 reflects the different profile, financial standing and credit risk of those two cohorts.

Issuers outside the ASX 200 are less likely to be accessing wholesale bond markets and therefore are unlikely to have an established profile or financial standing in that market. They also will not have as high a profile with, or be as well understood by, retail investors as ASX 200 issuers. It makes sense that they should have to produce a two-part prospectus for any new bond issue they wish to make to retail investors. Thereafter, however, any further issues of bonds within the same series should be able to be listed with just a term sheet and cleansing notice.

For Issuers outside the ASX 200, this would effectively align the legal framework for bonds with the legal framework for 'low doc' rights issues, where listed issuers are required to issue a prospectus when they first list, but thereafter are allowed to issue ordinary shares in a rights issue effectively with just a term sheet and a cleansing notice. This recognises that ASX listed issuers are subject to a robust continuous disclosure regime under the ASX listing rules and

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[9] A reference to an issuer within the ASX 200 should include a special purpose wholly owned subsidiary of an ASX 200 listed entity that is guaranteed by the listed entity. This is a common structure for entities to access debt markets.
[10] Again, a reference to an issuer outside the ASX 200 should include a special purpose wholly owned subsidiary of a listed entity outside the ASX 200 that is guaranteed by the listed entity.

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the Corporations Act. It also reflects the fact that bonds are relatively simple instruments that carry much less risk than ordinary shares. In this regard:

- **Ranking in insolvency:** bond ranks higher than shares in an insolvency, resulting in bonds have a lower risk of loss of capital than shares
- **Priority of payment:** the interest due on bonds is generally payable before dividends can be paid on shares
- **Certainty of returns:** bonds will have regular payment dates for interest and a date for repayment of principal, whereas ordinary shares have no certainty as to dividends or capital return.

Issuers within the ASX 200 are far more likely to already be accessing wholesale bond markets than those outside the ASX 200 and therefore will have an established profile and financial standing in that market. They will also have a higher profile with, and be better understood by, retail investors than issuers outside the ASX 200.

Removing the requirement for them to produce a prospectus (including a trimmed down two-part prospectus) and allowing them to issue bonds off the back of just a term sheet and cleansing notice will substantially reduce some of the biggest impediments to larger issuers accessing retail bond markets – the management time, costs and additional liability associated with producing a prospectus for retail investors.

These issuers can usually meet their commercial fund raising objectives through wholesale debt markets for negligible cost and risk. They are therefore extremely sensitive to any additional cost and risk involved in a retail offering.

Removing the need for a prospectus will effectively allow them to use much the same documentation for a retail offer as they use for a wholesale offer.

Early redemption flexibility for SCBs is essential

Removing the restriction in the prescribed terms of SCBs limiting early redemption is fundamental to unlocking the barriers between listed and wholesale bonds. Early redemption by the issuer is a common feature of wholesale bonds. As a result, the restriction in the prescribed terms of SCBs limiting early redemption prevents wholesale programmes being extended to the listed market via the SCB regime.

There is no real policy basis for this restriction and it directly interferes with policy efforts to expand the corporate bond market.

In this regard, it should be noted that many of the wholesale bonds currently available to retail investors on an intermediated basis (e.g. through Exchange Traded Funds or Managed Investment Schemes) have early redemption features.

Early redemption is important for prudent and flexible balance sheet management by issuers. A restriction on early redemption adds to the risks and costs of refinance and is a major disincentive to issuers raising debt through retail corporate bonds.

New Zealand market demonstrates the opportunity

Disclosure reforms have already been implemented in the New Zealand market that have simplified the processes for issuing listed bonds. Consequently, there are numerous examples in that market of the new regime being used for listed bond issuance. The prescribed terms for listed bonds in New Zealand do not have the same restrictions as SCBs.

Section 4. Conclusion

Allowing existing senior wholesale bonds to qualify as SCBs would provide the critical mass needed to establish a listed bond market. Our initial research indicates that there are up to 40 corporate, and 100 bank, existing bond issues which would qualify to take advantage of this improved regime.

The changes proposed above are minor and would not compromise investor protections. The benefits of the changes would be profound. They would:

- **Remove the barriers** to transmuting wholesale bonds into retail bonds
- **Result in much deeper liquidity**, leading to improved price discovery
- **Reduce cost for issuers**
- **Provide direct investment opportunities for retail investors** into wholesale bonds, which are presently available only on an intermediated basis (e.g. through Exchange Traded Funds or Managed Investment Schemes), with a corresponding impact on returns.

We commend these changes to Parliament.

ASX

Appendix A- Reference from Australian Office of Financial Management

Australian Government

Australian Office of Financial Management

In December 2010, as part of its *Competitive and Sustainable Banking Package* the then Government announced its intention to facilitate the trading of Australian Government Bonds on a securities exchange in Australia aimed at developing a deep and liquid corporate bond market.

In November 2011 the AOFM issued an approach to the market for the trading of Australian Government Bonds on financial markets in Australia accessible by retail investors. The ASX proposal for the creation and trading of CHESS Depository Interests in Australian Government Bonds on its ASX Trade platform was selected as the preferred model. The AOFM worked with the ASX, The Treasury and ASIC to implement the proposed approach.

Implementation required the appointment of a debt registrar; and legislative review and amendment, including to the *Commonwealth Inscribed Stock Act 1911*, the *Corporations Act 2001*, the *Competition Market Integrity Rules* and the *ASX Market Rules*. On 21 May 2013, the trading of CHESS Depository Interests in Australian Government Bonds commenced on the ASX.

The approach implemented works as follows. Ownership of a CHESS Depository Interest is with the investor; and such ownership represents a beneficial interest in the underlying financial product, including rights to the associated principal and interest payments. In addition, whilst CHESS Depository Interests in Australian Government Bonds are governed by the ASX Operating Rules (as opposed to the *Commonwealth Inscribed Stock Act 1911*, the code governing the issuance and management of Australian Government Securities), the Australian Government has the primary obligation to meet interest and principal payments.

The CHESS Depository Interests beneficial ownership model was assessed as the preferred approach because:

- only minor changes were required to the *Commonwealth Inscribed Stock Act 1911;*
- no changes were required to the core business processes associated with the Government's debt management functions (which includes tendering, trading, clearing, settlement and redemption of Australian Government Securities);
- trading on the ASX Trade platform was readily facilitated through the ASX sponsored broker network (relieving the Government of the need to build a retail bond network);
- there was a ready ability to appoint dedicated market makers with a strong presence in the wholesale market to provide liquidity and fair pricing in this financial product;
- it was possible to leverage existing market solutions to act as a conduit between CHESS and Austraclear (an electronic securities depository system for Australian denominated debt securities, including Australian Government Securities) in order to provide for the creation of the CHESS Depository Interests; and
- Australian Government Securities (the underlying financial product) are not required to be transferred between CHESS and Austraclear.

As at 30 April 2020, $334.6 million of CHESS Depository Interests in Australian Government Bonds were on issue to 1,992 holders.