Inquiry into the Development of the Australian Corporate Bond Market

We support the Treasurer's inquiry into the Development of the Australian Corporate Bond Market (**Inquiry**). We understand the Inquiry will examine:

- the tax treatment of corporate bonds for both issuers and investors to determine whether there are any impediments in the tax system to the issue of corporate bonds compared to other forms of debt financing for business;
- related impediments within the Corporations Act to the further development of the corporate bond market, including how they interact with the tax system; and
- comparable policy settings in other jurisdictions, with a focus on those jurisdictions that are major sources of debt finance for companies operating in Australia.

We are pleased to provide our submission in relation to the Inquiry.

1 Introductory remarks

1.1 Opening observations

We make the following opening observations:

- the most significant impediments to the further development of the Australian corporate bond market relate to a range of non-tax matters. However, in acknowledgement that the Inquiry is focussed on tax issues, we have highlighted in this submission areas that we believe may benefit from further tax reform;
- whilst the liability regime and the complexity of complying with prospectus disclosure requirements are relevant considerations, the commercial constraints on “simple corporate bond” (**SCB**) terms is the most pressing issue affecting the development of Australia’s corporate bond market. These constraints have a major impact on the ability of issuers to access this market, and for the structuring of SCBs generally. In particular, the requirement that SCBs cannot be subordinated to unsecured creditors is a major issue, as are constraints around redemption events (see paragraph 2.4 below for further details); and
- we do not believe that the introduction of a 'low doc' liability profile is essential to the development of Australia’s corporate bond market and also question whether it is practical to do this for corporate debt instruments. Unlike ordinary shares or ordinary units, debt instruments are not homogenous and so there will always be a need to ensure there is appropriate disclosure of the terms of issue of the debt (and the risks associated with those debt instruments). However, we do believe there is room for the full prospectus requirement for non-SCBs to be replaced with slimmed down disclosure requirements which will also result in a less time-consuming due diligence process for non-SCB issuers (see paragraph 3 below for further details).

1.2 Summary of key issues

Our submission outlines the following recommendations to address the key constraints to the development of Australia’s corporate bond market:

- SCB regime – we recommend:
  - removing the current requirements for SCBs to have a fixed term with limited redemption rights and to rank at least equally with unsecured creditors, in favour of relying on disclosure standards to ensure the terms of issue, and the associated risks for retail investors, are fully disclosed;
  - rather than mandating the inclusion of specific ratios in an SCB prospectus, the issuer should be required to explain how it intends to meet its obligations to pay principal and interest on the bonds (leaving it up to the issuer to determine how best to do that);
  - removing the time limit on the base prospectus (leaving it to the issuer to determine whether it should still rely on the previous base prospectus or update it);
  - considering whether directors should be relieved for liability for omissions or misstatements they are not directly involved in under the criminal liability provisions for prospectus contents; and
  - introducing relief from deemed civil liability for prospectus contents for underwriters not actually involved in a contravention;
- Non-SCB regime – we recommend replacing the full prospectus requirement for non-SCBs with slimmed down disclosure requirements, which will also result in a less time-consuming due diligence process for non-SCB issuers;
- Chapter 2L – we recommend amending Chapter 2L of the Corporations Act so that it strikes a more commercial balance between the risk/reward analysis for trustees and the needs of retail investors, including the removal of any monitoring obligations. These reforms would also align Chapter 2L closer to the position in other jurisdictions;
- Tax treatment – although we do not believe that tax issues are determinative of the size and shape of the corporate bond market, we have noted in this submission areas where tax reforms may be considered. While the tax treatment of bonds and other forms of debt is similar, there are differences in the tax treatment of Australian resident and foreign resident investors. As to whether these warrant reforms such as an increase in the interest withholding tax rate would require detailed modelling by the Government. As between debt and equity, a question arises as to whether there is an investor bias towards equity due to the availability of franking credits and discounted capital gains. However, in considering a more neutral taxation of returns from debt and equity, care must be taken to have regard to the overall impact on the Australian tax revenue of such a proposal including the policy underpinning the different treatment of debt and equity returns;
- Seasoned bond framework – we recommend the introduction of a seasoned bond framework which allows any listed corporate that has issued corporate bonds through the wholesale market to also make these available to retail investors through the listed market once the wholesale notes have become seasoned (12 months after the date of issue); and
- Tracing notices – we recommend the introduction of tracing notices to allow issuers to obtain details of the beneficial ownership of their debt securities on issue.

