

Mr Paul Eastment
Senior Manager, Investment Managers
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001
Facsimile: 07 3867 4725
Email: infrastructureconsultation@asic.gov.au
paul.eastment@asic.gov.au

Dear Mr Eastment,

**SUBMISSION ON ASIC CONSULTATION PAPER 134 "INFRASTRUCTURE ENTITIES:
IMPROVING DISCLOSURE FOR RETAIL INVESTORS"**

The Corporations Committee of the Business Law Section of the Law Council of Australia offers the attached submission in relation to the Australian Securities and Investments Commission's ("**ASIC**") *Consultation Paper 134: Infrastructure entities: Improving disclosure for retail investors*.

Please note that this response has been endorsed by the Business Law Section. Owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia.

Yours sincerely,



Bill Grant
Secretary-General

12 July 2010



Infrastructure entities: Improving disclosure for retail investors

**The Business Law Section of the Law Council
of Australia**

Submission on ASIC Consultation Paper 134

12 July 2010

Introduction

Submission

The Corporations Committee of the Business Law Section of the Law Council of Australia (“**Law Council**”) offers the following submission in relation to the Australian Securities and Investments Commission’s (“**ASIC**”) *Consultation Paper 134: Infrastructure entities: Improving disclosure for retail investors* (“**CP 134**”). This submission has been endorsed by the Section, but due to time constraints, the submission has not been reviewed by the Directors of Law Council of Australia Limited.

Approach to submission

The Law Council is supportive of an objective of improving disclosure frameworks for retail investors generally. However, the Law Council has a number of concerns with the proposals in CP 134, and considers that overall, the proposals do not achieve that objective.

In this submission, the Law Council has not responded to all of ASIC’s specific consultation questions, but has selected key questions to respond to, and has provided some detailed comments on particular aspects of CP 134.

Key responses

Concept of “infrastructure entities”

The concept of “infrastructure entities” adopted in CP 134 is too broad to be appropriate for a “one size fits all” approach to disclosure.

Benchmark disclosure methodology and “if not why not” approach

The adoption of prescribed benchmarks carries a number of disclosure risks:

- Despite an “if not, why not” approach, non-compliance may unjustifiably stigmatise the relevant entity;
- Compliance may not be achievable or desirable for some infrastructure entities or sector;
- The proposed benchmarks implicitly provide regulatory “sanction” for certain operating structures that comply with the benchmarks, in circumstances where those benchmarks may not be a good indicator of risk or potential financial performance for a particular entity or sector;
- The “if not, why not” approach may lead to misleading or confusing disclosure, where the relevant benchmark is not appropriate for the entity or sector;
- The benchmarks are not easily amenable to short form tabular disclosure at the front of a disclosure document, without the potential for those summary responses being misleading.

There are a number of other particular concerns with the benchmarks approach:

- As noted above, the “one size fits all” approach is not appropriate for an industry as diverse as infrastructure;
- A benchmark approach risks being arbitrary;
- The proposed benchmarks should avoid adverse impact on commercially sensitive matters; and
- The proposed benchmarks should be assessed in order to avoid uncommercial outcomes.

The Law Council is aware that a potential response to these concerns is that the only requirement is to disclose against these benchmarks. However, the Law Council does not believe that this is a satisfactory answer, as:

- This potentially produces unnecessary and confusing disclosure; and
- Non-compliance with the benchmarks has the potential to affect the retail marketability of any offer to retail investors, notwithstanding that compliance with the benchmark may not be relevant to the risk profile or the ability of the asset to produce financial returns.

Additional mandatory disclosure requirements

As well as the disclosures against benchmarks, CP 134 imposes further mandatory disclosure obligations on infrastructure entities, over and above the general disclosure requirements of the Corporations Act and the Listing Rules. The Law Council considers that:

- Infrastructure should be regulated in a manner that is consistent with other industry sectors, including in relation to related party transaction, entrenched management arrangements, funding and distributions;
- CP 134 has not identified a sufficient basis for concluding that the current disclosure requirements of the Corporations Act or Listing Rules are inadequate;
- The additional disclosure requirements may not be relevant or meaningful information for all categories of infrastructure entities. Mandatory disclosure obligations of this kind are not appropriate, and at best should be included in policy guidance which allows for greater discretion and judgment to be applied to disclosure;
- Many of the particular disclosure requirements presuppose the existence of external management, funding, distribution and related party arrangements that are not common to all infrastructure entities. These requirements appear to be directed to a fund structure which is now less prevalent in the market, and policy guidance on disclosure would be more appropriate for those funds that continue to use this structure; and
- More detailed consideration could be given as to whether CP 134 contains disclosure requirements that are too complex for retail investors.

