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Financial System Inquiry
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Dear Panel Members

Financial System Inquiry – Second Round Submission

We refer to the *Financial System Inquiry – Interim Report* (**Interim Report**) released on 15 July 2014, and the request for a second round of submissions by 26 August 2014 to gather further evidence, check the validity of observations and test potential policy options.

We welcome the opportunity to make a submission as the issues set out in the Interim Report are of great importance to the future development and functioning of our financial system.

Our submission relates to a number of discrete legal, governance and policy matters under seven headings:

- RMB internationalisation;
- superannuation and retirement products;
- stability: resolution powers and bail-in;
- consumer outcomes;
- retail bond market, equity and convertible markets and disclosure;
- electronic documentation; and
- harmonisation of securities laws.

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1 RMB Internationalisation

- **Immediate steps should be taken towards (a) ensuring the benefits of RMB internationalisation being available to future generations of Australians, and (b) establishing Australia as a financial and RMB hub for Asia**
- **The Australian government to take an active involvement in the establishment of an RMB clearing bank in Australia to China, so that the Australian financial system is able to give effect to the RMB clearing bank arrangements quickly**
- **The Australian public sector to encourage, or even participate in, the creation of significant RMB denominated investments in Australia**
- **The export of locally manufactured financial products overseas to be supported**

In section 10 (*International integration*) of the Interim Report, the FSI has asked for comments on potential impediments, policy formation and public and private sector coordination relating to how Australia can better integrate its financial system with the rest of Asia.

We consider that there two critical and interrelated parts to this:

- the internationalisation of the Renminbi (**RMB**); and
- establishing Australia as a financial and RMB hub for Asia.

We agree with the Interim Report that the opportunities offered to Australia by the internationalisation of the RMB and the liberalisation of China's capital account are clear and need to be seized in order for Australia to maintain relevance as a financial centre in the Asian century. We also agree that the Australian government and its regulators have taken important steps in the right direction, namely by establishing a bilateral local currency swap agreement between the Reserve Bank of Australia (**RBA**) and the People's Bank of China (**PBC**), by holding foreign currency reserves in RMB and by facilitating the development of a local RMB settlement system.

However, we believe that more needs to happen for the benefits of RMB internationalisation to be available to future generations of Australians. Although there is much to be done in this regard by the Australian market participants in the private sector, there is also a continuing and critical role for Australia's public sector.

Of critical importance is a recognition that the current path of steadily working towards removing identified barriers to the use of RMB within Australian financial services is insufficient to drive fully the use of Asia's international currency in Australia.

Instead, a much higher level of engagement is needed from both the public and the private sectors in Australia. The current trajectory needs to be lifted, to increase awareness of, and preparation for, the "seismic" event of the deregulation of China's capital account and liberalisation of its currency. We have already seen an exponential increase in Chinese regulations which relax restrictions on cross border capital flows. The latest developments include the Shanghai Free Trade Zone, intra-group cross border loans, granting of cross border security (including, PRC credit support to back off-shore funding) and the expansion of the QDII and QFII investment regimes. This engagement needs to result in:

(a) first, Australian industry and government establishing a clear understanding of the transformational impact which RMB internationalisation and convertibility can have to Australian financial services;

(b) secondly, committing to taking advantage of the opportunities which it presents; and

(c) thirdly, actioning the steps needed to lead the global marketplace by seizing those benefits for growth of business in, and regional relevance of, Australia.

Our financial services industry has a role to ask the Australian government for what it needs to make this happen. However, examples of further actions which could be initiated immediately by the Australian government and its regulators include the following:

- *RMB clearing bank in Australia.* The Australian government could take an active involvement in the establishment of an RMB clearing bank in Australia to China. This needs to happen as soon as possible. Of course, the decision of who the clearing bank is and when it is announced is ultimately a matter of the Chinese authorities, but there is a role for the Australian regulators and government too. It is important that the Australian regulatory and financial system is able to give effect to the RMB clearing bank arrangements quickly after the announcement is made, whilst the momentum will be at its greatest. This includes ensuring that the Australian systems are able to effect transactions rapidly, with clarity and certainty. For example, it will be important that participants are able to identify when these settlements are made in commercial bank money, and when they involve central bank money. For this purpose, the Australian government should facilitate the recognition of fiduciary accounts linked to the PBC under the Australian regulatory and legal system. Further, it would be important to provide further clarity on when the inter-central bank bilateral currency swap arrangements between the RBA and the PBC are intended to be used.
- *Encouraging RMB denominated investments.* The Australian public sector should encourage, or even participate in, the creation of significant RMB denominated investments in Australia – such as the issuance in Australia of RMB denominated bonds by Australian issuers (which should include Australian government bodies), now that the financial market infrastructure is being put in place to permit this to occur. This step beyond using RMB to pay for trade flows is fundamental to integrating Australia in the regional financial system, and to the relevance of our financial sector to those overseas. Many Asian investors understand that Australia has a sophisticated financial system with a reliable regulatory and legal system. They will have greater incentives to invest in Australian financial services and products if the investment can be facilitated by being made in Asian currencies, particularly RMB. Also, there are a number of Australian investors who would be interested in investment in China, as the driving economy of the region. However, at the moment there is a perceived lack of RMB denominated yield opportunities which are manufactured in Australia. Instruments offered by Australian product issuers in Australia which are denominated in RMB allow Chinese and other Asian investors to invest in Australian-manufactured financial products, as well as allowing Australian investors to make an "investment linked to China", without needing to invest in Chinese financial products issued in China which otherwise then requires them to understand the regulatory and disclosure regimes of China itself.
- *Supporting the export of financial services to China.* As noted above, there is a real opportunity for Australia's sophisticated financial markets to export locally manufactured financial products overseas. These exports would fit with comparative advantages which the Australian financial markets have in the region (including comparative sophistication,

time zone proximity, legal and regulatory certainty and broader international recognition). The Australian government has an excellent opportunity here to treat financial products and services like other critical Australian exports to China by working with the Chinese authorities to expeditiously break down the cross-border regulatory roadblocks which prevent RMB denominated financial products manufactured in Australia from being offered to a Chinese investor base. Opening a window to China for Australia's region-leading funds management industry could develop into an enormous new export market for Australia.

We emphasise that a key element is to increase awareness, understanding and commitment of the RMB internationalisation opportunity. This is a journey, and it will take some time to reach the ultimate destination. Nevertheless action to set this path needs to be taken now so that Australia can become a regional financial services hub, exporting Australian financial services into the region, rather than just another spoke on an RMB-centred wheel. Global competition in this area will be strong. The UK and some Eurozone governments clearly recognise the opportunities and, given the size of their markets, stand to dominate this space if Australia is not careful and nimble. Expanding our relevance to Asia beyond natural resources and agriculture is a responsibility we all share. Exporting our financial services has a critical role to play in maintaining that relevance.

2 Superannuation and Retirement Products

- **Superannuation policy settings lack stability – the constant change has added to the costs of the superannuation system**
- **There should be no proposals to make wholesale changes to the existing regulatory settings, with any such review to be set at a time when a sufficient period will have elapsed to assess the effectiveness of the present system**
- **However:**
  - **the illiquidity exceptions in the portability rules to be relaxed to permit a period longer than the maximum timeframe in relation to that portion of member's benefits invested in frozen funds or which cannot be priced without the need for APRA approval or member consent**
  - **to facilitate investment in less liquid underlying assets, the conditions under which a longer than standard portability regime can be applied should be relaxed to allow disclosure as an alternative to prior written consent**
  - **to facilitate the increased use of retirement income projections by superannuation fund trustees, the law should be amended to clarify that a calculator or benefit projection does not comprise personal financial product advice unless its output includes an express recommendation to acquire or deal in a financial product**
- **The trust structure continues to be best placed to meet the needs of members in a cost effective manner, although any impediments to the use of alternative legal structures should be removed**
- **Policies should be pursued to encourage the development of retirement income products to offer retirees greater choice in securing an income in the retirement phase**

In sections 4 (*Superannuation*) and 8 (*Retirement income*) of the Interim Report, the FSI has asked for views on a number of features of the superannuation and retirement income systems, and their effectiveness in achieving policy outcomes. This section of our submission sets out some commentary on the consequences flowing from certain of the different options which may be recommended by the FSI to, and followed by, the government and sets out our own recommendations on those matters.

Effectiveness of the MySuper regime

The aim of MySuper is to lower overall costs for members while supporting and encouraging a competitive market-based, private sector infrastructure for superannuation.[1]

The Interim Report's initial observation is that fees in superannuation remain high despite the introduction of MySuper. However, the fee benefits for MySuper can only properly be measured after the costs of implementation have been recouped and the true long term fees can be ascertained.

The Stronger Super reforms involved a number of major costs for the superannuation industry, including:

- costs of developing MySuper products and the associated documentation to obtain a MySuper authorisation from the Australian Prudential Regulation Authority (**APRA**);
- costs of funding operational risk reserves which, for most superannuation funds, must equal to at least 0.25% of funds under management by 1 July 2016;
- costs of building the technological infrastructure necessary to support the SuperStream reforms;
- costs of developing data streams in order to comply with the substantially more onerous APRA reporting regime;
- additional SuperStream levies, as the industry has been required to provide additional funding to APRA to enable it to properly regulate the Stronger Super proposals. Treasury has estimated that the cost of implementing the SuperStream reforms was $467 million in total over 7 years to be paid for by a temporary SuperStream levy on APRA-regulated funds. If you average the full levy increase of $121 million to apply in 2012-13 across the approximate 33 million accounts existing at that time, the cost was estimated by Treasury to be roughly in the order of $4 per account[2];
- costs of additional mail-outs to members; and
- compliance costs arising from new disclosure rules.

In the Super System Review's *Final Report – Part One*, Treasury estimated that an average wage earner paying average MySuper fees could benefit from around a 40% fee cut in the future. However, Treasury recognised that the SuperStream reforms were expected to involve initial up-front costs for the industry and the full benefits might not be realised immediately.

Accordingly, the Super System Review understood the need for super funds to recoup from members the initial up-front compliance costs before the cost benefits of the new regime could be enjoyed by those members.

1 Super System Review, *Final Report – Part One* (2010): <www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htm>.

2 Treasury's SuperStream Fact Sheet: <ministers.treasury.gov.au/ministers/brs/content/pressreleases/2012/attachments/28/SuperStream_factsheet.pdf>.

In this regard, it should be remembered that while superannuation funds were able to offer a MySuper product from 1 July 2013, many did not do so for some months after. Further, the obligation to offer MySuper did not commence until 1 January 2014. MySuper is accordingly only in its infancy and has not had time to demonstrate whether or not it will be effective in reducing costs.

Other factors that should be taken into account are as follows:

- due to the transitional arrangements, many current default balances have yet to be transferred to a MySuper product (and don't need to be transferred until 1 July 2017), so that any benefits of scale in MySuper have yet to be fully realised; and
- there are a variety of Stronger Super measures which remain outstanding and are the subject of government consultation[3] which could involve significant compliance costs for the superannuation industry.

