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To The House of Representatives Standing
Committee on Tax and Revenue
PO Box 6021
Parliament House
Canberra
Canberra ACT 2600

By email: TaxRev.reps@aph.gov.au

Dear Committee Secretariat

Inquiry into the Development of the Australian Corporate Bond Market

This submission is made by King & Wood Mallesons ("**KWM**") in response to the Australian Government's inquiry into the absence of a deep and liquid Australian retail corporate bond market announced on 9 February 2020. The inquiry is led by The House of Representatives Standing Committee on Tax and Revenue ("**Committee**").

KWM is extremely supportive of measures that can be taken to encourage the further development of the retail corporate bond market in Australia. In particular:

- the existing issuance regime has not served to encourage corporate Australia to access the retail bond market. That market has the potential to serve as an important source of capital for Australian businesses to fund investment and growth. This is especially important when off shore markets are unable or unwilling to invest in corporate Australia due to adverse economic conditions; and
- retail investors have limited opportunities to access an important investment product as part of a balanced investment portfolio. Australian retail investors should have the opportunity to invest in and support Australian businesses through debt investments as well as share ownership.

We believe that the process for the raising of debt capital in the Australian corporate retail bond market can be significantly streamlined without jeopardising consumer protection and this submission presents our reasons for that view. A safe and streamlined issuance process should encourage vibrant retail participation in the funding of corporate Australia. This will be of broad benefit to issuers, investors, intermediaries and the Australian and regional debt capital markets more generally. In addition, it will enhance Australia's position as an important financial hub for the Asia-Pacific region.

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Except as expressly set out below in the section entitled "Tax issues", this submission does not address any issues in connection with the issuance of bonds to the institutional or wholesale bond market. We consider that that market remains robust and that there is no current need to reconsider or reassess its vibrancy or regulatory environment.

We would welcome the opportunity to discuss any of the matters raised in this submission and the form of amendments prior to those amendments being finalised by Treasury.

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Background

Historically, the regulation of retail bond issuance in Australia has focused on disclosure of information through a prospectus prepared in connection with each specific issue of bonds. Recent modifications to the traditional prospectus requirements through the introduction of the simple corporate bond reforms and a two-part prospectus regime that permits multiple issuances over a three year period have attempted to streamline the issuance process. However, the current regulatory regime has not resulted in an increase in volume. Since 2014 there have only been 5 offerings of simple corporate bonds and only one issuer has made use of the two-part prospectus regime to undertake a second issuance within the three year time frame during which a base prospectus may be utilised. Simple corporate bond issuance is still costly and time consuming and the current regime has not significantly enhanced either the issuer or investor experience (although it has gone some way towards streamlining the process).

The regulatory environment for the issuance of any investment product needs to balance ease of access to capital for issuers and appropriate consumer protection for investors. The key elements necessary for a properly functioning capital market at scale are:

- transparency; and
- efficiency.

Working together, these two elements will build trust amongst issuers, investors and the regulators.

Transparency and Efficiency

A primary consideration is that investors should have timely disclosure of information to enable them to make an informed decision regarding their investment, both at the time of subscribing for bonds and at the time of the sale of those bonds in the secondary market.

Australian corporates with equity listed on the Australian Securities Exchange ("**ASX**") are subject to a continuous disclosure regime whereby they are required to immediately disclose any information that would have a material effect on the price or value of their shares.[1] In addition, they are able to offer and issue additional shares (e.g. through a rights issue) to retail investors without a prospectus or other disclosure document through the use of the "cleansing notice" approach.[2] That is, prior to the offer being made, an issuer is required to ensure that any information:

- otherwise withheld from the market on the basis of an exemption from the continuous disclosure requirements; and
- that investors would reasonably require for the purpose of making an informed assessment of:
  - the assets and liabilities, financial position and performance, profits and losses and prospects of the issuer; or
  - the rights and liabilities attaching to the relevant shares,

[1] ASX Listing Rule 3.1.

[2] Section 708AA of the Corporations Act 2001 (Cth) ("**Corporations Act**") as amended by ASIC Corporations (Non-Traditional Rights Issues) Instrument 2016/84.