1.3 Timing considerations

A corporate bond market often becomes an attractive source of funding during or after a financial crisis, simply because banks limit their lending. When interest rates are at record lows, investors are looking for yield and retail corporate bonds usually offer more attractive interest rates (with the associated risks) than term deposit rates and government bonds. In addition, fixed-income securities carry less risk (but lower returns) than shares. It is likely that the COVID-19 pandemic will cause some retail investors (particularly retirement savers moving from the growth to income phase) to reassess their appetite for risk and drive greater demand for fixed income products.

For issuers, bonds may be attractive in volatile equity market conditions, avoiding shareholder dilution while at the same time offering potentially longer-term funding than the banks are prepared to offer. Bonds also allow issuers to access more diversified sources of financing.

Introducing further reforms that facilitate the development of Australia's corporate bond market in the aftermath of the COVID-19 economic crisis is likely to provide corporate issuers with access to a very important market at a time when there is a commensurate level of demand from investors. At the same time, we would argue that once banks return to their standard lending capacity, the retail market will again become less attractive. This underscores the need for the reforms to not only be timely, but to have enough cut-through to ensure any nascent revival of the retail corporate bond market survives in the longer term.

Our detailed submission on the above issues follows.

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2 SCB regime

2.1 Background

The Australian Financial Centre Forum's report on *Australia as a Financial Centre* led to a series of initiatives by the Government to encourage the growth of Australia's retail corporate bond market. One of the first initiatives was the introduction of class order relief (CO 10/321) by the Australian Securities and Investments Commission in 2010 (now repealed). This permitted companies to issue "vanilla corporate bonds" to retail investors using a vanilla bonds prospectus (essentially a two-part prospectus, with similar content requirements to a transaction-specific prospectus).

This was followed by amendments to the Corporations Act in 2014[1] to introduce a new simple corporate bonds regime (**SCB regime**). The SCB regime implemented a version of the earlier class order disclosure relief (via the use of a two-part prospectus) but went further to provide certain safe harbours from director liability for issuers of "simple corporate bonds" (**SCBs**), as outlined in more detail below.

2.2 Two-part prospectus disclosure regime

The SCB regime allows listed companies (or their wholly-owned subsidiaries) to issue SCBs to retail investors without compliance with the full prospectus requirements of Chapter 6D of the Corporations Act. Instead, companies with their shares listed on a "prescribed financial market" (including the ASX and Chi-X) can issue SCBs to retail investors using a two-part prospectus that is supplemented by continuous disclosure announcements rather than containing all relevant information.

Trading in the entity's listed securities must not have been suspended for more than five trading days in the 12 months preceding the offer and the issuer's most recent auditor's report must have been unqualified. Any SCBs issued by wholly-owned subsidiaries must be guaranteed by the parent.

[1] Corporations Amendment (*Simple Corporate Bonds and Other Measures*) Act

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2.3 SCB eligibility

The SCBs themselves are required to satisfy certain criteria:

- they must be "debentures" as defined in the Corporations Act;
- they must be quoted;
- they must be denominated in Australian currency, with a face value not greater than $1000;
- they must have a fixed term of no more than 10 years, and only can be redeemed before that in specified circumstances (such as at the holder's option or if there is a change of control of the issuer);
- the principal and accrued interest must be repaid at the end of the fixed term;
- the interest rate must be fixed or floating (i.e., a reference rate and a fixed margin), and cannot be reduced (although it can be increased);
- the issuer cannot defer or capitalise interest payments;
- the debt to bondholders cannot be subordinated to unsecured creditors;
- the bonds cannot be convertible; and
- the offer price must be the same for everyone who accepts the offer.

2.4 Areas for further SCB reform

The SCB regime was introduced in an effort to strike an appropriate balance between streamlining disclosure for issuers and protecting the interests of retail investors. The fact that only 4 companies[2] have issued under the SCB regime suggests that the right balance is yet to be struck and more is required to improve the attractiveness of the corporate bond market for both investors and issuers. In our view, the commercial limitations on the SCB structure is the key reason for the low amount of take-up by issuers. We have highlighted proposals to address this issue below, along with other areas for reform of the SCB regime.