In our view, it would be a difficult proposition for the superannuation industry to be told that the MySuper regime is a failure within the first 12 months of its operation (and before all the Stronger Super proposals have been properly bedded down) when super funds are still in the process of recovering their large initial up-front costs and members are still funding SuperStream levies and the establishing of operational risk reserves.

Recommendation - The FSI make no proposals to change the regulatory settings for fees in the default superannuation market. Instead, it is recommended that the position be set for review after 2017, when a sufficient period has elapsed.

Three day portability rule

The ability to freely transfer monies within the system is a fundamental operational feature of an efficient and mature superannuation system.

The efficiency of the portability regime was strengthened under the SuperStream reforms. From 1 July 2013, APRA-regulated funds began receiving rollovers electronically and full compliance with the Australian Taxation Office's (**ATO**) new data and payments standards for portability was required by 1 January 2014.

The portability rules were significantly amended as part of these changes. The previous 30 day timeframe was reduced to 3 business days (at least where the member has not made a member investment choice).

Accordingly, the portability regime in Australia has only recently (within the last 12 months) undergone significant structural and regulatory change.

For the most part, the portability system works well and operates to facilitate the timely and efficient transfer of benefits between superannuation funds. It should be pointed out that the SuperStream amendments inserted a note to the superannuation regulations which expressly recognise the ability to implement a staged transfer of benefits from a fund where one of the illiquidity exceptions in the portability rules is satisfied.

3 See Treasury's *Better regulation and governance, enhanced transparency and improved competition in superannuation* Discussion Paper (2013):
<www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2013/Better%20regulation%20and%20governance/Key%20Documents/PDF/Discussion_Paper.ashx>.

We see no need for wholesale changes to the portability system. The current prescriptive regime creates certainty in the application of the timeframes. In this situation, involving two (normally unrelated) superannuation funds, certainty is a necessary component. We are concerned that a principles-based approach creates too much ambiguity in operation and could lead to different interpretations by different superannuation funds.

The industry has seen no major overarching roadblocks with the portability requirements. However, certain aspects of the portability system are problematic particularly in cases of underlying investments being frozen or being unable to provide accurate prices. The current mechanisms of obtaining member consent or seeking approval from APRA to delay a transfer are impractical or cumbersome in these circumstances.

For investment options other than MySuper products, the Super System Review recommended some relaxation of the conditions under which a longer than standard portability regime can be applied. In particular, the current regime requires the consent of members to be obtained before investing in an illiquid investment option. Obtaining written consent can be onerous and one alternative would be to allow a change to be made to an existing investment option by giving members adequate notice of the restriction and an opportunity for members to switch into other investment options if they prefer a more liquid investment. Such a change could assist trustees to include infrastructure and like investments in their investment portfolios for some investment options.

Recommendation - The FSI make no proposals to make wholesale changes to the regulatory settings for the portability rules. However, the illiquidity exceptions in the portability rules should be relaxed to permit a period longer than the maximum timeframe in relation to that portion of member's benefits invested in frozen funds or which cannot be priced without the need for APRA approval or member consent. Also, to facilitate investment in less liquid underlying assets, the conditions under which a longer than standard portability regime can be applied should be relaxed to allow disclosure as an alternative to prior written consent.

Competition under the MySuper regime

The Stronger Super regime adopts a number of inter-related policy "planks" which are designed to ultimately improve competition with a view to achieve better outcomes for members. These include:

- the introduction of the MySuper which has been designed to be a simple product with few "bells and whistles" and which can be readily compared to MySuper products in other funds;
- the new obligation imposed on trustees of MySuper products to promote the financial interests of the beneficiaries of the fund who hold the MySuper product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes);
- the SuperStream reforms which mandate use of technology solutions for the streamlined payment of superannuation contributions and for the transfer of benefits between superannuation funds;
- APRA has an obligation to publish on a quarterly basis MySuper league tables. According to the Revised Explanatory Memorandum, this obligation is designed to provide a central source of information on MySuper products, help inform members and drive competition. The league tables must set out the fees charged in relation to MySuper products, on a product by product basis, the costs incurred in relation to MySuper products, on a product by product basis and the net returns to beneficiaries of regulated superannuation funds who hold MySuper products, on a product by product basis. APRA has yet to publish the league tables but has flagged it will commence doing so in late 2014; and

- MySuper product dashboards, which are designed to display simple, plain-English information about investment strategies for MySuper products focussing on risk, returns, fees and costs.

A number of these elements have only just been implemented while others, such as the MySuper league tables, have yet to be put into effect. As a result, the competitive pressures developed under the Stronger Super regime are in their infancy and have not had time to develop or demonstrate their long term benefits.

Recommendation - It is too early to determine whether or not the competitive pressures in relation to MySuper will be reflected in higher after-fee returns.

Tailoring asset allocation

The tailoring of asset allocation can only be properly achieved with the engaged member. To date, many of the lifecycle investments are offered only in MySuper products which are designed for the disengaged. In our view, the ability of member to exercise investment choice, particularly when matched with considered personal advice (whether full advice or scaled advice) provides members with the best outcomes.

Recommendation - No wholesale changes should be made to the MySuper regime - there are no benefits to members of mandating that superannuation trustees tailor asset allocation to members.

Calculators and benefit projections

Calculators and benefit projections are important tools to assist in engaging members in their superannuation arrangements. The prevalence of defined contribution arrangements in Australia, and the regulatory reporting surrounding them, means that member attention is on return on investment rather than adequacy of retirement savings. Benefit projections and calculators can assist in shifting the focus towards retirement income.

The Australian Securities & Investments Commission (**ASIC**) has historically taken the view that since calculators and benefit projections allow a degree of tailoring to the individual, both constitute financial product advice and, as such, cannot be provided other than by those entities that hold an Australian financial services licence, the conditions of which permit them to provide personal financial product advice. ASIC has provided some relief by way of class orders to allow for the publication of calculators and the use of benefit projections. However, the relief is narrow and unduly restrictive, inhibiting the use of both tools.

By way of illustration, benefit projections can be provided by a super trustee in a super statement in accordance with ASIC Class Order [11/1227] and ASIC Regulatory Guide 229. ASIC Class Order [CO 11/1227] contains a set of very prescriptive requirements, including setting the permitted assumptions that a trustee must adopt in order to obtain regulatory relief.

There are several specific restrictions associated with ASIC Class Order [CO 11/1227], including:

- it is not possible for superannuation fund trustees to show the impact of different contribution levels, different retirement ages, investment in other funds or receiving the age pension on a member's retirement benefit projection. This is because trustees are required to provide retirement estimates as a lump sum (at age 65) and annual income stream (from age 65 to age 90) and to rely on the applicable fees, contribution levels and insurance premiums over the last 12 months when providing these estimates;

- although there is no formal restriction on the type of superannuation funds that may provide retirement income projections, the ASIC relief is best suited to accumulation schemes and may not readily lend itself to defined benefit schemes; and
- trustees must not provide a member with a retirement estimate if doing so would be misleading (or likely to mislead) and it is up to the trustee to determine whether this would be the case. In some cases, use of the assumptions prescribed in ASIC Class Order [CO 11/1227] could produce misleading and deceptive results.

As a result, the take up of ASIC Class Order [CO 11/1227] has been extremely limited despite the recognised advantages of providing projecting retirement savings in super statements.

We think it would be beneficial to clarify, in the legislation, that a calculator or benefit projection does not comprise personal financial product advice unless its output includes an express recommendation to acquire or deal in a financial product. Of course, a person who publishes a calculator or benefit projection would still need to comply with general legal restrictions, such as ensuring that the material is not misleading or deceptive.

Recommendations - The FSI should recognise the advantages to members of providing calculators and benefit projections in super statements. To facilitate the increased use of retirement income projections by superannuation fund trustees, the FSI should recommend that the law be amended to clarify that a calculator or benefit projection does not comprise personal financial product advice unless its output includes an express recommendation to acquire or deal in a financial product.

Trust structures

Superannuation funds operate under a trust model in part governed by the general law of equity. There is a corporate trustee (or a group of individual trustees) who controls the fund's assets and manages them for the benefit of members. Each trustee has general law and statutory duties to members, which involves taking ultimate responsibility for the management and administration of the superannuation fund.

There are advantages and disadvantages of trust structures for members.

For example, trust structures create significant complexity and, accordingly, a degree of costs for members. On the other hand, trusts and the duties imposed on trustees provide an important layer of protection for members.

The utility of the trust structure was only recently considered by the Super System Review. In its early stages, the Super System Review raised a similar question to the one raised by the Interim Report.

Further, the Super System Review closed the issue off during the early stages. In their *Phase One – Preliminary Report*, the Super System Review referred to a general belief that the costs of changing from a trust model would be considerable. However, it also noted that many submissions identified features of the trust model that make it attractive in the superannuation context, including:

- the separation of legal and beneficial ownership (which protects both member and government interests);
- the substantial body of well-established principles that are inherent in the trust concept;
- the flexibility inherent in the trust model as it can be used in many commercial contexts; and

- where it is convenient to separate actual ownership from day-to-day control of the underlying assets.

It is submitted that the benefits of a trust structure for a superannuation arrangement have not changed and continue to apply today.

We therefore would not support any change requiring funds to conform to a different legal model.

That said, we think there is merit in allowing flexibility in determining the preferred legal structure for a superannuation product. For example, a provider may be able to realise cost reductions by structuring a new superannuation product as a type of account in a similar way to a retirement savings account.

Recommendation – While we consider that the FSI should find that the trust structure continues is best placed to meet the needs of members in a cost effective manner, we think that any impediments to the use of alternative legal structures should be removed.

Stability of superannuation policy settings

The Stronger Super reforms are the most recent set of regulatory reforms impacting superannuation. Constant regulatory reform has been a feature of the superannuation industry since 2002. Some of the more significant changes have been:

- in 2002, the splitting of superannuation upon breakdown of marriage and the Australian financial services licensing and product disclosure reforms;
- in 2004, the Choice of fund rules;
- in 2006, the introduction of the RSE licensing regime and anti-money laundering and counter-terrorism financing rules;
- in 2007, the Super Simplification superannuation and taxation reforms;
- in 2010, introduction of the short-form PDS regime;
- in 2012, the Future of Financial advice reforms; and
- in 2014, the reform of the Australian privacy rules.

During that time, there has also been a large variety of more minor policy changes including introduction of terminal illness conditions of release, interdependency rules, same sex relationship changes, changes to contribution caps, splitting of super upon breakdown of de facto relationships transition to retirement pensions, to name a few.

Accordingly, we support the preposition that superannuation policy settings lack stability. In our view, the constant change has added to the costs of the superannuation system.

Retirement income product development

The FSI has sought views on policy options for addressing the observation that the retirement phase of superannuation is underdeveloped.

We agree that policies should be pursued to encourage the development of retirement income products to offer retirees greater choice in securing an income in the retirement phase.

There appears to be a general consensus that the current arrangements do not provide retirees with an adequate suite of retirement income products from which to choose. We therefore consider that reform is needed to simplify the rules which a retirement income product needs to satisfy in order to be treated as complying.

