



27 October 2010

Mr Hamish Hansford
Committee Secretary
Senate Legal and Constitutional Committee
PO Box 6100
Parliament House
CABBERRA ACT 2600

Dear Mr Hansford

Corporations Amendment (Sons of Gwalia) Bill 2010

The Australian Financial Markets Association (AFMA) supports the amendments in the Corporations Amendment (Sons of Gwalia) Bill 2010 and asks the Committee to recommend that the Bill should be enacted.

AFMA represents the interests of participants in Australia's wholesale banking and financial markets, including domestic and foreign-owned banks and securities companies. Our members, who are the key intermediaries in the banking and debt capital markets, are of the firm view that the practical effects of the High Court's decision in the *Sons of Gwalia v Margaretic (2007)* case on lending behaviour are harmful and warrant a change to the law to reverse the effect of the Court's decision.

We support the legislation because, in summary:

- it will help to sustain foreign investor confidence and, thus, provide Australian business with better access to the international capital markets and, in particular the US private placements market;
- it gives certainty about the priority accorded to shareholders and restores the traditional distinction between debt and equity interests in a company;
- it provides an economically sensible outcome that reduces legal and operational complexity and enables the corporate debt market to operate in an efficient manner; and
- it is consistent with the Government's broader policy objectives for financial markets, including the development of a retail corporate bond market.

1. Effect of the Sons of Gwalia Decision

A result of the *Sons of Gwalia* decision is that claims by shareholders against a company under consumer or investor protection legislation do not arise from their statutory rights of membership and therefore fall outside the postponement of member claims provided for in section 563A of the Corporations Act. This recharacterisation of shareholder claims allows them to rank equally with unsecured creditors in any distribution to creditors, after payment to secured creditors and to priority creditors. This outcome conflicts with the general understanding of the law previously held by lenders and investors that payment of a debt owed by a company to a person in the person's capacity as a member of the company is postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied. This blurring of the distinction between debt and equity interests in a company by effectively giving shareholders the same priority as unsecured debt in some circumstances undermines the fundamental risk reward relationship that underpins debt and equity investment to the detriment of debt capital raising.

The practical effect of this re-ordering of the traditional priorities between debt and equity interests is to dilute the claims of unsecured creditors, including investors in unsecured bonds and small business who have unsecured claims on a company, and increase their credit risk. Moreover, it introduces other practical complications as the inclusion of shareholder claims would slow down the administration process for insolvent companies in some instances and delay the receipt of payments to other creditors. Higher administration costs associated with the inclusion of shareholders would compound the effects of these problems.

While the *Sons of Gwalia* decision is expected to affect relatively few cases in practice, as most companies repay their debts, it has much broader relevance because lenders are unable to determine which cases it will ultimately apply to at the time credit is given. For instance, financiers have to monitor all unsecured loans to ensure that the conduct of a borrower does not increase their risk by creating potential shareholder claims in the event of insolvency.

The natural reaction of lenders in these circumstances is to increase the cost of credit through higher lending charges, tighten credit conditions (for example, by seeking higher levels of security) or reduce the amount of unsecured credit made available. Obviously, this has undesirable consequences for Australian companies seeking to finance their businesses through debt issues.

2. International Capital Markets

A decision about law reform to address the problem created by the *Sons of Gwalia* decision requires careful judgment based on real market impacts and economic circumstances.

In this context, our member firms report that the *Sons of Gwalia* decision has disadvantaged Australian companies seeking funding in the international debt markets, especially in the private placements market in the US, because lenders are reluctant to advance funds on an unsecured basis if their chances of recovering their money in the event of the company going into administration are diminished. Loans are typically of a

long term nature (eg 7+ years), which makes them more susceptible to credit risks than providers of shorter term debt.

This is noteworthy because the US private placements market is attractive to Australian companies and an important source of finance to them because it has good liquidity, documentation requirements are less onerous, long dated debt finance is available and deals may be brought to market quickly. Investors in this market are accustomed under US law to all shareholders, whether aggrieved or not, being subordinated to secured and unsecured creditors. Consequent to the *Sons of Gwalia* decision, some US corporate bond market investors have a markedly reduced appetite for unsecured Australian debt. The indications are that reduced corporate bond issuances reveal a tightening of the market and reduced limits of risk appetite which are consistent with the market's negative reaction to the decision.