Restrictions on commercial structuring of SCBs

Issuers typically refinance maturing bonds by the issue of new bonds. Given their dependence on market conditions for a new issuance, issuers often require the flexibility to restructure the bonds in advance of a refinance by either seeking to redeem the bonds early or extending their maturity date. The restrictions on redemptions and bond tenor under the SCB regime reduces this flexibility, increasing the refinance risk for bonds to levels that may be unpalatable for risk-averse issuers.

The restrictions on subordinating SCBs to unsecured creditors are also problematic for issuers who are subject to senior loan covenants which may place restrictions on their ability to incur further debt unless it is subordinated (that is, this limits the pool of issuers, potentially significantly).

These two restrictions significantly impact the commercial viability of issuing under the SCB regime for many issuers. We therefore recommend removing these restrictions and placing more reliance on the requirement for the relevant early redemption and subordination features to be adequately disclosed (with appropriate risk disclosure).

[2] Australian Unity Limited (in December 2015 and October 2019), Peet Limited (two issuances in May 2016 and June 2017), Villa World Limited (in March 2017) and Axsesstoday (in July 2018).

Prospectus content requirements – ratios

Regulations 6D.2.05 and 6D.2.06 of the Corporations Regulations require issuers to include key financial ratios in the offer-specific prospectus for an SCB. These include; the gearing ratio (calculated as total liabilities over total equity), the working capital ratio (calculated as current assets over current liabilities), and the interest cover ratio (calculated as earnings before net interest expense, taxes, depreciation and amortisation over net interest expense). The same ratios apply to all debt disclosure documents regardless of the industry.

There are several concerns with this 'one size fits all' approach. Each issuer has a different capital structure and its cash flow liquidity depends on various factors. Therefore, a ratio applicable to an issuer in one industry may not be as commercially relevant to another issuer operating in a different industry. Indeed, Australian Unity, the first company to issue an SCB, found that their business structure distorted the prescribed ratios and as such had to explain the distortions and provide adjustments, complicating the disclosure (and the transaction). A further issue is that while the ratios are useful to track changes in a business over time, they are not as useful when comparing one company to another since there are many factors which impact such ratios. In particular, comparing companies operating in different sectors by the same standard can be misleading, especially to retail investors.

To address these issues, we recommend that rather than mandating the inclusion of specific ratios in an SCB prospectus, the issuer should be required to explain how it intends to meet its obligations to pay principal and interest on the bonds (leaving it up to the issuer to determine how best to do that).

Two-part prospectus requirement – time limit on the base prospectus

To streamline the issuing process, we recommend removing the time limit on the base prospectus (leaving it to the issuer to determine whether it should still rely on the previous base prospectus or update it).

Director liability

The SCB regime removes a director's deemed liability under section 729 of the Corporations Act for a prospectus that contains misleading or deceptive statements. However, if the director was 'involved' in the misleading or deceptive statement, the exemption from deemed liability will not apply. There is concern that the 'involvement' of directors in a prospectus can still be inferred from the continued requirement under section 720 of the Corporations Act for the directors of an issuer to consent to the issue of a two-part prospectus[3]. This potentially undermines the intended protection from deemed liability. If this is not the intention of the exemption, then it should be broadened to make it clear that a director authorising the issue of an SCB prospectus under section 720 does not qualify as involvement for the purpose of section 729.

Even if directors are not liable under section 729, the SCB regime does not remove the need for directors to be involved in the due diligence process. This is because a failure to do so may expose directors to the criminal liability provisions under sections 1308 and 1309 of the Corporations Act for failing to take reasonable steps to ensure the contents of a prospectus is not materially false or misleading (including by omission). Therefore, if the intention is to relieve directors of the compliance burden of the due diligence process for omissions or misstatements they are not directly involved in, more needs to be done to achieve this outcome.

[3] Under Section 79, 'involved' means that the person has, amongst other things, been in anyway, by act or omission, directly or indirectly, knowingly concerned in, or party to a contravention.

Underwriter liability

The SCB regime makes no change to an underwriter's 'deemed' civil liability for an SCB prospectus. This means that directors must still actively participate in due diligence committees to reduce the liability risk faced by underwriters, and others *involved* in the process. This further negates the ability of the SCB regime to reduce the burden on directors of companies issuing SCBs. We therefore recommend that consideration be given to introducing relief from deemed civil liability for underwriters, unless the relevant underwriters are actually involved in the contravention. This would allow directors to access the practical benefits of the relief already extended to them in this area.