We also support offering tax incentives for retirees to purchase retirement income products which address longevity risk, however we are not in favour of compulsion.

We support law reform to facilitate the provision of deferred lifetime annuities since these products can be offered on a more affordable basis than immediate annuities and naturally complement the dominant retirement income product, the account-based pension. We welcome the release of the Australian government's *Review of retirement income stream regulation* Discussion Paper in July 2014.

There is little interface between the tax, superannuation and social security legislation in relation to retirement income products. Introducing common terminology across these areas would assist in the development of new retirement income products, as would a set of policy principles to categorise retirement income products.

3 Stability: Resolution Powers and Bail-in

- **The introduction of a statutory bail-in regime is another example of an idea emanating from overseas regulation that needs careful consideration and refinement before it migrates to Australia**
- **For it to operate here fairly we may need to re-examine features of our existing prudential regulation, in particular the unlimited preference to protected accounts in Australia**
- **In order to avoid limitations on the effectiveness of statutory bail-in, it may be preferable to promote the creation of a new class of instruments, under which senior creditors agree to be bailed-in, after the holders of regulatory capital instruments**

In section 5 (*Stability*) of the Interim Report, the FSI has asked for views in relation to the resolution powers available to APRA to deal with a distressed bank and in particular one that is considered "too big to fail". The Interim Report states that Australia's resolution regime is broadly consistent with international best practice but that a comparison with the Financial Stability Board's (**FSB**) *Key Attributes of Effective Resolution* revealed "several gaps in resolution tools and powers". It continues:

> *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*
>
> - *No change to current arrangements.*
> - *Increase the ability to impose losses on creditors of a financial institution in the event of its failure.*

In this section of our submission we argue that:

- it is not self-evident that the existence of a power to bail-in senior creditors in and by itself will change the behaviour of market participants so as to reduce the moral hazard associated with an institution being "too big to fail";
- any bail-in power needs to operate clearly and fairly. This may require a careful re-consideration of Australia's existing preference for "protected accounts" and other changes to the *Banking Act 1959* (Cth) (**Banking Act**), which may distort the effect of the bail-in; and
- there are impediments to the operation of a bail-in power in certain circumstances, for instance bonds governed by a foreign law. The most secure way to circumvent this impediment is to supplement the power with a contractual agreement by the bondholders to be bound by the exercise of a power under the statute. It may be preferable to recognise senior debt containing an agreement to be bailed in as a category of obligation contributing to the capital structure of the bank.

Should there be a bail-in power?

There are two reasons commonly advanced for introducing a bail-in regime. The first (the "preventive argument") is that its mere existence would contribute to financial stability.[4] The second (the "fair distribution of loss argument") is that, if losses must be absorbed it is fairer that these be allocated among creditors who have contracted with the institution rather than socialised by government and general taxation.[5] As a threshold matter it is worth considering whether these reasons are compelling.

The argument that the existence of additional regulatory powers to bail-in creditors contributes to financial stability rests on a number of premises:

(a) first, that the existence of these powers would reduce the expectation that there would be public sector support for the institution should it get into difficulty;

(b) secondly, that the reduction of that expectation would temper the tendency of management to engage in risky behaviour in which it might otherwise engage; and

4 See e.g. the argument in the first para of the International Monetary Fund (**IMF**) Staff Discussion Note of 24 April 2012, *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions* (SDN/12/03) (**IMF Paper**), p 3:

> *Large-scale government support of the financial institutions deemed too big or too important to fail during the recent crisis has been costly and has potentially increased moral hazard. To protect taxpayers from exposure to bank losses and to reduce the risks posed by too-big-to-fail (TBTF), various reform initiatives have been undertaken at both national and international levels, including expanding resolution powers and tools.*

5 Bank of England, *Resolution and Future of Finance* (Speech given by Paul Tucker, Deputy Governor Financial Stability, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of Prudential Regulation Authority Board, 20 May 2013), p 14:

<www.bankofengland.co.uk/publications/Documents/speeches/2013/speech658.pdf>;

Board of Governors of the Federal Reserve, *Remarks on "The Squam Lake Report: Fixing the Financial System*" (Speech by Chairman Ben S. Bernanke, 16 June 2010):

<www.federalreserve.gov/newsevents/speech/bernanke20100616a.htm>.

(c) thirdly, that the reduction in that expectation would make the creditors who may be bailed-in more reluctant to extend excessive credit to the institution or in some other way to discipline its activities.

Each of these premises is questionable.

First, more important than the existence of a legal power is the perception of whether and how it would be exercised. The failure of a large Australian bank would most likely have some effect on every Australian household: the household may not bank with the distressed bank, but it is likely to be reliant to some degree on a payment, delivery or service from someone who does. The potential economic disruption is enormous and it is difficult to imagine how it would not become an immediate political problem. So long as that is the judgment of market participants, merely adding further powers into the Banking Act is unlikely to change fundamental behaviours[6].

Secondly, even accepting the assumption that bank management might tend to engage in more risky behaviour through the hope of government intervention, it is not obvious why that behaviour would be moderated if the risks are instead insured by senior creditors through a bail-in mechanism.

Thirdly, reliance on creditors to discipline bank management may be optimistic. A creditor's tools are most limited: refusal to lend, withdrawal of funds or increasing the price of their funding. The practical ability to do that is liable to be distorted by factors other than risk assessment, including the availability of alternative investment opportunities, the level of interest rates and fund mandates.

The "fair distribution of loss argument" rests on the premise that if losses have to be absorbed, it is fairer that they be visited upon the private sector than on society as a whole. Put crudely, bankers, shareholders and bondholders enjoy the profits of financial expansion, so they should bear the losses of any contraction. Bondholders may not be well placed to discipline bank management, but they are in a better place than the general public. As with most assertions of what is fair, that premise might be contested: it discounts the role of government and its agencies in contributing to financial crises, for example, through lax monetary policies, irresponsible public spending or gross supervisory failure, factors thankfully absent from Australia for many decades. It also tends to assume that bondholders (and shareholders) are a body divorced from the public at large, which in Australia is untrue (except so far as many bondholders are foreigners - see the discussion below). It discounts the fact that the continuance of the financial institution is likely to be of great public utility, as it avoids the disruption to the economy as a whole that would otherwise result. Perhaps it discounts or ignores the alternative approach of sharing losses through the industry.[7]

That said, as belief in this argument is widespread internationally,[8] for the purposes of the rest of this section of our submission we shall assume that it is generally fairer for losses to be absorbed by creditors rather than the public and that this is of itself a justification for introducing a bail-in regime. It is still nonetheless reasonable to require that the regime:

6 For a contrasting example, take the Financial Claims Scheme (**FCS**): this is in no legal sense a guarantee of deposits (to the relevant amount): its application depends on APRA applying to wind up the bank and the Minister deciding to apply the scheme to the bank; see section 11AF of the Banking Act; APRA's Prudential Standard APS 910, Financial Claims Scheme (January 2012). Yet, some market participants act as if it were a guarantee, presumably out of the belief that the Australian government would in fact decide to apply it.

7 Bank failures have sometimes been addressed by having the strong banks take over the business of the weak. That may work tolerably where a small bank fails, but with a major bank that carries the risk of a weak bank dragging down others and perhaps the system as a whole.

8 See footnote 4 above.

- operates in a manner that is likely to achieve its objects; and
- operates fairly among the creditors.

In Australia this would require very careful consideration of the details and definition of the power. It is not a question of simply plugging a gap in existing powers. It will involve a re-examination of some long-standing provisions in the Banking Act. We set out our reasons for saying this below.

How would bail-in work in Australia?

Three points in particular will need consideration:

(a) what is the trigger point for the operation of the bail-in and how does it relate to other elements of the prudential regulatory regime?

(b) which creditors are to be bailed in? Are they being treated fairly compared to other creditors and shareholders?

(c) will measures of the Australian Parliament be effective without further international cooperation?

– Trigger Point

It is important that the trigger point for the operation of a bail-in is defined with sufficient certainty. A failure to achieve this would frustrate the regulator's ability to use the power with confidence, and does not assist the efficient pricing of liabilities that are likely to be bailed in. It may also contribute to the exercise of the power undermining, rather than improving, confidence in the bank[9].

The choice of the trigger point can also have important economic consequences. A trigger point close to insolvency is less costly, and more easily understood than one removed from it. On the other hand, a point close to insolvency runs a greater risk of the bail-in failing to restore the confidence necessary for the bank to continue to trade.

The current Banking Act and prudential standards are also relevant to the definition. APRA's current powers to appoint a statutory manager to a bank or to order a recapitalisation of a bank are likely to be triggered at the point where APRA considers that in the absence of external support the bank may become unable to meet its obligations or may suspend payment[10]. Under the prudential

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9 Note in this regard the IMF Paper, p 10-12, but we would not agree with the comments about excluding the role of the judiciary: that may not be constitutionally possible.

10 Section 13A(3) of the Banking Act provides that APRA may appoint a statutory manager to an authorised deposit-taking institution (**ADI**) if:

(a) the ADI informs APRA that the ADI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment; or

(b) APRA considers that, in the absence of external support:

(i) the ADI may become unable to meet its obligations; or

(ii) the ADI may suspend payment; or

(iii) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or standards for regulatory capital instruments, all instruments of a bank constituting regulatory capital[11] must contain a loss absorption provision under which the instrument will be converted into ordinary shares or written off if a non-viability trigger event occurs. This is defined as:

> *the earlier of:*
>
> *(a) the issuance of a notice, in writing, by APRA to the ADI that conversion or write-off of capital instruments is necessary because, without it, APRA considers that the ADI would become non-viable; or*
>
> *(b) a determination by APRA, notified to the ADI, in writing, that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.*[12]

Instruments constituting Additional Tier 1 Capital that are accounting liabilities must also be converted or written off if the bank's common equity capital falls to or below 5.125% of its risk weighted assets.[13]

The prudential standards reflect requirements of the Basel Committee on Banking Supervision.[14] Terms reflecting these requirements are included in regulatory capital instruments issued by Australian banks.[15]

If other creditors ranking senior to regulatory capital are to be bailed in, the trigger point cannot be earlier than the measures for the conversion and write-off of regulatory capital. To provide otherwise would be to completely subvert the hierarchy of creditors' claims.[16] Whether it should be the same

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(iv) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system in Australia; or

(c) the ADI becomes unable to meet its obligations or suspends payment.

Assuming a vigilant regulator it would seem more likely that (b) would arise before (a). The same grounds apply to an order by APRA requiring the ADI to increase its capital in Section 13E of the Banking Act.

11 Very broadly, perpetual non-cumulative preference shares and their equivalents and certain term subordinated debt.

12 APRA's Prudential Standard APS 111 – Capital Adequacy: Measurement of Capital (January 2013) (**APS 111**), Attachment J para 3.

13 APS 111, Attachment F para 1.

14 Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010 (revised June 2011)), p 56: www.bis.org/publ/bcbs189.pdf>.