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(being "**excluded information**") is released (e.g. through an ASX announcement and investor presentation) so that the market can make a fully informed investment decision.[3] A cleansing notice is then released to ASX by the issuer before the offer opens to confirm that there is no excluded information which has not been released to ASX.[4]

If the issuer becomes aware at any time between the date of issuing the cleansing notice and the last issue of shares under the rights issue ("**relevant period**") that:

- any information that would be excluded information that would need to be included in the cleansing notice if the notice had been given at that time and that has not been included in the cleansing notice or otherwise provided to ASX; or
- a material change to the potential effect the issue of the relevant shares will have on the control of the issuer or the consequences of that effect,

the issuer must, as soon as practicable but in any event before the end of the relevant period, give ASX a notice that sets out details of the information or material change.[5]

We submit that this existing cleansing notice regime can easily be adapted to help facilitate the issuance of bonds.

Prior to the offer and issue of retail bonds, investors would, by virtue of the continuous disclosure regime and cleansing notice process, have all material information about the relevant issuer. Once issued, and given that retail bonds would be listed on the ASX, the issuer would be subject to the continuous disclosure obligations. This would ensure that retail investors receive up-to-date material information over the life cycle of the bond.

The structural asymmetry between the existing process to offer and issue shares and that in place to offer and issue bonds has acted as a significant impediment to the development and growth of a retail bond market and we submit that greater reliance should be placed on the existing continuous disclosure regime for bonds.

An overview of our submissions and their benefits is set out in the table below.

Submission	Benefits of submission
Leverage the existing disclosure regime for bond issuance by allowing ASX-listed issuers to rely on a 'cleansing notice' regime to make an offer of bonds A "cleansing notice" style regime for bonds could involve a short document ("**Offer Document**") that outlines: • the key commercial terms of the bonds; • the material risks associated with an investment in those bonds; and • a description of how to apply for the bonds.	The benefits of this approach are that: • the cleansing notice regime is already well understood and accepted in the Australian market; • it would help streamline the disclosure investors receive in connection with an offer; • it would allow for a more streamlined and "issues-focussed" due diligence process for issuers – similar to that adopted for rights issues and wholesale regulatory capital issues; and

3 Section 708AA(8) of the Corporations Act.
4 Sections 708AA(2)(f) and (7) of the Corporations Act.
5 Section 708A(12) of the Corporations Act.

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Submission	Benefits of submission
The Offer Document would be accompanied by disclosure of any "excluded information" and a "cleansing notice" for each offer of bonds. This would be consistent with the existing cleansing notice regime for rights issues of shares as set out in the Corporations Act. We also submit that a significant number of the "boilerplate" terms and conditions of the bonds can be standardised and made consistent for all bond issuers.	• it would allow for issuers to come to market with an offer more quickly. We consider that it would also be possible to design an issuance regime such that only key commercial terms such as maturity, interest rate, redemption events and certain financial covenants differ between different issuers. This would significantly enhance an investor's ability to easily compare products and would help streamline the issuance process for issuers, with significant time and cost savings. We consider that a "cleansing notice" style regime for the issuance of bonds should apply the existing liability regime in place for share issuance. This would remove the requirement for directors to consent to the lodgement of a "two part" prospectus (for simple corporate bonds) and remove deemed liability for underwriters, allowing for a more streamlined due diligence process that would permit issuers to come to market with an offer more quickly. In our view, it is not appropriate for underwriters to be subject to deemed liability when directors are not equally liable. The existing Corporations Act regimes for "misleading and deceptive" conduct and liability for disclosure would continue to apply. We note that issuers in New Zealand are able to offer bonds which are in the same class as existing bonds to retail investors by issuing a term sheet. The New Zealand regime is simple and streamlined and allows debt issuers to access retail investors in a cost effective and efficient manner. New Zealand has a vibrant retail bond market and may be a useful model to consider for Australia.
Requiring issuers to disclose credit ratings should lead to an increase in the number of investment-grade issuers The existing simple corporate bonds regime does not allow disclosure of ratings information about the bonds or the issuer (because ratings disclosure to retail investors is not permitted by ASIC unless the ratings agency holds a retail licence, and the main credit ratings agencies do not hold retail licences). We submit that issuers of simple corporate bonds (and retail bonds more generally) should be required to disclose this	In our experience, losses associated with the issuance of corporate bonds are more often the result of the credit quality of the issuer (and therefore the level of risk associated with the investment), as opposed to the type and extent of disclosure provided to investors. We submit that the retail bond market cannot be properly informed if disclosure of ratings information about the bonds or the issuer is not permitted. As investors in bonds assume no upside, the fairness of the price of a bond involves an assessment, amongst other things, of the interest rate and its component (i.e. the