3 Non-SCB regime

One of the legal impediments to retail bond issuances outside the SCB regime is the requirement to issue a full prospectus, coupled with the lengthy due diligence process which arises because of, among other things, the deemed directors' liability provisions for prospectus content under section 729. Directors can generally be sued for damages under section 729 for prospectuses which contravene the prohibition against misleading or deceptive statements in prospectuses even if they are not involved in the particular contravention.

As a result, the process for issuing retail corporate bonds outside the SCB regime is perceived as costly and onerous in comparison to other avenues for borrowing.

To address this issue, we recommend replacing the full prospectus requirement for non-SCBs with slimmed down disclosure requirements (along the lines of a section 713 "transaction specific" prospectus for continuously disclosing entities). While this still attracts prospectus liability, disclosure is limited to the terms of the debt and its impact on the issuer together with any information held by the company that is materially price sensitive and which is not generally available to the market (which is broadly the existing approach under the SCB regime). This will also result in a less time-consuming due diligence process for non-SCB issuers, which could encourage more take up by potential issuers into the corporate bond market (particularly those who are currently unable to access the SCB regime due to the commercial constraints on structuring SCBs referred to above).

4 Chapter 2L

4.1 Background

A trustee is normally a financial institution (such as a trust company) who is appointed by the issuer of the bonds. It is ultimately a representative of the bondholders, although its fees and expenses are paid by the issuer.

The duties owed by the trustee to the bondholders are of a fiduciary nature, subject to a common law and statutory duty of care. These duties entail exercising reasonable care and skill, avoiding conflicts of interest, acting in the beneficiaries' interests, and acting in good faith and with honesty and integrity.

In practice, the trustee's role during much of the pre-distress/default stage is almost mechanical in nature, and not dissimilar to the role of an agent bank, although its precise duties will be dictated by the terms of the bonds. Trustees are traditionally unwilling to assume broader duties, due to the additional costs and risks that this involves, which they are not paid to assume.

Consistent with this, a trustee's equitable duty to use due diligence and care in the administration of a trust has not been extended by the Australian courts to require a note trustee to investigate, monitor or police the performance of any party under the note documents. Nevertheless, it is common practice for trustees under wholesale note programs in Australia to expressly disclaim monitoring duties with respect to the issuer's financial performance and compliance with its covenants.

4.2 Chapter 2L issues

The position is different for trustees appointed under Chapter 2L of the Corporations Act.

In addition to general fiduciary duties imposed on trustees, Chapter 2L of the Corporations Act[4] requires that trustees appointed for the benefit of holders or retail corporate bonds must (among other duties):

- exercise reasonable diligence to ascertain whether the property of the issuer and of each guarantor that is or should be available will be enough to repay the amount lent when it becomes due;
- exercise reasonable diligence to ascertain whether the issuer or a guarantor has committed any breach of the terms of the debenture, the trust deed, or Chapter 2L; and
- do everything in its power to ensure that the issuer or a guarantor remedies any breach known to the trustee of any terms of the debentures, the trust deed or Chapter 2L, unless the trustee is satisfied that the breach will not materially prejudice the debenture holders' interests or any security for the debentures.

A recent case, *Oztech Pty Ltd v Public Trustee of Queensland*,[5] made it clear that trustees' duties under section 283DA of Chapter 2L includes the obligation to *actively monitor* developments within the trustee's portfolio throughout the duration of its appointment, with the extent of active monitoring required depending on the circumstances. Accordingly, a retail bond trustee cannot approach its appointment in an administrative fashion, as it would under a wholesale note appointment.

Section 283AC of Chapter 2L also restricts who can be appointed trustee by imposing specific criteria, such as capital requirements.

4.3 Areas for further reform

Trustees are traditionally paid quite low fees which are commensurate with their administrative role. These fees do not support a business model that requires trustees to do anything more than administrative tasks and does not reward them for assuming reputational or commercial risks. For the trustee obligations under Chapter 2L to be properly met, this is likely to increase the cost burden for trustees significantly, putting further pressure on their business model. As a consequence, there are very few trustees that service the Chapter 2L market. Any potential momentum for the growth of a corporate bond market will be significantly hampered if this situation continues.