15 For recent examples, see:

- National Australia Bank Limited, *Prospectus NAB Convertible Preference Shares II (NAB CPS II)*, 20 November 2013;
- Westpac Banking Corporation, *Westpac Capital Notes Prospectus*, 7 February 2013;
- Australia and New Zealand Banking Group Limited, *ANZ Capital Notes 2 Prospectus*, 19 February 2014; and
- Commonwealth Bank of Australia, *Commbank PERLS VII Prospectus*, 18 August 2014.

16 See FSB, *Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines* (Consultative Document dated October 2011), Principle 5.1, p 11:

> *Resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (pari passu) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole. In particular,*

test as regulatory capital, or a later point, is a matter of some difficulty: how "non-viability" relates to traditional concepts of insolvency is not clear, as the term is not further defined in the prudential standards and APRA has so far declined to provide guidance as to its meaning.[17]

– *Creditors to be bailed in*

Since capital instrument holders are already subject to a bail-in regime through the terms of their instruments, bail-in is necessarily a matter of selecting the unsubordinated creditors who are to be affected. Unsubordinated creditors of a bank come in many classes: they include depositors, bond creditors, holders of bills of exchange or promissory notes, derivatives counterparties, trade creditors, employees, the ATO and the RBA. Any law mandating a bail-in has to consider which classes of creditors are affected and to what extent.

At this point, three general propositions may be noted.

First, it is critical to the effectiveness of the bail-in to keep payments being made by the bank as its customers require. They need to be made to or as directed by the customer - for example, to enable it to settle the customer's debts. Payments are made from current deposit accounts. To some degree, these need to be insulated. Defining the degree of insulation by amounts is arbitrary and problematical - what might be an extraordinary payment to one customer might be in the ordinary course for another and the systemic effect of disrupting large payments may be significant.

Secondly, it does not seem appropriate for a resolution regime to bail-in creditors on whom the law has conferred a preferred position in the event of a liquidation, at least until after the lower ranking creditors have been bailed-in.[18]

A third general principle might be that it is important to protect the position of essential suppliers, so that the bank can continue to operate.

Here, some awkward facts in the existing legal regime intrude: a great many creditors of an Australian bank enjoy a preferred position over general creditors: holders of protected accounts in Australia have a priority over general creditors for payment out of the bank's Australian assets.[19] Unlike the FCS, the amount of these claims is unlimited. Claims of the RBA are preferred for payment out of the bank's Australian assets.[20] Holders of covered bonds have their specific security (and to compromise that would be to defeat the purpose of the covered bond).[21] Holders of

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equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off entirely (whether or not that loss absorption through write-down is accompanied by conversion to equity).

17 See APRA's response in its information paper of 4 March 2013:

Non-viability trigger event

Submissions also requested that APRA provide guidance on the definition of a non-viability trigger event.

APRA has considered whether it would be helpful to provide broad guidance, However, it is not possible to define in advance all the circumstances or factors that would lead to APRA triggering the non-viability provisions. Consequently, APRA will not, at this time, provide any further guidance in relation to non-viability trigger events.

18 FSB, Principle 5.1 (see reference in footnote 16 above).

19 Section 13A(3) of the Banking Act.

20 Section 13A(3) of the Banking Act.

21 This is recognised in sections 11CA(2AA), 13A(4A) and 31B of the Banking Act.

derivatives under a close-out netting contract can net their positions and the collateral by exercising rights of close out. The integrity of those rights is protected by statute and to interfere with that would raise profound systemic issues.[22]

The hierarchy from the point when a bank suspends payment can be illustrated as follows:

	Type of obligation or security	**Examples of obligations and securities**
Higher ranking	Secured obligations	- Covered bonds - Collateralised derivatives
	Preferred Senior obligations	- Claims in respect of the FCS (liabilities to APRA for claims paid under the FCS) - Liabilities in Australia in relation to protected accounts under the Banking Act (e.g. savings accounts and term deposits in Australia in Australian dollars) - Other liabilities mandatorily preferred by law (e.g. employee entitlements)
	General creditors	- Unsubordinated unsecured debt (bonds and notes; saving accounts and term deposits outside Australia or in Australia in foreign currency; trade and general creditors)
	Subordinated creditors	- Term subordinated unsecured debt (e.g. Tier 2 subordinated notes)
	Preference Share holders	- Preference shares and other equally ranking instruments (e.g. Additional Tier 1 Capital Instruments)
Lower ranking	Common Equity	- Ordinary shares

These arrangements have been added piecemeal over time.[23] Each has its justifications but the scheme as a whole lacks clarity of concept and certainty of application. Core concepts, including the concept of an "account" and when assets and liabilities are in Australia for the purposes of the definition, are undefined and could be contested in a situation of distress.[24]

But if all the existing preferred creditors are excluded from the bail-in regime, and trade creditors are also immune in the interests of the bank continuing to trade, that throws the whole or primary burden of the bail-in on a smaller group of creditors, principally:

22 Section 14 of the *Payment Systems and Netting Act 1998* (Cth).

23 Section 13A(3) was originally section 16 of the Banking Act 1959 and conferred a preference on deposit liabilities in Australia. The section was amended to refer to "protected accounts" in 2009 and was last amended in 2011 in connection with the introduction of covered bonds.

24 By way of analogy see the arguments as to the location of insurance liabilities in *AssetInsure Pty Ltd v New Cap Reinsurance Corp Ltd (in liq)* (2006) 225 CLR 331 and also *Re HIH Casualty & General Insurance Ltd* (2005) 215 ALR 562.

- holders of bonds and bills;
- holders of accounts located outside Australia; and
- holders of accounts in a foreign currency.

Consideration should also be given to the extent of the losses being imposed on these bailed in creditors and where they are likely to be located.

It is said to be a principle of bail-in that losses should be imposed on senior creditors only after ordinary shareholders. Shareholders should have their claims written off or eliminated first.[25] Merely converting the senior creditors to equity does not eliminate the claims of shareholders. It dilutes them, but they will participate equally with the bailed-in creditors in the recovery of the bank. Even that dilution would be limited, if the number of shares into which the bailed in debt could convert is capped, as it is in the case of regulatory capital instruments,[26] if the shareholders are truly to absorb losses ahead of the creditors, the rights attaching to their shares would need to be cancelled[27]. What certainty would be given to creditors that such would be the case?

In deciding this, the likely location of the bailed in creditors may be a factor. It is likely that a large proportion, perhaps the majority, will be foreigners. As is well known, much of the major banks' wholesale funding is raised offshore. For medium term notes the figure is presently about 73%.[28] For short term commercial paper it would be about 41%.[29] The bulk of deposits located outside Australia for the purposes of section 13A(3) of the Banking Act are likely to be owed to foreign investors.[30] They might also be expected to hold a percentage of accounts in Australia in foreign currency.

25 FSB, Principle 3.5, p 9:

> *Powers to carry out bail-in within resolution should enable resolution authorities to:*
>
> *(i) write down in a manner that respects the hierarchy of claims in liquidation (see Key Attribute 5.1) equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses; and to*
>
> *(ii) convert into equity or other instruments of ownership of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation;*
>
> *(iii) upon entry into resolution, convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution and treat the resulting instruments in line with (i) or (ii).*

IMF Paper, p 13:

> *To avoid the possibility that pre-restructuring shareholders and junior creditors could benefit from haircuts imposed upon senior creditors, the debt restructuring under a bail-in should reflect the order of priority applicable to liquidation.*

26 See APS 111, Attachment F para 8(c), p 43, Attachment J para 12(c), p 57.

27 As a statutory manager is empowered to do under section 14AA of the Banking Act.

28 Australian Bureau of Statistics, *Financial Accounts* (March Quarter 2014), p 35, where the amount of Australian issued bonds and offshore issued bonds is $110.7 billion and $303.4 billion respectively.

29 *Ibid*, where the amount of Australian commercial paper and offshore commercial paper is $145.4 billion and $102.6billion respectively.

30 It is likely that this is only a small proportion of all depositors.

Thus, the losses of a bail-in, constructed consistent with the existing hierarchy of creditors' claims, is likely to fall largely on foreign investors. These are the investors on whom the nation depends to fund the gap between domestic savings and investment. It may be said that they currently understand the risk of coming behind protected account holders and other preferred creditors in the event of a bank's failure.[31] But it is a different question to ask what price they will charge if, after only holders of capital instruments, they are expected to bear the primary burden of recapitalising a distressed Australian bank. It might also be asked whether it is fair that they bear the primary burden of the mismanagement of an Australian bank and the failure of Australian prudential regulation. And it might be asked whether we have considered that a by-product of a bail-in might be to transfer ownership of a large Australian bank to offshore interests.[32]

In this regard, we note that preferring domestic claims in the manner currently provided by the Banking Act is not consistent with FSB principles.[33] It is not a feature of many other countries' banking laws, including New Zealand. Introducing a bail-in regime that operates in accordance with the existing hierarchy exacerbates the effect of the hierarchy. That hierarchy needs to be reconsidered if a fair bail-in proposal is to be developed. On the other hand, the depositor preference regime has been a feature of Australian banking regulation for over fifty years and the policy implications of abandoning or modifying it would need careful consideration.

– *Effectiveness of Australian government action*

As we note above, a large proportion of the indebtedness most liable to bail-in is raised offshore. It is usually raised under contracts governed by foreign law, usually English law or New York law. This raises issues as to the effectiveness of an Australian bail-in law.

Absent express words, an Australian statute bailing-in creditors would be read by an Australian court as not affecting contracts governed by a foreign law.[34] Express words in the statute can alter that result, so as to bind an Australian court.[35] However, this will not determine the result before a foreign court, which will decide the matter by its own rules and which, if they are like Australian rules, will not give effect to the Australian statue. Avoiding this outcome requires one of three courses of action:

- increased international cooperation to recognise banking resolution laws;
- requiring Australian banks to conduct all their debt issues under Australian law; or

31 The ranking is disclosed to bondholders in most debt information memoranda or other disclosure documents.

32 Certainly, the interaction between a bail-in proposal and shareholding laws affecting ownership of banks, principally FSSA and FATA, as well as the Corporations Act and the ASX Listing Rules would need to be considered — see the IMF Paper.

33 FSB principle 7.4:

> *7.4 National laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. The treatment of creditors and ranking in insolvency should be transparent and properly disclosed to depositors, insurance policy holders and other creditors.*

34 *Barcelo v Electrolytic Zinc Co of Australasia Ltd* (1932) 48 CLR 391; *Antony Gibbs & Sons v La Societe Industrielle et Commerciale des Metaux* [1890] 25 QBD 399; *Adams v National Bank of Greece SA (Greek Bank case)* [1961] AC 255.

