**CREATING A RETAIL CORPORATE BOND MARKET – NOT THAT HARD?**

The retail market for corporate bonds in Australia is largely non-existent, despite the growing volume of potential investors such as Self Managed Super Funds. The Australian Financial Centre Forum sees this as a significant deficiency of our financial markets and is planning a workshop of senior industry participants on October 18 to discuss ways of rectify it (AFR "Experts to discuss stalled retail bonds", October 8, 2010). A potentially simple solution – allowing companies to issue bonds via a renounceable rights issue to shareholders – should be on their agenda.

ASIC has taken some steps to enable simpler disclosure requirements for "vanilla" corporate bonds which are to be listed on the ASX and sold to retail investors (set out in Regulatory Guide 213 "Facilitating Debt Raising" issued in May 2010). But if a retail bond market is to develop, it is likely to take more than changes to disclosure, and serious examination is warranted of whether alternative efficient issuance and distribution mechanisms are inhibited by regulation.

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. This can be a relatively high cost exercise when targeting the retail market, and a significant impediment to doing so.

An alternative cost-effective approach would be to allow the issue of bonds by way of a renounceable rights issue to shareholders, just as is currently available for new share issues. While they are different types of claim on the company, bonds rank ahead of shares in priority. Offering higher ranked claims to existing shareholders does not raise problems of marketing to uninformed investors.

But one difference is that a market valuation of shares is already available, whereas there is no market valuation of yet-to-be-issued bonds, and retail investors will be hard put to know if they are fairly priced. However, because bonds and shares are both claims on the company, any mispricing of bonds is offset by equivalent gains or losses on the share price. In a pro-rata rights issue, if the bonds are underpriced (sold to cheaply) losses to shareholders are offset by the overvaluation of the rights to purchase bonds which they receive.

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. Retail investors who are not shareholders could purchase bonds by purchasing rights offered on the ASX.

One complication is that a pro-rata bond-rights issue is likely to see many small investors having too few rights and large institutional investors having many unwanted ones. ASX trading of rights can resolve that, but there may be other potential solutions, such as allowing issues of rights to only retail shareholders - akin to current share purchase plans.

Another option, with some risk issues to be sorted out, could be to allow institutional shareholders such as banks or super funds, to directly sell/provide rights they have received to clients of their wealth management businesses or fund members. (If the bond issue is fairly priced, the rights should have a market value close to zero anyway – although issuer risk concerns about take-up are likely to see the bonds offered at a slight discount such that the rights would have some value).

Another alternative would be a placement of bonds to one or more financial institutions 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 of such securities. This avoids the need for distribution via pre-listing marketing to retail investors, and is no more dangerous to retail investor wealth than the issue and marketing processes for the (often very complicated) warrant products issued that way.

Developing a retail bond market is important, both to provide fixed interest investment opportunities to investors such as self managed super funds, and also to provide alternative opportunities for debt financing for companies to put more competitive pressure on banks as lenders.

It is not apparent that there are natural impediments to such a market – as past popularity of securities such as converting preference shares with retail investors indicates. Rather, it is important that regulatory, legal and institutional barriers to cheap and effective issuance mechanisms be carefully looked at.

*This article draws on an Australian Centre for Financial Studies Financial Regulation Discussion Paper available at: http://www.australiancentre.com.au/deregulating-retail-bond-issuance/*

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