To address these concerns, we recommend that Chapter 2L be amended so that it strikes a more commercial balance between the risk/reward analysis for trustees and the needs of retail investors. This could be achieved by the inclusion of provisions which:

- expressly exclude a trustee's responsibility to:
  - monitor the financial performance of the issuer;
  - monitor the issuer's compliance with its covenants; and
  - interfere in the running of the company if it has no knowledge of any wrongdoing, and
- provide that a trustee is entitled to assume that the parties will comply with their obligations and may assume that no event of default or potential event of default has occurred until a trustee has "actual knowledge or written notice" to the contrary.

[4] Specifically section 283DA

[5] *Oztech Pty Ltd v Public Trustee of Queensland (No 15) [2018] FCA 819*

This approach is consistent with the approach taken in other jurisdictions such as the United States of America, England, Singapore and Canada. We would be happy to provide a comparative analysis of the position in each of these jurisdictions if of interest.

The availability of trustees to service the retail corporate bond market is also negatively affected by the capital requirements for trustee appointments, which makes it difficult for medium-sized trustee companies to enter this market. We therefore recommend that consideration be given to introducing a more commercial and weighted approach to appointments of trustees to enable more entities to be eligible to assume these roles.

5 Tax treatment of corporate bonds

5.1 Introduction

As mentioned above, the most significant impediments to the further development of the Australian corporate bond market relate to a range of non-tax matters canvassed elsewhere in this submission. However, in acknowledgement that the Inquiry is focussed on tax issues, we have below areas that we believe may benefit from further tax reform.

5.2 Corporate bonds and other forms of debt

The tax treatment of corporate bonds generally does not differ from that of other debt. We do not consider that there is a tax-related preference for other forms of debt over corporate bonds. However, we note that the tax treatment of Australian resident and foreign resident investors in debt is different and have discussed this potential bias below.

(a) Issuers

From the issuer's perspective, a corporate bond would usually satisfy the requirements to be characterised as a 'debt interest' for tax purposes and interest would be deductible. Deductibility may be subject to other rules such as thin capitalisation, transfer pricing, and withholding tax where the holder or lender is a foreign resident.

Other vanilla corporate debt may also be structured as a debt interest for tax purposes in which case the tax treatment would be similar to that set out above for corporate bonds.

Note that the introduction of features such as convertibility, subordination, limited recourse, or returns which are contingent on profits may mean that the corporate bonds and other debt are characterised as equity rather than debt for tax purposes.

(b) Investors

Current treatment

Turning to the holders of bonds and corporate debt, again the tax treatment is broadly similar.

For Australian resident investors, returns on bonds and debt should be assessable income. Any difference between the amount paid for a bond and the amount received at maturity or on disposal or redemption should generally be assessable or deductible where the bond is a 'traditional security'. Where the investor is an Australian resident individual, returns and any gain on disposal should generally be subject to tax at marginal tax rates of up to 45% (excluding the Medicare levy and other imposts).

Foreign resident investors, on the other hand, are subject to interest withholding tax at a rate of 10% unless the subject to a potential exemption under section 128F of the Income Tax Assessment Act 1936 for debt that is publicly offered. Any interest should not be assessable to the investors, although they may be subject to tax in their jurisdiction of residence with potentially a tax credit for any Australian withholding tax.

Neutralising the apparent preference for foreign investors

Australian investors in debt appear to be taxed at high rates (15% up to 45%) as compared with foreign investors (0% to 10%). This could imply that foreign investors are being preferred over Australian investors.

We consider this is an overly simplistic analysis for several reasons.

First, increasing our withholding tax rate on interest (when combined with the tax ultimately borne in foreign jurisdictions) may reduce the pool of investors available to invest in debt. Some foreign investors may be subject to a higher rate of tax on the interest in their home jurisdictions and may be entitled to a foreign tax credit for withholding tax deducted in Australia. But this may not always be the case. Some jurisdictions may exempt the income from tax and others may not allow foreign tax credits. Furthermore, even if a foreign tax credit is available, the timing of any claim for the credit must also be taken into account; interest withholding tax is imposed when the interest is paid but a credit would ordinarily not be claimed until a foreign investor lodges its income tax return in its country of residence.

The analysis is further complicated where a foreign investor is entitled to be indemnified under the terms of the debt for any interest withholding tax. The taxation of the indemnification amount in a foreign investor's country of residence needs to be considered and, in some cases, an indemnification amount may be subject to tax in Australia, for example, where an investor is resident in a country with which Australia does not have a treaty and the amount is considered Australian sourced.