35 Examples are in the sections 13N, 14AC and 15C of the Banking Act.

- requiring Australian banks to include in the terms of their foreign bond issues a clause under which the foreign bondholders agree to be bound by a foreign bail-in order.[36]

As regards the first of these options, so long as Australia maintains its preference for local protected accounts, that would require remarkable generosity and co-operation on the part of foreign governments. The second option would be a significant departure from market practice and would come at some cost. The third may be the best available solution to this problem.[37]

A further limit on Australian government action may be the constitutional limitation that an acquisition of property must be on just terms.[38] Bonds issued by a bank are property, as much as are its shares.[39] Extinguishing the bond may arguably be an acquisition and the justness of the terms through conversion into shares may be a matter of debate.[40] It is likely that attempting to limit the role of the courts in the bail-in process, as advocated by the IMF, may be liable to challenge in so far as it purports to exclude any role of the courts in determining the justness of the terms of an acquisition.[41] It should be noted that including a requirement for government to compensate bondholders to some extent for the acquisition of their rights (for example, by compensating them to the extent the bail-in puts them in a worse position than they would have been in a liquidation) detracts from the purpose of a bail-in regime, namely to avoid exposing the public sector to the costs of the bank failing. This risk can be defused by having holders agree in the terms of the bonds to be bound by the regulatory regime so that their property in the bonds is always defined and limited by the regulation.

An alternative approach?

The legal advantages of having the creditors agree to be bailed-in prompts a further thought.

36 For the second and third options see the IMF Paper, p 15:

> *The analysis outlined below assumes that a restructuring would be implemented on the basis of the following principles and applied on a legal-entity-specific basis:*
>
> - *The home-country authorities would initiate, approve, and implement the restructuring process.*
> - *The statutory bail-in powers could, in principle, apply to all liabilities of the ailing bank, including liabilities "held" abroad and claims governed by foreign laws (foreign lex contractus).*
>
> *The process of debt restructuring would be governed by the law of the home country (lex fori concursus). However, as noted below, this process could be undermined by separate proceedings in third countries, including concurrent territorial insolvency procedures of jurisdictions hosting branches.*

37 It should be noted that merely including a description in the disclosure of the bail-in mechanism in an Australian statute would not by itself mean that the holders were contractually bound to accept the results of exercise of the power.

See <www.lse.ac.uk/fmg/events/conferences/past-conferences/2011/DBWorkshop_14Mar2011/6-IBAFull.pdf>; *Report of the International Bar Association in connection with Legal Issues arising in relation to Proposals for Bank "Bail-in" Measures* (2010), Australia, para 1.2.

38 Constitution, section 51(xxxi). See e.g. *Telstra Corp Ltd v Commonwealth* (2008) 234 CLR 210; *Commonwealth v WMC Resources* (1998) 194 CLR 1; *Re: Dohnert Muller Schmidt & Co Ltd* (1961) 105 CLR 361.

39 For the latter, see *Bank of New South Wales v Commonwealth* (1948) 76 CLR 1.

40 The point is recognised in the current Banking Act in relation to the cancellation of shares or the variation of their rights under section 14AA: see sections 14AB 69E of the Banking Act.

41 See *Bank of New South Wales v Commonwealth* (1948) 76 CLR 1.

For Australia, rather than introducing a bail-in regime which may not work, or may not work fairly, or may be seen as tending to promote the priority of local over other claims, would it be better to promote the creation of a new class of instruments, under which senior creditors agree to be bailed-in, after the holders of regulatory capital instruments? The agreement of creditors, who can price freely for the risk they assume, answers any arguments about fairness or the limitations on Australian government action. A target could be set for the total of these instruments and qualifying regulatory capital, which institutions could meet by issuing these instruments or more regulatory capital. There are proposals along these lines under consideration in the United Kingdom.[42]

Key recommendations

The introduction of a statutory bail-in regime is another example of an idea emanating from overseas regulation that needs careful consideration and refinement before it migrates to Australia. The idea will have merit only if it is properly adapted to Australian conditions and that will require careful consideration of existing law and practice.

For it to operate here fairly we may need to re-examine features of our existing prudential regulation, in particular the unlimited preference to protected accounts in Australia.

In order to avoid limitations on the effectiveness of statutory bail-in, it may be preferable to promote the creation of a new class of instruments, under which senior creditors agree to be bailed-in, after the holders of regulatory capital instruments.

4 Consumer Outcomes

- **'Improving' the current disclosure regime yet again would necessarily require changing it, clear benefits would need to be demonstrated given the costs involved and the shortcomings of disclosure noted in the Interim Report**
- **Shifting responsibility for assessing the suitability of products from the consumer to the product issuer would be a very significant change**
- **If a shift was made, a stocktake of the other regulatory protections should be done to see whether introducing a suitability test would obviate the need for some of the other current or proposed regulatory protections**

In section 6 (*Consumer outcomes*) of the Interim Report, the FSI has asked for views on how to improve consumer outcomes. In particular it seeks views on the costs, benefits and trade-offs of a number of policy options or other alternatives. This section of our submission sets out some comments on some of the consequences flowing from the different options relating to disclosure and shifting responsibility for assessment for product suitability from consumers to product issuers, which may be recommended by the FSI to, and followed by, the government.

42 This is part of the proposals for setting a UK banks' "primary loss absorbing capacity" (or PLAC) as including, as well as regulatory capital, long term unsecured debt that is clearly identified as subject to the anticipated future bail-in power: see HM Treasury, "*Banking Reform, draft secondary legislation*", July 2013 para 4.10 available at <www.gov.uk>.

Improve the current disclosure requirements

One alternative is to improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.

The financial services disclosure regime has changed over time with each new regime criticising the previous regime. For example, in 1997 the Wallis Report recommended a consistent regime for all financial products and a 1997 Corporate Law Economic Reform Program paper[43] stated that it was "vital that investors be supplied with clear and comprehensible disclosure". That led to diverse disclosure regimes being replaced with a single regime of retail product disclosure statements for all financial products except securities. Over time the uniform regime has been supplemented with additional or different requirements for particular types of products such as hedge funds, superannuation products and margin lending products, while relief has been provided for other products, for example, basic deposit products. In relation to credit products, a range of additional disclosures have been included for specific types of credit contracts, together with the introduction of Credit Guides and key fact sheets for some products. Each time the regime changes, costs are incurred and often the costs are passed on to investors or borrowers.

"Improving" the current disclosure regime once again would necessarily require changing it, and clear benefits would need to be demonstrated given the costs involved and the shortcomings of disclosure noted in the Interim Report.

Shifting responsibility for assessing the suitability of products from the consumer to the product issuer

Another option is to implement further measures that shift responsibility for assessing the suitability of products from the consumer to the product issuer. However, the Interim Report states that any substantial shift in the regulatory regime would require compelling evidence to support it.

Shifting the regulatory regime in this way would be a very significant change for the industry. We can draw on the consumer credit experience as a guideline.

In the credit context, much of industry already had procedures which reflected responsible lending requirements to at least some degree. However, their legislative mandate has resulted in some significant changes. Some types of loans have become virtually unavailable – more information is required on the individual customer's objectives in relation to proposed credit rather than making broad assumptions about customer requirements. Despite the infrastructure which already existed in credit providers to perform credit assessments, in addition there has been a material increase in back office work and costs, for example in relation to verification of information provided by customers and costs of record keeping.

These administrative burdens would be amplified in an investment context for issuers who currently collect much more limited information on investors, in particular those who are introduced through intermediaries.

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43 Corporate Law Economic Reform Program, *Financial Markets and Investment Products - Promoting competition, financial innovation and investment* (1997):

<www.archive.treasury.gov.au/documents/286/RTF/Full.rtf>.

If the FSI, and subsequently the government, were to adopt this approach we would recommend that it do a stocktake of the other regulatory protections to see whether introducing a suitability test would obviate the need for some of the other current or proposed regulatory protections.

Please refer to section 5 below for further submissions in relation to product suitability and listed products.

5 Retail Bond Market, Equity and Convertible Markets and Disclosure

- **Permit simple retail bond issues by any listed issuer using a 'debt standard' cleansing notice – to promote extension of wholesale bond issues to retail**
- **Streamlining offering rules more generally, including:**
  - **Permitting post-IPO capital raisings by listed issuers to be conducted using an 'equity standard' cleansing notice (not just placements and rights issues) – equivalent to the New Zealand regime**
  - **Rationalising features of the legislation that intensify prospectus processes – directors deemed civil liability; directors consents; third party consents; incorporation by reference mechanisms and liability; remove distinction between prospectuses and product disclosure statements for listed products**
- **Dilution rules in the ASX Listing Rules do not need to be reformed – the Listing Rules are sufficient. The selection of an appropriate capital raising structure is a matter for directors duties, and involves significant considerations beyond dilution – more prescriptive rules would not allow these to be balanced in a way that best serves the interests of the company as a whole**
- **Exercise caution regarding differentiated 'junior' markets – these have tended to suffer from poor liquidity and a high rate of corporate failure, impacting on the reputation of the exchange**
- **Regulatory 'bans' on financial products, or intrusion into structuring, will cause harm to the market, to innovation and to access to funding for Australian banks and businesses, and will not achieve the intended aim. It may also prevent genuinely experienced investors from accessing sophisticated products**
- **Investor education and improved access to, and quality of, financial advice is important. However, suitability assessments should be conducted by skilled advisers and intermediaries rather than issuers – issuers are in no position to determine suitability. The logic of suitability assessments particularly needs to be tested for listed products where any investor can trade in the securities**

In section 3 (*Funding*) and section 6 (*Consumer Outcomes*) of the Interim Report, the FSI has asked for views on proposals:

- to permit listed issuers to offer retail vanilla bonds without a prospectus, and offers some comments on equity raisings;
- to introduce additional dilution "protections" for investors in relation to equity private placements and non-renounceable rights issues, but considering the impact on the capacity of corporates to raise funds in times of stress;
- to introduce differentiated markets to allow market access by smaller companies;

- to provide ASIC with additional product intervention powers to prescribe marketing terminology for complex or more risky products, and power to ban temporarily ban products (potentially to apply to prospectuses); and
- to require issuers to conduct suitability determinations for product issuance (again, potentially in a prospectus context).

Disclosure reforms – retail bonds and streamlined disclosure

– *Issuing simple bonds without a prospectus*

There are strong arguments to support listed issuers being able to issue simple or “vanilla” debt securities for retail investors without a prospectus.

The rationale for this is grounded in the applicable standard of existing disclosure:

- periodic disclosure (which contains financial information and information about material business risks) and continuous disclosure obligations already cover material information that is relevant to an equity investment (the “equity standard” of disclosure);
- a simple vanilla bond, with no conversion or subordination features, is less sensitive to that information than an investment in ordinary shares;
- any company information that will be relevant to whether the company can meet the coupon and repay, ultimately, the principal on the bond (the “debt standard” of disclosure) will be covered by the “equity standard” of disclosure;
- the most relevant additional information to the trading price of a bond (as distinct from whether the obligations of the instrument will be met) will be the interest rate environment – for example, whether an investor can get a better return on another instrument, causing them to exit their investment on the bond; and
- retail investors are trading on a daily basis in and out of equity securities, based on that publicly available information – so our regulatory system must be taken to accept that the continuous disclosure standard is “enough” from the company – it is up to investors to inform themselves, and draw together whatever additional market information, sector information and advice they need.