The requirement in CP 134 for disclosure of 5 year operating cashflow forecasts conflicts with the principles in Regulatory Guide 170 in respect of forward looking statements. This is not justifiable, and would lead to potentially misleading disclosure.

More detailed comments on certain aspects of CP 134

A “one size fits all” approach may not be appropriate for an industry as diverse as infrastructure

The concept of disclosure against a set of benchmarks has successfully been deployed in the context of ASX’s *Principles of Good Corporate Governance and Best Practice Recommendations* (“**ASX Governance Principles and Recommendations**”). While a set of broad principles may assist in assessing the overall framework in which corporates operate, such an approach may be of less value in assessing how particular industry sectors, and particular businesses, are actually operated.

The benchmarks assume that there is a prescribed set of criteria against which a retail investor can test a particular infrastructure entity and form an assessment as to whether it is a suitable investment opportunity. This approach risks adopting a “one size fits all” solution by assuming that an industry sector which has varying business structures can be assessed against a single set of criteria.

ASIC has recognised this point at paragraph 15 of CP 134, which states that “*different ratio settings and formulae are appropriate for different infrastructure entity assets and different infrastructure structures. However, for consistency of disclosure, we have used common ratios*”. The Law Council submits that the adoption of common ratios is not justifiable and may give rise to confusing or misleading disclosure.

A key risk involves legitimising an inference that an infrastructure entity which does not meet a benchmark is somehow “sub-standard”. This approach may be reasonable in the context of corporate governance or directors’ fees, but it is submitted that there is no “right” or “wrong” way to structure an infrastructure project. There is a risk that an “if not, why not” explanation may not nullify the headline “non-compliance”.

To illustrate, *Benchmark 1 (Corporate Structure and Management)* requires disclosure of management arrangements if these arrangements are entrenched beyond a five year term. This contrasts to ASX’s approach in *Guidance Note 26* which recognises that listed entities should retain flexibility to enter into management arrangements where they are considered to be appropriate and beneficial (provided that investors receive prominent and balanced disclosure on the terms of those arrangements). The Guidance Note recognises that a long term management arrangement may be appropriate for a variety of reasons such as providing investors with exposure to the management skills of a particular entity for a determined period of time. *Benchmark 1* contains an inherent bias against such arrangements.

A “benchmark” approach risks being arbitrary

The Law Council recognises that, if a benchmark system is to be adopted, ultimately any such benchmark will risk being regarded as arbitrary. This is an area where the Law Council submits that ASIC should give further consideration, for example, considering appropriate mechanisms for flexibility within, and revision of, the Benchmarks.

Benchmarks that are unduly onerous or inflexible may put pressure on infrastructure developers to structure a proposed investment in a manner that meets (or has the greatest potential for meeting) the relevant Benchmarks, but which may not necessarily be the most suitable structure for the proposed project.

To illustrate, *Benchmark 1* requires that an “if not, why not” explanation is to be provided if the base fee payable to a manager for managing the infrastructure entity’s assets will be greater than 1% of enterprise value. It is unclear why a 1% benchmark is regarded as appropriate and why a red flag should be raised if it is higher than this.

The proposed benchmarks should avoid adverse impact on commercially sensitive matters

The Law Council submits that ASIC should give further consideration to benchmark requirements where compliance could necessitate a requirement to disclose commercially sensitive information.

To illustrate, it is submitted that sensible recommendations have been made in relation to *Benchmark 2* which requires disclosure of an entity’s debt position, including a breakdown of debt maturities. Such disclosure would assist investors in understanding the key risks associated with refinancing. However, the proposal that an entity should provide “granular” details in relation to its debt facilities, such as interest rates, details of material covenants and the name of the financier (together with other requirements contained in paragraph 33 of CP 134), may place the entity in a less competitive position when it comes to refinancing loans with alternative lenders. Disclosure of such commercially sensitive information will give competitors (or traders who want to short sell the stock) strategic information which may place the infrastructure entity at a competitive disadvantage.

The proposed benchmarks should be assessed in order to avoid uncommercial outcomes

The Law Council submits that ASIC should give further consideration to certain Benchmarks that have potential to result in uncommercial outcomes. Such Benchmarks will generate non-compliance and difficulties for industry participants and their advisers.