Second, there is an element of quid pro quo in the 10% rate. Australian lenders to foreign borrowers are subject to a comparable rate of withholding in most of our treaty partners. An increase in our withholding tax rate will increase reliance on the treaty rates and exemptions for not much benefit.

Third, the 10% withholding tax rate assumes there is a cost of borrowing in the foreign investor. Australia imposes a lower withholding tax rate on a higher base being the gross amount of interest paid. There is no concept of deductions in working out a liability for withholding tax. For example, if Australia was to require foreign investors to submit returns in Australia and subject the returned income to a 30% tax (assuming the investor is a company), it would be obligated to allow a tax deduction for interest and other costs that the foreign investors incur in making the investment. This could lower Australian tax revenues.

These matters should be carefully modelled by Treasury, the Reserve Bank and the Australian Taxation Office before a decision is taken to increase the withholding tax rate. In any case, it is questionable to what extent this impacts on the decision of Australian investors to invest in debt.

In summary, while there are differences between the tax treatment of Australian resident and foreign resident investors who invest in Australian corporate bonds or debt, there is broadly no difference between the taxation of corporate bonds as compared with other forms of debt financing. As to whether the differences in tax treatment as between Australian resident and foreign resident investors requires the introduction of reforms such as an increase to the interest withholding tax rate requires careful modelling.

5.3 Debt (including corporate bonds) and equity

The differences between the tax treatment of debt and equity are more pronounced.

(a) **Issuers**

The obvious difference for issuers is that returns on financing that is characterised as a debt interest for tax purposes may be deductible while returns on an equity interest are non-deductible but potentially frankable.

(b) **Investors**

In the interim report issued by the Australian government in July 2014 from its Financial System Inquiry, it stated that "Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development"[6]. The report continues on to mention a bias for individuals and institutional investors (including superannuation funds) created by the dividend imputation system as potentially contributing to the lack of a deep domestic corporate bond market in Australia[7].

We have outlined below the tax treatment of returns on equity in the form of dividends, franking credits attaching to dividends, and capital gains, and how that differs from the tax treatment of returns on debt.

(c) **Dividends and franking credits**

When comparing the impact of the tax treatment of dividends (and franking credits) on the one hand and interest on the other, the tax treatment in the hands of the issuer and the resulting impact on the tax revenues should be borne in mind.

In the case of dividends and franking credits, certain types of investors such as Australian resident individuals and complying superannuation funds benefit the most from franking credits and, in some cases, may be entitled to a refund of credits. For example, the cash tax cost for an Australian resident individual on the top marginal tax rate of 45% is reduced to 15% (excluding the Medicare levy and other imposts), with those on marginal tax rates below 30% potentially entitled to a refund of excess franking credits. In the case of complying superannuation funds, they may also be entitled to a refund of franking credits. If they are in the accumulation phase, they will be subject to tax on franked dividends they receive at a rate of 15% but obtain a refundable tax offset for the corporate tax paid on the profits out of which the franked dividends were paid (either 27.5% or 30%).

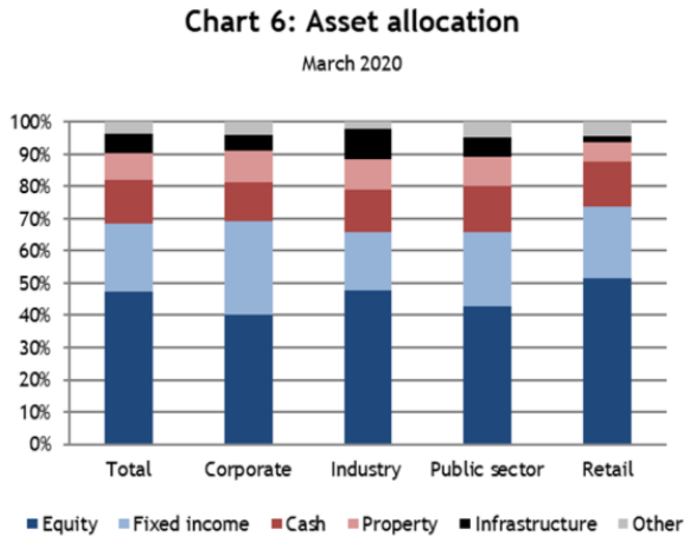
The above should be contrasted with returns on debt which, as highlighted earlier, are essentially taxed at marginal tax rates. In the case of an Australian resident individual, this would be at rates of up to 45% (excluding Medicare Levy) while a complying superannuation fund in the accumulation phase would be subject to tax on those returns at a rate of 15%.