Given an equity issue is typically a “riskier” investment than a simple debt issue (although liquidity risk for debt may be higher), it is a very strange regulatory outcome that we require a prospectus to be issued by listed company for a simple debt issue, when equity can be issued under a rights issue with an equity “cleansing notice”.

– *What does a prospectus add, post-listing?*

An initial public offer (**IPO**) prospectus has a broad general content test, expanded by significant policy guidance in ASIC Regulatory Guide 228 and ASX’s listing requirements. That disclosure is then maintained by periodic and continuous disclosure, which provides financial information, information on material business risks, operating updates and other information material to the price or value of the company’s securities.

Post-listing, for an offer of further ordinary shares to the general public, a “transaction specific” prospectus uses a more streamlined content test – which acknowledges continuous disclosure by requiring that the company simply must disclose the effect of the offer and any information withheld from the market under carve-outs to the continuous disclosure requirements. Those carve outs typically relate to confidential information that is incomplete, or uncertain in some way – it raises some challenges for disclosure because it is inherently less reliable and subject to change at that point in time. However, those two concepts distil the core difference between information already in the market, and information that must be contained in a post-listing prospectus.

Beyond that, a prospectus adds significant cost, a complex liability overlay, numerous process requirements, personal obligations for directors and an additional regulatory tool – the "stop order" power, which enables ASIC to halt an offer without approaching a court for an injunction (although in practice, the mere threat of ASIC action is typically sufficient).

Regulatory policy[44] and market practice has substantially expanded the expected content of a transaction specific prospectus, requiring the repetition of information that is already in the market – in particular, information about the company's operations and material risks.

The liability framework, case law around defences to liability and regulatory expectations of market practice drive a reasonably intensive due diligence process to support the preparation of the prospectus.

It is worth noting that the "transaction specific" prospectus standard applies only to further tranches of existing classes of listed securities (typically, just ordinary equity), or securities that convert into existing classes of listed securities (for example, convertible bonds and many hybrid securities). For non-convertible debt (for example, vanilla bonds and subordinated bonds with no equity conversion) a full "IPO–standard" prospectus is required. This is a bizarre anomaly in the law, which should be remedied.

Prospectuses can serve an educational purpose – but they may not be the most effective vehicle for fundamental investor education, and this can lead to increasingly lengthy prospectuses. Sign-posts to information that explains relevant categories of investment may be more useful.

There is much to be said for the view that a prospectus should not often be required, post-listing.

– *Rationale for "cleansing" notices*

The core content difference between a transaction specific prospectus[45] and the continuous disclosure test, in essence, is any material information that falls within the carve-outs to continuous disclosure. The effect of a new issue of securities on the company, to the extent it is material to the company, is addressed by the continuous disclosure test itself combined with certain specific listing rule disclosure requirements. For information to be disclosed under a cleansing notice, it must still meet more general disclosure tests or restrictions – importantly, that it not be misleading or deceptive, which applies to all public releases.

As a result, the issue of a "cleansing notice" has been taken to be equivalent in substance to having addressed a prospectus requirement for institutional placements and rights issues, ensuring that the listed securities issued with the cleansing notice can be traded freely on the stock exchange (without "secondary sales" restrictions, that stem from prospectus anti-avoidance provisions in section 707 of the Corporations Act).

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44 Under section 713 of the *Corporations Act 2001* (Cth) (**Corporations Act**). See also ASIC Regulatory Guide 228.

45 A transaction specific prospectus is for listed issuers, and applies a more "streamlined" prospectus content test – although it is often still a substantial document (see below).

The rationale for cleansing notices is grounded in equivalence of publicly available information – the existence of a fully informed market. That rationale would apply equally to any further issues of listed securities, or to new classes of listed securities where the relevant disclosure standard has already been met for those securities.

– *Extension of the cleansing notice regime beyond placements and rights issues*

The limitation of the exemption to institutional placements and rights issues is a matter of regulatory caution – it does not reflect a restriction on the availability of material information in other contexts. The rationale seems to be, in part, that institutional investors and existing shareholders may be more likely to have informed themselves about the relevant class of listed securities.

However, where there is a fully informed market, there is no "disclosure" rational for limiting the cleansing notice mechanism to placements and rights issues. Recent periodic reports and continuous disclosure are accessible via the internet. It would be viable (and logical) to extend it to any listed equity offers, post-IPO, and simple retail debt offers.

The broader use of cleansing notices would have a number of impacts:

- The change from a prospectus regime to a cleansing notice regime significantly reduces the corporate and administrative processes involved in an offer, and the levels at which it needs to be conducted. The prospectus regime involves costs to issuers and cumbersome processes that are not justified by the regulatory and consumer outcomes for listed entities.
- Due diligence processes are still typically followed for issues under cleansing notices, but these can be more streamlined based on the purpose and scale of the offer and can be conducted by management. Rigid requirements for director involvement, third-party involvement and third-party consents do not apply, and are a matter of judgement for the issuer and its advisers.
- Market practices around rights issues (using cleansing notices) and wholesale debt issues does not tend to suggest that prudent due diligence would be abandoned.
- The liability regime does not involve "deemed" civil liability for directors and underwriters in the same way as a prospectus. However there is still civil and criminal liability for the company and accessories, for misleading and deceptive conduct, and a form of "deemed" criminal liability still persists through section 1309 of the Corporations Act where directors approve the release of a cleansing notice.
- This is the same liability framework that applies to continuous disclosure, and it is more frequently used for actions by regulators and class action claimants – so there is no question that it offers sufficient consumer protection.
- Similarly, there are some differences in ASIC's powers – there is no stop order power for a cleansing notice (i.e. the ability for ASIC to simple block the offer by issue of a notice).
- However, there is a comprehensive liability regime, and a broad range of regulatory powers and sanctions that apply in a cleansing notice context. ASIC is not left without powers, and ASIC's powers under the continuous disclosure regime have been used more actively and with a greater track record of regulatory outcomes than under the prospectus regime.
- For instance, ASIC's normal investigative powers apply and ASIC can block an offer by application to court for an injunction where disclosure is misleading or deceptive. In practice the mere threat of ASIC action is often sufficient to cause an issuer to address any concerns that ASIC may raise. ASIC can also use the "infringement notice" regime, the civil penalty

regime, and the 'innocent misstatement' regime which have lower thresholds for liability or lower standards of proof than prospectus liability.

- Importantly, for listed retail simple bonds offers, a cleansing notice regime would be a viable alternative to a simplified prospectus regime. The debt disclosure standard is already covered by the equity disclosure standard, there would be flexibility to adapt wholesale offering materials for use in the retail offer, and it would create better alignment with wholesale processes and liability (see below).

For ordinary equity issues, cleansing notices reference the continuous disclosure "carve outs"[46] but these implicitly reference an "equity standard" of disclosure. As there is a narrower range of corporate information relevant to a vanilla debt issue, it would be more appropriate for a "debt cleansing notice" regime to be addressed to a debt standard of disclosure, rather than an equity standard, when assessing any material information that is not already in the market.

Where rights issues are made under a cleansing notice, it is common to include a summary of material risks (or to sign-post where that information can be found in periodic disclosure). However, in a debt context, statements of risks should be tailored to a debt instrument – for example, including key risks such as the effect of the interest rate environment and constrained liquidity. It has not been necessary to prescribe this content in an equity environment.

The new legislative regime in New Zealand has introduced reforms that address a number of these points, with listed companies able (from the end of 2014) to issue any new securities with a cleansing notice, and with revised liability provisions for directors (in particular).[47]

– *Importance of aligning wholesale and retail debt markets*

Importantly, in a retail debt context, the adoption of a cleansing notice regime would permit retail and wholesale processes to be more closely aligned. Making this "easy" will be key to the success of initiatives to develop a retail bond market.

A key impediment to the development of a retail bond market is that it is costly and inconvenient to extent wholesale debt offerings to retail investors, because of the different documentation required and the different processes needed. If those wholesale and retail processes, and the corresponding liability and flexibility around documentation are brought closer together, it would be easier for a retail component to be "added" to a wholesale offer.

The Simple Corporate Bonds Bill[48] recognises this, in part, by its inclusion of a mechanism to create a platform and mechanism for linking the retail market to the existing wholesale market – to easily move securities from ASX (CHESS) to the Austraclear system, and back. This is an important reform. It offers a potential source of liquidity for retail simple bond issues, as well as making it easier for an issuer to contemplate making a retail offer.

However, as it stands, a streamlined 2 part prospectus (of the kind contemplated by the Simple Corporate Bonds Bill) requires routine debt funding to be escalated to board level in order to extend

46 That is, "excluded information" from continuous disclosure.

47 In passing, we note that the mutual recognition regimes between Australia and New Zealand have not yet been adapted to address the new disclosure framework in New Zealand. However, we submit that cleansing notices under each country's legislation should be recognised in the other jurisdiction without further process requirements beyond mandated "warning" statements.

48 *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014* (Cth).

an offer into the retail market. This is because of director consent requirements and liability provisions (even with the removal of deemed civil liability for a streamlined 2 part prospectus).

Some commentators have suggested that directors should not be dissuaded from issuing a prospectus on the basis of liability, because there have been only a small number of successful prospectus liability cases against directors. However, the fact is that the perception of prospectus liability risk, and the need to fit prospectus processes into the board's calendar, does and will discourage many boards from using a prospectus-based regime. The risk of potential liability for directors also increases under the prospectus regime if formal processes are not followed to establish prospectus liability defences.

If the retail vanilla bonds regime is taken outside the prospectus regime, those processes are less onerous and able to be conducted at management level, in the same way that they are for wholesale issuance.

– *Still a place for retaining prospectuses in some contexts*

Prospectuses still have an important role to play in some contexts. They are useful in the unlisted market, where current company information is much less accessible (see below), although it may not always be necessary to prepare a prospectus to a full "IPO-standard" in the unlisted market.

However, in a listed environment, the utility of "secondary prospectuses" (i.e. post listing) is much more limited:

- they make sense where a new tranche of more complex securities is being offered. In the hybrid securities market, the terms of different securities are not standardised, and regulatory guidance on content is helpful to educate the market and financial intermediaries (who are the predominant distribution streams for these products);
- where there is a "transformational" transaction, a listed company may consider that a prospectus is justified – particularly if it is equivalent to a fresh IPO of a company (for example, backdoor listings or fundamental restructures). In this situation, there will be overlap with other forms of substantial company disclosures (for example, an Explanatory Memorandum for a shareholder meeting or a Scheme Booklet for a restructure), in which case the mechanisms for integrating these forms of disclosure with prospectus requirements (or allowing one to substitute for the other) would provide a valuable opportunity to streamline process requirements and reduce company costs.

