

Manager
Financial Services Unit
Retail Investor Division
The Treasury
Langton Crescent
PARKES ACT 2600

Development of the Retail Corporate Bond Market: Streamlining Disclosure and Liability Requirements

Please find attached a paper on the topic of development of the Retail Corporate Bond Market. It does not directly address the questions you pose in your call for submissions, but suggests that there is a need to think more broadly as follows.

In your discussion paper, the focus is upon the primary issue market, ie the creation and initial distribution of corporate bonds. This is, of course, important, and ensuring that initial investors are well informed and appropriately protected is important – particularly because there are generally no secondary market prices available for comparable bonds against which the fairness of the new issue price, terms and risk can be judged.

But equally relevant is the extent to which investors who purchase bonds in secondary markets are well informed and appropriately protected. Whether such retail investors (or their advisers) consult original prospectuses and disclosure documents is open to question. (It would be an interesting exercise to determine how many investors who incurred losses from defaults on bond issues by listed companies which failed, such as Timbercorp, were initial investors or purchasers on the secondary market).

Companies may issue bonds at prices (yields) which are too high or too low for the risk involved, and ideally the primary market disclosure requirements seek to reduce this risk (in particular that the prices paid by initial investors are too high). But it is important to note that if the bonds are priced incorrectly, the loss or gain to the initial investors is exactly offset in aggregate by gains or losses to shareholders. This leads to an important consideration:

If bonds are issued pro-rata to existing shareholders then any gain or loss to them from mispricing of those bonds will be exactly offset by loss or gain on their shareholdings.

Hence, it is worth examining whether there are new issuance processes which involve allocations of rights to subscribe to new bond issues to existing shareholders for several reasons. First, existing shareholders already hold interests in the company, are arguably informed about risks and returns, and the securities they currently hold (shares) will have lower priority than the new securities (bonds) to be issued. Second, any mispricing of the new bond issued will become apparent through the secondary market rights price established via on-market trading in the rights (assuming that the rights are renounceable,

as would ideally be the case). Purchasers of rights in the secondary market could be ill-informed, but it can be expected that informed investment professionals will drive the secondary market rights price towards its fundamental (correct) value.

There are a number of difficulties in implementing such an issuance process for corporate bonds, including the skewed size distribution of shareholdings (and thus subscription rights for new bonds) for most companies. But experience with different processes for rights issues of shares to institutional and retail investors suggests that there are ways of dealing with these complications. And just as prospectus requirements for rights issues of shares are relatively minimal, so prospectus requirements for rights issues for bonds issued to existing shareholders should be similarly so. Also relevant is the fact that issuance of a bond via a rights issue to shareholders and trading in the rights should help establish an active secondary market in the bond itself – with ability to trade in a deep secondary market being an important benefit to investors in primary issues.

For these reasons, I would argue that there is merit in looking beyond the issues raised in the discussion document to consider alternative issuance and distribution mechanisms rather than just the current emphasis upon disclosure. Markets provide information, and perhaps better information than disclosure documents, and efforts should be made to tap into this resource.

Professor Kevin Davis
Research Director, Australian Centre for Financial Studies
kevin.davis@australiancentre.com.au
Ph: 03 9666 1050

FINANCIAL REGULATION DISCUSSION PAPER SERIES

Deregulating Retail Bond Issuance

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ASIC's relaxation of information/disclosure requirements for retail bond issuance are warranted, but successful development of the retail bond market may require further steps to facilitate efficient issuance methods and investor demand.

The retail (and wholesale) market for corporate bonds in Australia has been largely non-existent, despite the growing volume of potential investors such as Self Managed Super Funds. Whether this has reflected inherent market economies of alternative corporate funding arrangements or regulatory impediments is open to debate, but relaxation of excessive regulatory constraints is to be welcomed.

Following responses to its December 2009 consultation paper CP126¹, ASIC released Regulatory Guide 213 "Facilitating Debt Raising"² in May 2010 setting out simpler issuance requirements for "vanilla" corporate bonds which are to be listed on the ASX and sold to retail investors.

"Vanilla" bonds are defined as unsubordinated bonds with a defined term of 10 years or less, paying interest at regular dates at either a fixed or a floating rate (at a fixed margin to a market indicator rate), with principal repaid at maturity. Issues must be for \$50 million or more to achieve secondary market liquidity for investors. Required disclosures include key features of the bond (term, interest rate, payment dates etc), key financial information such as gearing, interest cover, working capital ratio, senior debt outstanding, plus information about the effects of the transaction on the company. Detailed corporate financial data is not required, provided that it is available via continuous disclosure requirements.