The materiality of any bias towards equity will differ for each investor. As highlighted above, complying superannuation funds may have a tax preference to invest in Australian equities due to the refundability of franking credits, but may also be seeking higher returns (with commensurate risk), to support the growth of its funds during the accumulation/growth phase to cater for the eventual pension phase when more conservative assets (including debt) are invested in. This is in addition to

[6] Australian Government, 'Financial System Inquiry - Interim Report', July 2014, p. xxi
[7] Ibid, p. 59

the discount that may be available to reduce gains made on the disposal of those shares. Furthermore, complying superannuation funds often benefit from off-market share buy backs where any discount applied in working out the buy-back price is offset by the ability to treat part of the buy-back price as a franked dividend.

However, we note that superannuation statistics released by the Australian Prudential Regulation Authority for the March 2020 quarter suggest no particular preference of superannuation funds (with more than 4 members) between Australian equity likely to produce franking credits and fixed income investments that are not (noting also the significant investments in other classes that do not produce franking credits)[8]:



The commentary accompanying the statistics states 24.1% of investments were in international listed equities, 18.7% in Australian listed equities, 4.6% in unlisted equities, 21.1% in fixed income, and 13.6% in cash.

The estimated asset allocations for self-managed superannuation funds should also be considered. In the Australian Taxation Office's quarterly statistical report for the quarter ended September 2019, the asset allocation tables indicated that listed shares comprised 30.50% of investments by those funds. Cash and term deposits comprised 20.71% of the asset allocation while debt securities and loans comprised only 2.19% of the allocation.

However, it is important to note the difference in the tax treatment of equity and debt in the hands of the investors reflects the tax treatment in the hands of the issuers. Dividends are not deductible to the companies issuing equity – in fact, for the dividends to be franked, the company paying the dividends must have paid (or indirectly borne) Australian corporate tax. On the other hand, interest is generally deductible to companies that issue debt. The franking system recognises this difference and provides the offset to reflect the fact that the company has in fact paid tax on the profits ultimately distributed to the equity holders.

Having regard to the above, whilst it may be tempting to consider a more "neutral" taxation of returns from debt and equity, care must be taken to have regard to the overall impact on the Australian tax

[8] Australian Prudential Regulation Authority, Quarterly superannuation performance statistics highlights, March 2020

revenue of such a proposal, not to mention the policy underlying the different treatment of debt and equity returns.

(d) **Capital gains**

In relation to capital gains on the disposal of equities, Australian resident investors (excluding companies) may also be entitled to a 50% capital gains tax (**CGT**) discount such that they are only subject to Australian tax on 50% of any capital gains. Complying superannuation funds may be entitled to a lesser CGT discount of 33⅓%.

The position is different for debt in that no CGT discount is available for gains may arise on the disposal or redemption of bonds.

Foreign residents should not be subject to tax on capital gains arising from the disposal of Australian equities provided their interest does not constitute 'taxable Australian property'. This would ordinarily require them to hold at least 10% of the shares in an Australian land-rich company.

The taxation of foreign residents on debt it more complicated. Generally, foreign residents are only assessable on Australian-sourced income. Source is not defined and depends on various factors identified by judicial authorities. Treaty relief may also be available depending on where an offshore investor is tax resident. However, in principle, it would be reasonable to expect foreign residents are not subject to tax on gains from the disposal of Australian-issued debt.

As to whether the differences in CGT treatment as between debt and equity materially impacts the depth of the Australian corporate bond market, we note that while interest rate movements and other factors can affect the price of bonds, the potential for capital gains or losses is generally lower with bonds as compared to equities. Accordingly, we query whether a decision to selectively extended the CGT discount to particular debt investments is the right strategy in light of the lower likelihood of gains on bonds and also taking into account the additional complexity that may be introduced into the tax system.

6 Seasoned bond framework

6.1 Background

Wholesale debt securities (**OTC notes**) which have been trading in the wholesale market for at least a year can be acquired by retail investors.

However, access to these seasoned OTC notes is complicated by the fact they are generally lodged in Austraclear and held by investors via a custodian. Therefore, if a retail investor wishes to buy seasoned OTC notes, it must usually engage a custodian to hold the OTC notes on its behalf.