The case for greater flexibility to use streamlined prospectus disclosure

A "full" IPO prospectus under section 710 of the Corporations Act is a useful document in an IPO context. In that situation, there may be a broad offering to the market of new securities, and public information about the company will be limited.[49]

However, absent an IPO, there is a lot to be said for encouraging more streamlined or flexible forms of prospectuses to be available to companies in a variety of contexts. For instance:

- The 2 part prospectus regime proposed by the Simple Corporate Bonds Bill could be useful in an unlisted context, where an unlisted company has made a "base" prospectus available

49 It is worth noting that there has been a trend away from large "general offers" in the IPO context. It is too difficult to get certainty as to the funds that will be raised and underwriters will be reluctant to take exposure on a large "general offer" component.

and then is able to make subsequent offers with a simple supplement to that base prospectus. This would reduce fundraising costs in the unlisted sector of the market while still drawing information together in a way that is useful for investors.

- The proposed 2 part prospectus regime also begs the question as to why it could not have greater application in the listed environment. For instance, if a board chooses to use it in preference to a cleansing notice, there does not appear to be any reason to restrict its availability (nor to limit the changes to the liability regime from extending more broadly).
- As noted above, there is a "transaction specific" prospectus regime available to listed companies, but through a combination of market practice, the liability regime, and regulatory guidance, this has become a substantial document and involves onerous preparation processes. This is not justified, in light of the periodic and continuous disclosure context. Guidance should be given to drive a change in practices and expectations for transaction specific prospectuses (including revision of lengthy policy guidance). To drive a real change, liability reform is needed, at least akin to that in the Simple Corporate Bonds Bill.
- There should be greater flexibility to clearly "sign-post" the availability information on company websites, and to reduce liability by reference to that information without having to "summarise" it in the main disclosure document, and without having to run fresh due diligence processes on that information or to update it to avoid liability. While it is currently possible to sign-post information, it does not then satisfy content requirements for disclosure.
- However, it is cumbersome to formally incorporate information by reference[50] and not clear whether the incorporation test has been met in any given case. In addition, as information incorporated by reference attracts the prospectus liability regime, fresh due diligence processes must be run on that information rather than allowing to simply "speak" as at the date and in the form that it was prepared.
- Third-party consent processes continue to limit information that can be presented in a prospectus context. Consent is required for any third-party information that is "quoted" in a prospectus, but consent is difficult to obtain because it attaches prospectus liability for that third-party. Issuers cannot always 'adopt' the information themselves (and assume liability for it) because they cannot conduct due diligence on the information, and cannot then describe the source of the information. It should be possible to reference third-party information with appropriate disclaimers, and clear disclosure of sources, without requirement for consent.
- Liability should flow where the information is "expert" information specifically prepared by the third-party expert for the prospectus. Even then, to encourage experts to permit information to be made available to retail investors in prospectuses, some consideration should be given to limiting expert liability or creating "safe harbours". Without that, there is increasing reluctance from experts to permit useful information to be included in prospectuses.
- The distinction, in a listed environment, between prospectuses and PDSs does not make sense. PDSs are designed, and suited, to "continuous issue" investment products that are not listed products. However, the prescriptive disclosure requirements often result in meaningless disclosure and increased costs for listed managed investment schemes or stapled securities.

50 See section 712 of the Corporations Act.

Additional "protections" against dilution for shareholders

The ASX Listing Rules contain dilution protections for holders of listed securities, and for the most part, these reflect an appropriate balance between:

- limiting the extent to which security holders can be diluted without being given an opportunity to participate; and
- ensuring the listed entity has the ability to raise capital swiftly, when needed, and to use scrip as consideration for acquisition activity.

The Interim Report cites examples of significant dilution during the 'global financial crisis' (**GFC**), which saw a number of emergency capital raisings conducted at significant discounts as listed entities sought to reduce leverage and to refinance debt ahead of looming maturity dates, in circumstances where the debt markets remained closed for a significant period of time. Those examples are not a good justification for changing the rules governing protections against undue dilution.

Significant use was made during the GFC of capital raising structures that ensured that retail security holders were given an opportunity to participate – whether through rights issues or security purchase plans at the discounted prices. However, levels of retail support for capital raisings were very low.

Boards had to exercise their directors' duties to consider the best capital raising strategies for the listed entity at a time of financial stress, and certainty of completion of a capital raising was one important consideration. For instance:

- At that time, non-renounceable structures (with the ability to apply for over subscriptions) were often chosen as they would encourage stronger support from institutional shareholders and they are relatively straightforward.
- Renounceable structures can tend to result in lower levels of participation, which can lead to large numbers of securities going to an underwriter, and impact on the availability and pricing of underwriting support.
- In a strong market, investors who do not participate may be paid something for their renounced rights, and Boards are more likely to choose a renounceable structure in a strong market.
- In a very weak market or circumstances of financial stress, it is often not possible to obtain any premium for renounced rights, and a renounceable offer structure may impact offer certainty without any corresponding benefit to non-participating security holders.
- Placements were often combined with a security holder offer, as the need for funds (and a change to leverage levels) was urgent. It is critical that companies retain the flexibility to raise urgent funds, quickly, and placements are the most effective way of doing so.

The important consideration for dilution protections is that they encourage listed entities to give their security holders the opportunity to participate in capital raisings to preserve their proportional interest, and the current rules (together with the "cleansing notice" regime for rights issues) do so. However, the choice of offer structure should remain a matter of directors' duties.

Differentiated markets – to facilitate raisings by smaller companies

ASX has previously had a "junior board", and a number of foreign exchanges have junior markets in addition to the main board. In strong market conditions, these junior boards have been useful for encouraging fundraising for start-ups and other small enterprises.

However, some caution should be exercised before re-establishing a junior board on ASX. Experience during the GFC has shown that these junior boards can be highly susceptible to liquidity constraints, and a higher level of corporate failures than the main board. This is explicable, given the more vulnerable nature of the companies being listed, but the poor outcomes for investors can tend to discredit the exchange.

We note that ASX's reforms over the last couple of years to its spread requirements, and a degree of discretion around strict application of listing criteria, have increased the flexibility for listing smaller ventures on ASX's main board.

Complex products

- *ASIC intervention and banning powers*

We do not support a proposal that ASIC be given additional powers to "intervene" in complex products issues, and powers to temporarily ban certain categories of products.

There are a number of reasons for this:

- ASIC has very broad powers at present to restrain (or take other actions in respect of) any offering that is misleading or deceptive – that is sufficient to address any concerns regarding product descriptions.
- Regulatory concerns, to date, regarding the nature of particular forms of highly structured products have been addressed, swiftly and effectively, by regulatory guidance and consultation with financial intermediaries.
- Blanket rules about product descriptions or specific prescribed disclosures have tended to produce anomalous or inappropriate results, which can themselves be misleading[51], but where there is no flexibility to adapt or omit them. Policy guidance is a more appropriate means of suggesting disclosure protocols, without producing anomalous or misleading results.
- These sorts of powers, if used without market consultation, can create a degree of disruption to the ability of companies and banks to fund themselves that is not commensurate with the concern around the relevant product or supported by evidence of a

51 The PDS regime, which tends towards highly prescriptive disclosure regimes, offers a number of examples of inappropriate prescribed disclosure – including mandatory fee tables that still apply to listed managed investment fees that don't have entry and exit fees; and "cooling off" language for listed managed investment schemes in circumstances where cooling off rights do not apply. Other examples include the strange rules in the Corporations Act that set out broad definitions of "debentures", but limitations in section 283BH of the Corporations Act about which categories of debentures may be called debentures in an offer document, including some rules that require debentures that are actually secured over an identified pool of investment products to be (mandatorily) described as "unsecured notes".

problem.[52] There are limited (and largely inaccessible) forms of seeking review of the exercise of these sorts of powers, where they have been applied in an inappropriate way.

- Banning measures can tend to deny genuinely experienced investors, or investors who have received skilled advice, access to sophisticated investments that they can use to drive returns. They can prevent some structured instruments from being listed which in turn can collapse legitimate funding markets for key institutions, because of liquidity requirements in institutional mandates.

– *Education and suitability*

It is far preferable for issues around complex products to be addressed via a combination of:

- appropriate educational resources for investors – including resources made available by regulators (but not necessarily putting all of that sort of material into a prospectus);
- continued focus on clear disclosure regarding complex products, and appropriate risk warnings – but not an insistence on abbreviated disclosure to the extent that it oversimplifies complex products or does not provide financial intermediaries with the detailed information that they require;
- improvement in the education and ongoing training of financial advisers and other distribution channels, accessibility of financial advice, and encouragement of investors to seek professional assistance;
- coordination between different regulators so that, for instance, prudential regulatory requirements for capital instruments strike a reasonable balance with investor interests; and
- reasonable requirements for advisers to consider suitability issues when advising on or marketing securities and other investment products, balanced with the costs that these requirements can impose and without making the requirements so onerous that retail investors are simply excluded from investment opportunities or advisory services.

It is typically not appropriate to require issuers to assess suitability of listed securities to assess the suitability of investors to receive their products:

- issuers can describe the way that the terms of the securities "work" – and that is outlined in a prospectus or offer document and will apply to the whole tranche of securities;
- issuers are not in a position to assess whether it is a suitable investment product for particular individuals or classes of individuals, which may vary depending on factors that an issuer will not necessarily be aware of or able to learn;
- if issuers were to set any guidelines, they are not in a position to assess or control how closely distribution channels are adhering to those guidelines;
- suitability is important, but it is something that must be assessed at a point that is closer to the advice or sales interface with the relevant investors.

52 For example, in 2003, prospectus anti-avoidance provisions in section 707 of the Corporations Act were revised in response to regulatory concerns that companies could potentially work "around" the existing anti-avoidance provisions. The result was a test in section 707(5) that effectively prevented any institutional investors from investing in legitimate institutional placements, and collapsed the placements market. This had to be urgently remedied by class orders to "wind back" the application of the legislative reform.

There may be some standardised "suitability" tools that could generate warnings for certain categories of investors, when the tools are applied to the features of particular products or to particular investor profiles. This would have the advantage of reducing costs for investors, but it is heavily dependent on the "tool" being designed in a way that produces prudent recommendations. These sorts of tools carry a significant risk of getting the analysis wrong – whether because they cannot pick up on additional or unusual features or information, they cannot exercise judgment or because they can be "gamed" by investors. There is a real risk that investors may rely only on the suitability tool and not read any of the information provided to them. It is not appropriate to ask issuers to assume liability for a suitability tool of that kind.

6 Electronic documentation

In the interests of business efficacy and facilitating effective communication with customers, regulation of disclosure and contract documentation should be technology neutral such that documents may be provided by, and signed by electronic means, subject, where necessary, to some limited clear and consistent exceptions

In section 6 (*Consumer outcomes*) of the Interim Report, the FSI recognised that although steps had been taken to better enable online financial services disclosure, there was a lack of clarity and inconsistency across the different regulatory requirements and sectors in this regard. The FSI has sought submissions on ways of removing disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using electronic delivery.