To illustrate, *Benchmark 3* requires an independent expert to provide an *unqualified* confirmation that “*the key assumptions in the infrastructure entity’s base case model used for forecasting, including in relation to net profits, rates of returns or distributions, are reasonable*”. Where the base case reflects long term scenario planning, an independent expert’s report is likely (and fairly so) to be qualified in a number of important respects. In such scenarios, the benchmark may result in undue commercial pressure being placed on the independent expert to deliver an unqualified confirmation.

It is unclear whether it is ASIC’s expectation that this confirmation would be publicly available. This may not be appropriate if the report related to the medium to long term given ASIC’s cautious approach to the disclosure of prospective financial information in Regulatory Guide 170.

In addition, the requirement for disclosure of prospective information also potentially affects ongoing continuous disclosure, and would raise concerns for directors about the basis both for making the initial disclosure and of frequent re-assessment of that information for continuous disclosure purposes.

The selection of data as a benchmark has the potential to create a perception that the data is 'material information' irrespective of its actual significance to the particular entity. That raises the prospect of ongoing disclosure which may not, in the 'big picture' sense, have a great deal of relevance to the entity.

Existing disclosure requirements and assessing the need for change

Infrastructure should be regulated in a manner that is consistent with other industry sectors

The Law Council submits that there is no reason to single out infrastructure entities for these new disclosure requirements. Instead, infrastructure entities should be regulated consistently with entities in other industry sectors, and that if a case for change in the level of disclosure required to be given to investors exists, then that change should be made generally, and not just targeted towards infrastructure entities.

The existing disclosure framework, by way of Chapter 6D and Part 7.9 of the Corporations Act (including the requirements regarding "disclosing entities"), together with (for listed entities) the Listing Rules and ASX Governance Principles and Recommendations, is a well developed framework for disclosure that applies equally to all industry sectors (other than specific Listing Rules requirements for the mining industry).

The Law Council submits that ASIC should exercise caution so not to burden the infrastructure sector with disclosure obligations unnecessarily (and consequently, increase costs for raising capital) above and beyond the existing disclosure framework that are not also imposed on other industry sectors.

To illustrate, the requirements in *Benchmark 2 (Funding)* to disclose detailed financial ratios, and *Benchmark 1's* requirement that the infrastructure entity disclose whether material related party transactions have been entered into on the basis of independent expert confirmation that the transaction is fair and reasonable are inconsistent with the level of disclosure that non-infrastructure entities are required to provide.

Further, *Benchmark 3 (Assumptions and Sensitivity Analysis)* requires disclosure by way of detailed explanation where a project does not meet its financial assumptions. This is effectively disclosure by way of hindsight. The Law Council is unaware of any other disclosure regime, including the Listing Rules, that requires equivalent disclosure by way of hindsight. The Law Council encourages ASIC to consider the effects of such disclosure further, in particular, as to whether such requirements may generate overly conservative modelling.

Are existing disclosure requirements are inadequate?

It is unclear whether ASIC views CP 134 as attempting to remedy an existing deficiency in disclosure requirements for infrastructure entities or simply seeking to boost existing requirements.

It is submitted that, as a general proposition, the Listing Rules and the Corporations Act contain adequate disclosure requirements. Initial retail offers are regulated under Chapter 6D (prospectuses) and Part 7.9 (product disclosure statements) of the Corporations Act. Each regime includes a general disclosure standard (for example, in relation to a product disclosure statement, information that might reasonably be expected to have a material

influence on a reasonable person, as a retail client, whether to acquire the product). Each regime also includes a prescribed specific disclosures.

The Law Council is concerned that a “tick the box” approach to benchmarks may obscure rather than clarify the key factors which should be presented to retail investors in a way which undermines the policy of these provisions.

By way of illustration:

- The risk profile of (i) an already constructed single purpose infrastructure asset where the principal source of revenue is a recurrent State payment, is very different from (ii) an identical asset where the principal revenue is generated from a variable source of income dependent on patronage.
- In the case of the first asset, it is easy to conceive the entity could fail to meet the proposed benchmarks for financial ratios as the certainty of the revenue stream could allow a higher degree of leveraging to maximize investor returns. However, the failure to meet the benchmarks would potentially give a misleading impression as to the nature of the risk involved in that structure.
- By contrast, the second asset may appear to comfortably fall within those benchmarks; but the critical risk in this instance may be the veracity of the patronage forecast not the financial model adopted by the entity. While disclosure would have to address that “real” risk, the benchmarks would have the potential to obscure or confuse the effect of disclosure on this risk.

In respect of on-going disclosure, listed entities are subject to the continuous disclosure requirements in Listing Rule 3.1. Non-listed entities that are “disclosing entities” (as defined in the Corporations Act) are also subject to on-going disclosure requirements under the Corporations Act. On this basis, the entities not covered by the existing disclosure framework are entities with non-ED securities (for example entities whose securities are held by fewer than 100 persons).