In contrast, retail investors can more easily acquire retail debt securities directly from the issuer through a public offer or on the ASX (through a broker).

6.2 Linking the wholesale and retail corporate bond markets

Consideration should be given to facilitating a link between the wholesale and retail markets to allow retail investors to trade seasoned OTC notes on the ASX, while institutional investors continue to trade the same OTC notes in the inter-dealer market. This process could allow any listed corporate that has issued corporate bonds through the wholesale market to also make these available to retail investors through the listed market once the wholesale notes have become seasoned. The corporate bonds could be subject to certain eligibility criteria, which may give retail investors access to less risky or complex products than are currently available to them through the ASX-listed market such as hybrids.

For example, if seasoned OTC notes could be listed after 12 months and bought and sold via CHESS as well as Austraclear, this would significantly reduce the complexity for retail investors investing in these types of debt securities. It will also deliver a familiar quoting system for retail investors while maintaining the preferred over-the-counter market for wholesale investors. The potential benefits of making these seasoned OTC notes more accessible to retail investors are:

- it increases the number of corporate bonds available to retail investors;
- it improves liquidity in the retail corporate bond market; and
- it improves transparency and price discovery for retail investors.

A similar framework has been introduced in Singapore. Under this framework, retail investors can purchase bonds (that were initially offered only to specified investors) through secondary trading on the SGX after the seasoning period (six months in this case). Issuers can also make subsequent offers of new bonds with principally the same terms as those that have undergone the seasoning period. An issuer wishing to issue bonds under this framework must meet three tests relating to its size, listing history and track record.

6.3 CDIs

Technology is already being utilised to provide retail investors with access to exposure to Australian Government bonds through the creation of Chess Depositary Interests (**CDIs**). CDIs provide holders with the right to a proportion of the coupons and capital appreciation or loss derived from the underlying bond. The process requires a market maker to hold the bonds through the wholesale market, and to subsequently create CDIs. Once CDIs are created the market maker provides continuous bid and offer prices for the instruments to ensure liquidity and provide price transparency equivalent to that available in the equity market.

As an alternative to allowing retail investors to buy and sell seasoned OTC notes directly on the ASX, we recommend the Government considers adapting the CDI technology so that it can also be used to provide retail investors with an indirect interest in seasoned OTC notes.

7 Tracing notice reforms

Bond issuers must typically obtain the trustee's consent to any potential amendments or waivers to their bond terms if they wish to restructure these prior to their maturity. Understandably, trustees often decline to exercise their discretion to grant such consents and/or waivers without bondholder directions to do so.

The formal process for obtaining consents or directions from holders of retail corporate bonds is generally cumbersome and inflexible. The requisite majority for circulating resolutions (i.e. written resolutions) usually requires the issuer to obtain the consent of more bondholders than if a meeting was called. This results in issuers more often than not calling a physical meeting of bondholders with a minimum 21-day notice period, making it difficult for action to be taken swiftly in a restructuring situation or otherwise.

For most waivers or amendments to be approved, the meeting will need to be quorate, and the requisite majority of bondholders (often over 50% for ordinary resolutions and up to 75%, or sometimes higher, for special resolutions) will be required to vote in favour of the relevant resolution. This is usually a challenging process as bondholders are frequently passive investors who are indifferent to the concerns of issuers.

To compound matters, the bonds in question are often held through custodians. This means that the issuer does not know who the bondholders are and cannot be sure that they even receive the bondholder notices requesting the meeting (or receive these in time), particularly where there are multiple layers of custodians.

These issues have critically exposed constraints on parties' ability to address some of the problems caused by the recent turmoil in the financial markets in a timely manner, causing considerable frustration for all concerned.

To address this issue, we recommend the introduction of tracing notices to allow issuers to obtain details of the beneficial ownership of their debt securities on issue. This should improve communication channels between issuers and investors to ensure that meeting requests are swiftly communicated and bondholders are fully informed in relation to the issues at hand. Tracing notices are already used for equity markets[9] to promote a fully informed market and to provide a timely response to inquiries concerning the ultimate ownership of securities. We recommend that the Government give consideration to reviewing any policy reasons why these should not be relevant to holdings of debt securities as well.

8 Conclusion

We look forward to working with the Government to support the development of the corporate bond market in Australia.

Gilbert + Tobin
28 May 2020

[9] Section 672A. of the Corporations Act