The significance of these issues is evident through information given in a recent article in the Reserve Bank of Australia's Bulletin¹, which reports that foreign investors held 79% of bonds issued by Australian non-financial companies (onshore and offshore) at March 2010, with the remainder held by institutional investors. Non-financial corporates had \$115 billion in long term debt securities on issue in overseas markets in August 2010, a significant portion of which was unsecured. Corporate issuance in the local market was smaller at \$42 billion.

The availability of unsecured debt finance is dependent on risk appetite which varies in accordance with the economic cycle. Lending has changed in the post-global financial crisis environment, with credit tightening and lending institutions becoming risk averse, and corporate access to international sources of credit has become more difficult. Against this backdrop, the *Sons of Gwalia* decision raises important public policy issues concerning the ability of Australian business to raise debt finance in the most cost effective manner. Another relevant factor in this regard is that Australia requires significant overseas capital to finance the balance of payments, so it is important to maintain the best environment for the issuance of securities by Australian companies in overseas markets.

3. Other Unsecured Creditors

The *Sons of Gwalia* decision presents a greater commercial risk to small businesses who are often unsecured creditors of companies and will be disadvantaged as the level of secured lending by banks and other commercial lenders rises in response to the decision. These creditors are often not well placed to seek and obtain security over the assets of a company they have provided credit to in the course of their regular business trading. Moreover, they should be differentiated from shareholders because, unlike shareholders, they do not take an investment risk on the company; rather they provide their goods and services on commercial terms with credit as part of that business arrangement.

In addition, if the retail corporate bond market grows in accordance with the Government's objective to develop the market, then many retail bond holders would be

¹ *Ownership of Australian Equities and Corporate Bonds*; Black and Kirkwood, RBA Bulletin, September 2010.

exposed to greater credit risk because they could be competing with an expanded pool of unsecured creditors of an insolvent company from added shareholder claims. In our view, many retail investors were likely to understand the difference between debt and equity in terms of the position before the Sons of Gwalia was handed down. Continuing effort is going into making retail investors understand the risk reward calculation that comes from the subordination of equity investment to debt. This is the investor education message that the Australian Securities and Investments Commission currently provides in its guide to 'Investing in corporate bonds'. Therefore, in the absence of the proposed law change, it would be necessary to educate retail bond investors about this risk, which may to some extent temper their interest in the market.

4. Investor Reaction to the Bill

Our members advise that the Government's announcement that it will amend the law was well received by the debt markets and had a settling effect amongst US investors in particular. This development is being reflected in a renewed appetite for Australia debt amongst US investors and is considered timely as borrowing conditions in the US private placements market improve.

We would be concerned if the legislation was to be substantively amended or its passage delayed for an extended period, both of which could harm Australia's standing as an investment location, especially amongst international investors who are anticipating enactment of the of the legislation.

We note that it is not possible to provide data to measure the precise effect of the Sons of Gwalia decision and related government decisions, given the nature of the response by lenders, the impact of the global financial crisis and the range of other factors that impact the level and terms of unsecured lending. However, AFMA has received consistent and broad based feedback from member firms reporting the harmful effect of the decision on the price and availability of unsecured lending in recent years.

5. Concluding Comments

AFMA supports the Government's decision to reverse the effect of the High Court's decision in the Sons of Gwalia case and we believe the cost of no action for Australian business would be significant.

Members expect that reversing the effect of the Sons of Gwalia decision will increase the availability and lower the cost of unsecured debt finance for Australian companies. It will also assist development of the corporate bond market in Australia by providing greater certainty and lowering the risk associated with unsecured corporate debt.

We do not expect that the Bill will adversely affect investor confidence in the equity market, as the amendments would merely restore the traditional distinction between debt and equity. Of course, it is important in this context to ensure that the continuous disclosure and other protections afforded to investors are implemented in a fully effective manner.

AFMA appreciates the opportunity provided by the Committee to make a submission to the inquiry.

Yours sincerely

David Lynch
Head of Policy and Markets