The Law Council submits that CP 134 does not establish why it is necessary or appropriate to apply prescriptive disclosure requirements for infrastructure entities in addition to the current general disclosure requirements of the Corporations Act and the Listing Rules.

To illustrate, the proposed requirements under *Benchmark 1* in relation to a material related party transaction are, in the event where the infrastructure entity is listed, sufficiently dealt with under Listing Rule 10.10. If the obligations under Listing Rule 10 are not regarded as sufficiently robust, then ASIC (or ASX) should consider a change for all listed entities and not just for infrastructure entities.

Additional mandatory disclosure obligations (beyond “if not, why not” disclosure against benchmarks)

CP 134 envisages disclosure on an “if not, why not” basis (for benchmarks) and also by way of certain listed “additional disclosures” relating to each benchmark. The Law Council submits that these “additional disclosures” are potentially more onerous than the benchmarks themselves. There is a risk that these additional disclosure requirements may unnecessarily lengthen disclosure documents, reducing accessibility and utility to retail investors. The disclosure may also be confusing, as some of the additional requirements will not be appropriate or relevant for all infrastructure entities.

To illustrate, *Benchmark 6* which sets out a single benchmark “if not, why not” disclosure standard in relation to the review of the issue price of new units. This requirement is accompanied by six additional disclosure requirements, including disclosure on the withdrawal policy itself, risk factors that may impact on an investor’s ability to withdraw and information relating to the amount of capital in the infrastructure entity. CP 134 provides that these additional requirements “should” be disclosed, but are not qualified on an “if not, why not” basis.

Are some of the disclosure requirements too complex for retail investors?

The Law Council submits that ASIC should give further consideration to whether the benchmarks and additional disclosure requirements may ultimately prove contrary to CP 134’s objective to improve disclosure for retail investors.

The increased disclosure risks overwhelming retail investors with too much (complex) information. On one view, the objectives of retail investors in relation to disclosure of information are best addressed by way of simple and comprehensive disclosure about the stability of the capital invested and the likelihood of any return on investment.

To illustrate:

- The requirement for an infrastructure entity that is a trust to disclose under *Benchmark 5 (Distribution policy)* whether it will pay distributions from sources other than operating cashflow (in “contravention” of *Benchmark 5*) may unnecessarily alarm retail investors if payment is made by the entity through amounts generated through other means (such as asset revaluations).
- The nature of many infrastructure investments structured as “build, operate and transfer” means that the investment will only generate operating cashflow after a lengthy construction period. The trust may wish to distribute amounts equal to its taxable income (which may be higher than operating cashflow) so that investors are in a position to meet their tax liabilities and/or to generate a return for investors such as superannuation funds and retirees who would otherwise be discouraged from investing in the entity notwithstanding its potential long term attraction to them.
- The fact this benchmark is not satisfied or not would not appear to be of concern to investors, provided they are satisfied on the robustness of the financial model generating the projected returns.

The proposed disclosure against benchmarks and additional disclosure adds to, rather than merely clarifying, existing disclosure requirements. It is entirely possible that the length of the disclosure required may undermine the objective of the legislation that disclosure be “clear, concise and effective.”

Concluding comments

The Law Council submits that while the aims of CP 134 are commendable, the proposals in CP 134 in their current form should be reconsidered.

CP 134 notes that “investment in infrastructure assets is important for the maintenance of critical systems and services for our community”. The Law Council notes that the nature of some infrastructure investments, and in particular the financial complexity of developing

a model for an asset that is not yet been constructed and will operate for decades in the future, does pose challenges under the disclosure regime in the Corporations Act. However a relatively inflexible benchmark approach as proposed in the paper may result in an outcome that discourages projects of this nature being offered to retail investors in a manner that is not desirable for the community or investors who may benefit from the recurrent returns that infrastructure can provide.

The concern with the “benchmark” disclosure model is significant, when that model is applied to the infrastructure sector. However, it would also be of concern if this model of disclosure were to be proposed for other broad industry sectors.

The Law Council would be willing to consult further with ASIC in relation to formulation of more flexible and adaptable disclosure guidance for infrastructure entities. If ASIC wishes to discuss this submission, please contact any of the following: Shannon Finch (Mallesons Stephen Jaques - 02 9296 2497), Simon Morris (Corrs Chambers Westgarth, 03 9672 3201), or Tony Stumm (McCullough Robertson 07 3233 8885).