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Submission	Benefits of submission
information to investors to assist them in deciding whether to make an investment. A credit analysis is fundamental to an investment decision, and without credit ratings, investors do not have access to a credit analysis of a bond.	market rate and credit risk spread), as well as the probability of default over the term of the bond (and to some extent, the likely loss given default). Unlike equity investments (where a larger number of investors are able to conduct pricing analysis in relation to issuers of securities), investors in the retail bond market are unable to assess the fairness of the price of a bond through traditional disclosures. Such assessments are primarily undertaken by credit ratings agencies (in addition to certain sophisticated investors). An informed market requires that these ratings be disclosed at the time of their investment in order to allow retail investors to make an informed investment decision. Although investors may have access to credit ratings information if it is disclosed in a continuous disclosure announcement of the issuer (where the rating is considered to be material and price sensitive information), the investor may already have incurred losses by the time that announcement is made. In our view, ratings information is most relevant at the time of the investment decision and should be disclosed at this point. We submit that making the disclosure of credit ratings information mandatory for issuers of bonds would significantly improve the transparency of the regime. We note that under the retail bond issuance regime in New Zealand, issuers are required to disclose credit ratings.
The new regime should allow for the issue of subordinated bonds to retail investors too The current regime prescribes that an issuer's debts to the holders of a simple corporate bond must not be subordinated to any of the issuer's debts to unsecured creditors. We submit that the new regime should allow for the issue of subordinated bonds.	We submit that the issuance of subordinated bonds to retail investors under the new regime is appropriate because: • issuers can issue subordinated bonds (and bonds with other more complex and structured features) under a standard prospectus so it seems unnecessary to impose a restriction on the issuance of retail bonds in a new regime, provided that the relevant features are disclosed prominently; and • providing flexibility should be a commercial (and not legal) matter subject to the appropriate balance between issuer convenience and consumer protection. For the reasons outlined above, we do not consider that drawing a distinction between equity, subordinated bonds and senior bonds is relevant provided that there is a general disclosure standard which applies (requiring the disclosure of all

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Submission	Benefits of submission
	information which investors reasonably require to make an investment decision in relation to a particular type of security). The consequences/risks associated with subordination (and other features) can be adequately addressed by disclosing the risks of an investment in the bonds (compared with, for example, an investment in shares or senior bonds). We further note that subordinated bonds will rank ahead of ordinary shares (which are a common investment for retail clients).
The simple corporate bond regime is overly prescriptive and restrictive In addition to requiring that simple corporate bonds are unsubordinated, the current regime also requires the bonds to adhere to a number of restrictive features, including that their terms and conditions can only contain certain types of redemption events. This has made it difficult for issuers and their lead managers to bring wholesale bonds across into the retail market, given that wholesale bonds normally contain additional redemption events (e.g. issuer redemption event, ratings downgrade redemption).	**The simple corporate bond regime is overly prescriptive.** In our view, allowing issuers enhanced flexibility to select appropriate features would make simple corporate bonds more attractive to issuers and encourage a higher rate of participation in the retail bond market. We note that the retail bond regime in New Zealand does not prescribe the features of the bond to the same extent, offering greater flexibility to issuers.
The requirement for disclosure of prescribed financial metrics should be removed The current simple corporate bond regime mandates the inclusion of certain prescribed financial metrics. This should not be mandatory. In particular, of the five offerings of simple corporate bonds, all five presented their own internal ratios as a more accurate representation on financial performance. In one case, the prescribed financial metrics were excluded entirely.	The currently prescribed financial metrics are not relevant or appropriate for many issuers. The prominence given to the prescribed financial metrics suggests that they are the key tool on which to base an investment decision (which is not the case). Given the continuous disclosure regime available, up-to-date information that is material to the price or value of the bonds will be regularly provided allowing investors access to the information necessary to make an informed view. This regime has been accepted as appropriate for equity investments and it seems incongruous that it would not be appropriate for a debt (bond) investment where a bondholder sits higher up the capital curve than an equity investor.