The issuance requirements introduce a simplified "vanilla bond" prospectus which can be used by listed companies which are eligible to issue a transaction-specific prospectus for new issues of listed (continuously quoted) equities. There is also provision for a two part prospectus approach in which a first-part prospectus with a life of two years can be issued, enabling the company to make a number of separate bond issues during that time each requiring a second-part prospectus detailing only the bond characteristics such as interest rate, term, etc. For these latter documents, relief is granted from the exposure requirement (usually that 14 days public exposure of the document is required before funds can be raised).

In effect, the rationale for these changes is that, other than transaction-related information, investors should not need more information to assess the investment risks of "vanilla" bonds than they do for shares. Since both are claims on the company's assets and cash flows, albeit with different cash flow characteristics and

¹ [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp126.pdf/\\$file/cp126.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp126.pdf/$file/cp126.pdf)

² [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg213.pdf/\\$file/rg213.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg213.pdf/$file/rg213.pdf)

control rights, this has considerable merit for which support can be found in finance theory.

An important distinction in practice, however, is that a market valuation of shares is already available, whereas there is no market valuation of yet-to-be-issued bonds. Most investors, who are unable to derive a fair bond price (yield) from first principles using share price data and company financial accounts, require some other source of valuation information. In particular they will want to know the appropriate credit spread (risk premium) for the issuer over government bond rates. Ratings agencies can provide comparative information if the bond issue is rated (although they may not always get the rating "right"), and investors have ready access to market determined yields on bonds of similar rating.

Regulatory Guide 213 is silent on the need for a rating, but the ASX listing rules for debt (Chapter 1, section 1.8)³ require a rating of at least investment grade. While this provides useful information, for most retail investors decisions to invest in new bond issues will be significantly influenced by issuing procedures and the advice and information associated with those processes. Regulatory Guide 123 is also largely silent on this issue, other than the requirement that "vanilla" bonds must be sold at a price common to all investors.

Standard bond issuance procedures operate much like those for an Initial Public Offering of shares, with the issuing company hiring the services of an investment bank to underwrite, market, and distribute the bonds to potential investors.⁴ This can be a relatively high cost exercise, particularly if retail investors are the target, and may inhibit development of the market. And the ability of investors to assess whether the issue price (yield) is "fair" remains questionable, raising issues of incentives of parties in the transaction. Dividing an issue into a wholesale component where a "bookbuild" through institutional investors generates an issue price which is then applied for the retail component is one way of addressing this issue. But there are others methods of price discovery and distribution potentially available.

Recognising that bonds, like equities, are ultimately claims on the company's assets suggests that issuance of "vanilla" bonds by way of a renounceable rights issue to shareholders might be a feasible approach. Any mispricing of bonds is then offset by equivalent gains or losses on the share price. Investors (such as institutions) not wishing to hold such securities could offer their rights on the exchange and price discovery would occur through the rights trading.

While issuance costs would be low, a pro rata bond-rights allocation may mean that significant trading of rights is required for small shareholders to build a suitable scale investment, while institutional shareholders not interested in such investments may be substantial sellers. An alternative may be to allow companies to make a (non pro rata) "placement" of renounceable bond-rights to a particular group of (or all) shareholders. Provided that the issue size was limited relative to market capitalization (as occurs for equity placements) and that the issue price was pitched at (or near) fair value, there is probably less risk of inter-shareholder value transfers than currently exists from the ability of companies to make placements of shares.

An alternative approach would be a placement of bonds to a financial institution which would then on-sell the securities to retail (or other) investors via the stock market (as currently occurs with listed warrant products created by investment banks), relying on financial advisers etc to alert investors to the availability and value

³ <http://www.asx.com.au/ListingRules/chapters/Chapter01.pdf>

⁴ For example, arrangements for a recent AMP Note issue are described at http://media.corporate-ir.net/media_files/irol/21/219073/asx/3_11b.pdf (section 2.1.5).

of such securities. Whether this low cost issuance method would generate adequate price discovery and ensure fair pricing for retail investors is open to question.

But if a retail bond market is to be encouraged, it is likely to take more than changes to disclosure, and serious examination is warranted of whether alternative efficient issuance and distribution mechanisms are also inhibited by regulation.

*This FRDP was prepared by **Kevin Davis**, Professor of Finance, University of Melbourne, and **Research Director, Australian Centre for Financial Studies.***

kevin.davis@australiancentre.com.au

Ph: 0409 970 559