We agree with the Interim Report findings that there are developments that have been made in technology and the electronic delivery of financial services to customers, but that this is being hampered by regulation of disclosure documents that is fragmented, with different regulations applying in different sectors and to different products. In our view, there needs to be a consistent approach to regulation of electronic documentation across the various legislation and codes to make it clear that consumers can consent (expressly, including electronically, or impliedly) to documents being provided electronically and that regardless of their form applications and contracts can be signed electronically. Further, where consumers consent to electronic provision of documents, it should be clear that this can be complied with by making the documents available via some appropriate means (on a website, or on a private workspace), without having to ensure that particular consumers in fact access either that location or the particular document.

Where there are particular public policy reasons why specific documents should not be provided or signed electronically in this way, these should be clearly identified by way of exception.

For example, currently, there is a lack of consistency across different legislative regimes some of which provide for the signing of contracts and for the provision of documents via electronic means and other regimes that do not. For some documentary requirements it seems relatively clear that provision of information by an electronic facility is sufficient, such as under the Corporations Act requirement for confirmations[53], which contemplates such provision via that method. For other Corporations Act requirements the regulations may provide for electronic provision. However, under other regimes such as the credit legislation the ability to provide documentation electronically varies by document, with the provision of credit guides via electronic means in certain circumstances in the *National Consumer Credit Protection Regulations 2010* (Cth), and for some other documents under modifications to the *Electronic Transactions Act 1999* (Cth) (**ETA**).

53 Under section 1017F of the Corporations Act.

There are other areas where there could be further clarity as to whether electronic documents and signatures are valid. For example, the ETA does not apply to all types of documents, and there is a lack of clarity around the application of the ETA to documents such as deeds which at common law are required to be written on paper. Further, it is unclear whether for the purposes of execution of documents by companies under the Corporations Act, electronic signatures are sufficient given that the ETA excludes its application to the Corporations Act.

There is also a lack of clarity in the New South Wales, Western Australian, Queensland and South Australian Electronic Transaction Acts around the various exclusions relating to witness and attestation requirements. We submit that these be clarified to expressly state that either:

(1) documents which must be witnessed or attested cannot be in electronic form; or alternatively

(2) documents which must be witnessed or attested can be in electronic form, and can be signed by both the author and witness by electronic signature, such that the exclusion merely goes to the requirement that the witness be physically present at the signing.

The *Electronic Transactions Regulations 2000* (Cth) (**ETR**) would also benefit from clarification around whether the exclusions that expressly apply to the application of section 8 of the ETA, also apply to the corresponding section 15E (which provides that section 8 applies to contracts in the same way they apply to transactions) as this is not expressly stated in the ETR.

In addition, various form requirements in disclosure documentation are potential impediments to disclosure via electronic means. For example, the fact that a Financial Services Guide is required to have a ‘cover’ and certain statements on the ‘front of’ the document suggests an electronic version of such a guide would not be permissible.

Further, in our view, the regulation in this area should be broad enough to allow for technological developments. For example, the ASIC Regulatory Guide 221 and Class Order [CO 10/1219] have clarified online disclosure of financial services disclosure documents, with Product Disclosure Statements (**PDS**), Financial Services Guides and Statements of Advice now being able to be delivered by sending clients an email or written notice (in paper or electronic form) with a hyperlink to the disclosure. However, this focuses on disclosure via email and websites and may be too narrow to facilitate the use of new technologies such as disclosure via mobile phone apps and social media.

It is our submission that removing these impediments and unifying the approach across the different products, legislation and industry codes will reduce the costs of providing upfront and ongoing disclosure as well as facilitate the receipt of customer applications, consents and acceptance through electronic facilities. Improving regulation of electronic disclosure documentation will also assist organisations to better achieve the overall aims of disclosure and allow businesses more freedom to develop ways to best inform consumers who are time poor and often disengaged, and explore the use of new technologies for this purpose.

7 Harmonisation of securities laws

- **Approve additional territories for mutual recognition purposes; give flexibility to adapt**
- **Adopt broader unilateral recognition for regulated offering / disclosure documents from major securities law jurisdictions**
- **Remove process-focussed impediments to existing mutual recognition offers and class orders relating to foreign primary offers / disclosure**
- **Rationalise liability laws for directors with those for major securities law jurisdictions, and the division of responsibility between management and directors**
- **Rationalise disclosure laws for securities and listed financial products under one regime, rather than using the PDS regime for listed financial products (designed for different purposes)**
- **Adoption of business structures that are consistent with common foreign business structures (e.g. limited partnerships)**

In Section 10 (*International integration*) of the Interim Report, the FSI seeks views on improvements to regulatory processes to consider international standards and foreign regulation, and priority jurisdictions.

Mutual and unilateral recognition

The advantages of mutual recognition and unilateral recognition regimes already in operation are noted in the Interim Report – for example mutual recognition of New Zealand laws for securities offerings; and wholesale "passporting" Australian financial services licensing relief. These have the potential to offer significant cost savings, and to encourage cross-border activity. However, they are very limited in their scope and effect, and can be inflexible.

In the case of mutual recognition, regulatory powers to adapt the regime for quirks of a particular offer can be limited (with no power to vary the mutual recognition regime itself) – but legislative frameworks often contain anomalies or requirements that are inappropriate in a particular context, or may have overlooked procedural requirements that could frustrate the purpose of the mutual recognition framework.

Regulatory flexibility is key to the successful use of mutual recognition regimes, but regulators must be encouraged to grant ancillary relief that is supportive of the overall intent of the legislation. In practice, regulators can be reluctant to vary local procedural requirements or impediments to ensure that foreign issuers extending offers into Australia can do so without incurring significant Australian compliance costs. Similarly, the mutual recognition regime does not contemplate offers of convertible securities – so while the primary offer may be covered, the conversion of the security is not, and requires specific relief. The relief that is granted typically imposes procedural requirements for third party consents, and restrictions on content of the primary offer document that would not have applied under the mutual recognition regime.

A parallel example is ASIC's convertible bond class order relief[54]. That class order permits the future on-sale of ASX-listed ordinary shares, to be issued on conversion of a wholesale convertible bond, where the original disclosure for that convertible bond (often issued outside Australia, in

54 ASIC Class Order [CO 10/322].

compliance with foreign offering requirements) is released to ASX. The disclosure must effectively contain the same information that would be in an Australian prospectus. However, in addition, the class order includes presentation requirements and third party consent requirements for the content in circumstances where those may be inconsistent with the foreign offering document requirements. In practice, some deference is shown to the layout and style requirements of foreign offering documents, but the consent requirements can operate as a needless impediment to the use of the relief in circumstances where no offer is being made in Australia.

At present the mutual recognition regime under the Corporations Act is limited to New Zealand law.[55] This leaves major securities law jurisdictions, such as the UK, the US, Canada, Hong Kong and Singapore with regimes still at odds with Australian requirements. However, there is no suggestion that their disclosure regimes are regarded as insufficient. The significance of these jurisdictions to Australia's securities markets would suggest that unilateral recognition of offer documents from those jurisdictions should be considered, while mutual recognition continues to be explored. In particular, greater flexibility for offers in, and from, Canada and Hong Kong would have particular benefits for ASX-listed companies who may be interested in exploring a dual listing.

Rationalising laws on directors duties

Australian securities laws place significant personal obligations and liability on directors, beyond core directors' duties. Increasingly, directors are commenting that the board's attention is being absorbed by oversight and compliance matters, distracting the board from strategic oversight and business issues, and overloading directors with process.

There has been significant concern expressed by the legal community about obligations and liabilities for directors going beyond what makes sense. There are inconsistencies developing compared to international positions, with many Australian companies having increasing levels of global investment and operations, foreign directors on Australian boards are taken by surprise by the extent and weight of regulation affecting the directors on a personal level.

In addition, the obligations and liability rules seems to lose sight of the division of responsibility between boards and management. Boards should be held accountable for things that they influence, but they should not be asked to perform management's role or to be held liable if there is something management has overlooked.

This is not a suggestion that governance standards should not be maintained – more a suggestion that excessive regulation is in fact impeding effective governance of Australian companies.

In addition, inconsistencies with foreign laws affect the flow of business and investment into and out of Australia. In a securities law context, the requirements for directors' personal involvement and consent for issuing prospectuses frequently either deter foreign companies from extending fundraising programmes into Australia or deter them from permitting access by retail investors. For example, an international fund that had offered its shares into 30 countries over many years, in compliance with disclosure requirements in each jurisdiction, explored an Australian offering but abandoned it after the first year because (amongst other regulatory irritants) the processes were too disruptive at board level, and required annual renewal.

55 We note that the mutual recognition regimes between Australia and New Zealand have not yet been adapted to address the new securities laws framework in New Zealand.

Rationalising laws on disclosure

New Zealand will, at the end of 2014, adopt a disclosure regime that substantially streamlines disclosure by listed entities – using product disclosure statements as their primary form of disclosure document, with post-listing issues capable of being carried out simply with a notice to the NZX. For listed products, there will be a consistent disclosure regime, and procedural requirements (particularly post listing) around offers will be kept to a minimum. It is not yet clear how Australia will adapt the regime to the new New Zealand legislation. If the current mutual recognition regime were to be applied, the procedures required to extend the relevant offering into Australia would be significantly more onerous than those involved in offering within New Zealand.

Australian securities law also draws a needless distinction between the prospectus regime for offering securities (including listed securities) and the PDS regime which applies to offers of listed units in managed investment schemes.

The two disclosure regimes have different content requirements, although they often produce similar outcomes. For a stapled listed product, issuers must comply with both. The application of the PDS regime in a listed context is often ungainly, requires the inclusion of mandatory disclosure that is meaningless in a listed context and incurs additional costs.

The two regimes have different liability provisions and defences, which produce different outcomes for those involved in an offer. There is no good rationale for the difference in a listed context.

The PDS regime was designed to be appropriate to continuous issues of different sorts of investment products, to which it is more suited, such as superannuation products and unlisted investment funds. There should be reform to confine the disclosure regime in Parts 7.7 to 7.9 of the Corporations Act to the unlisted environment.

Recognising foreign legal structures

When determining cross-border investment structures, there are commonly used vehicles that are used around the world that are simply unknown (or prohibited) in an Australian context. The most common example is the limited liability partnership (**LLP**), which is commonly used by investment funds. As a result, investment funds seeking to invest into Australia will incur costs seeking to understand the differences between the nearest Australian equivalents, and the foreign LLPs, and to understand the extent to which Australian courts will recognise or treat the foreign LLP vehicles in the investment chain, and how they will characterise those partnership interests for Australian purposes. There does not appear to be any particular rationale for resisting the inclusion of the LLP in suite of available Australian investment structures.

* * * * * * *

We are making these submissions on behalf of our firm, and the views expressed are our own and not those of any of our clients.

We would welcome the opportunity to discuss these submissions with panel members of the FSI. Please contact:

- Berkeley Cox, the firm's Managing Partner, Banking & Finance and Dispute Resolution on 07 3244 8149 / berkeley.cox@au.kwm.com; or
- Ian Paterson or Jim Boynton (partners) on 03 9643 4237 / ian.paterson@au.kwm.com and 02 9296 2086 / james.boynton@au.kwm.com, respectively,

if there are any queries arising from these submissions.

Yours faithfully

[*Signed electronically*]