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Tax issues

Franking credits incentivise investment in equities

The Australian tax system provides significant incentives for investment in equities, and for investment in bonds by foreign residents. The dividend imputation system provides Australian residents with a credit for the tax paid by the company referable to the dividend amount, and in some cases this can result in a refund. There is no equivalent concession for interest derived by an Australian resident on a bond. In isolation, this incentivises investment by Australian residents into Australian equities as opposed to Australian bonds. We expect that this will remain a structural imbalance that will act as a brake on the willingness of certain investors to invest in bonds and incentivise a preference for equity investments over debt investments.

Foreign residents receive a dividend withholding tax exemption on fully franked dividends and are exempt from interest withholding tax on debentures that have been publicly offered under section 128F of the Income Tax Assessment Act 1936 (Cth) ("**1936 Act**").

Introducing a new tax concession for Australian holders of bonds may incentivise domestic investment in the Australian corporate bond market. However, any suggested roll back of existing concessions would need to be carefully considered and tested. In particular, the section 128F exemption has been an important and longstanding provision in facilitating the investment of debt capital into Australia. In our experience, holders of bonds have felt more certain in relying on section 128F than on any double tax treaties that may provide relief.

General observations

More broadly, there are some existing impediments in the tax system to the issue of certain types of bonds. KWM considers that, as part of a broader review into the corporate retail bond market, it would be timely to address the following specific tax issues.

- (**Notes issued in electronic form through the Austraclear system**): It is currently unclear whether "e-notes" (e.g. electronic certificates of deposit and electronic promissory notes issued through the Austraclear System) are "debentures" and therefore whether the section 128F exemption could apply to e-notes. This means that there is a disincentive to Australian issuers issuing this form of security. Whilst e-notes are issued to wholesale (and not retail) investors, it would be of broad benefit to clarify their status under Australian tax law.

- (**Bail-inable bonds**): As part of the response to the global financial crisis and a generally internationally agreed policy to strengthen bank capital for globally and domestically systemically important banks, central banks and prudential regulators have introduced new forms of "bail-inable" capital that can absorb losses before there is a need to resort to a publicly funded "bail-out".

  Many foreign banks who operate through a branch in Australia are subject to bail-in regimes in their home jurisdiction. These banks face difficulties in issuing "bail-inable" bonds through an Australian branch. Bail-in regimes in jurisdictions including the United Kingdom, United States, Canada, France, the Netherlands, Hong Kong and Switzerland provide for the conversion of the bonds into equity interests if a bank becomes non-viable. This poses a risk that the bonds could be characterised as equity for Australian tax purposes without the ability to provide imputation benefits to holders (on the basis that the issuer is a foreign resident). Regulation 974-135F of the Income Tax Assessment Regulations 1997 (Cth) provides relief from equity treatment for term cumulative subordinated debt with non-viability conditions. This regulation was specifically designed for the Tier 2 capital requirements in mind and may not generally apply to bail-inable bonds. We submit that an equivalent provision should be extended to foreign banks that issue "bail-inable" bonds through an Australian branch.

- (**Section 177EA of the 1936 Act**): Section 177EA is a broad anti-avoidance rule which denies imputation benefits on equity interests where a purpose (whether or not the dominant purpose but not including an incidental purpose) of the issuance was to enable a holder to obtain an imputation benefit. In practice, this provision has introduced a risk in raising equity capital (e.g. capital notes) as opposed to another form of funding (e.g. subordinated notes which are treated as debt for tax purposes).
- (**AT1 issuances out of an offshore branch**): Australian banks are generally able to issue Additional Tier 1 capital notes through an offshore branch (e.g. in the United States or the United Kingdom) without the need to frank the capital notes to the benchmark franking percentage applicable to the bank's ordinary shares. Specific relief in section 215-10 of the Income Tax Assessment Act 1997 (Cth) ensures such capital notes issued by authorised deposit-taking institutions ("**ADIs**") are unfrankable. However, no similar relief is provided to insurance companies that may have a need to issue Additional Tier 1 capital. This makes it comparatively more difficult for Australian insurance companies to issue Additional Tier 1 capital. We submit that it would be appropriate to harmonise these differing rules to ensure a level playing field for both ADIs and insurance companies.