

Credit Markets

Corporate Bonds

Opening up the UK Bond Market to Retail Investors

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A new UK retail bond market will launch on 1 February 2010. On that day the London Stock Exchange (LSE) will open an electronic trading platform offering retail investors access to an on-screen secondary market in London-listed gilts and corporate bonds. The launch follows the LSE Group's 2007 acquisition of the Borsa Italiana which operates a highly successful retail bond market on the electronic market for bonds and government securities (MOT) and the electronic market that trades Eurobonds, bonds from foreign issuers and asset-backed securities (EuroMOT).

Features of the New Market

What Is "Retail"?

Quite apart from the common distinction between wholesale and retail markets, "retail" is also used to denote bonds with a minimum denomination of less than €50,000, whether they are purchased by individuals or by institutions. Disclosure requirements turn on the minimum denomination, as does eligibility for the new LSE trading platform.

Disclosure Requirements for Retail Bonds

Bonds with a minimum denomination of less than €50,000 are subject to additional disclosure requirements including, most notably, publication of an annual information update containing or referring to all information that has been published or made available to the public over the previous 12 months under applicable laws and regulations.¹ The prospectus must also contain a summary of the characteristics of, and risks associated with, the issuer, any guarantor and the bonds,² and a summary description of the method by which yield is calculated.³

Low Levels of UK Retail Investment in Bonds

More than 10,000 debt securities are listed on the LSE's Gilt Edged and Fixed Interest Market but most are not electronically tradable on the LSE systems,⁴ so they trade on the over-the-counter (OTC) market. The OTC market is heavily dominated by bonds with minimum denominations of at least €50,000 and has long

been closed to individual investors for primary issuance, and virtually closed to them for secondary trading regardless of minimum denomination. The UK Financial Services Authority (FSA) estimated in a 2005 Discussion Paper that 1 percent of UK households held gilts directly, and that even fewer directly held corporate bonds (compared with 20-30 percent of households that held shares).⁵ The FSA also noted that during 2003 in Italy, direct investment in bonds accounted for 42 percent of total retail savings and investments.⁶ In Denmark in that year, direct household investment in mortgage-backed bonds accounted for nearly 20 percent of total Danish retail savings and investments.⁷

Barriers to Retail Investment in the UK Bond Market

What has stopped individual investors in the UK from investing directly in debt securities of any denomination? Certainly not the law. If debt securities are to be offered to the public in the UK, or admitted to trading on a regulated market in the UK, then a prospectus approved by the UK Listing Authority is required. All of the 10,000-plus London-listed debt securities mentioned above meet this requirement.

The FSA considered the barriers to entry for retail investors in the UK secondary bond markets in its 2005 Discussion Paper,⁸ and concluded⁹ that the very low levels of direct retail participation in the UK secondary bond markets were not due to lack of transparency. Instead, the FSA identified other structural factors that they considered unlikely to change rapidly, including poor investor knowledge and understanding of bonds and the relatively low level of interest among UK brokers and dealers in offering comprehensive bond-related services to retail investors.¹⁰ A number of respondents to the Discussion Paper cited the UK's "equity culture" as well as distribution channels and costs.¹¹ Other respondents commented that developing a retail-focused order book might be of benefit, and the FSA indicated its interest in hearing the industry's reaction to this suggestion.

The LSE's New Order Book for Retail Bonds

The LSE announced at their annual shareholders' meeting in July 2009 that it would seek to establish a market to cater for retail investors and small and medium-size enterprise borrowers.¹² On 17 November 2009 the LSE published a Service and Technical Description for the new market.¹³ There will be two new segments, one for electronically tradable gilts and one for corporates on the TradElect trading system. Market-makers will provide continuous two-way pricing. The trading day will begin with an auction phase, during which liquidity will build but no trades will be executed, followed by continuous trading until market close. All bonds will be admitted to trade on the Gilt Edged and Fixed Interest Market and all order book trades will be settled in CREST.¹⁴

The LSE published on 11 December 2009, for testing in the environment of the Customer Development Service (CDS), a provisional list of the 42 small denomination corporate bonds and 34 small denomination gilts that will be migrated.¹⁵ Initially, all of the securities will be Sterling denominated, although the LSE expects to add Dollar and Euro issues. There will be no rating requirement and the platform will not be limited to UK issuers.

The LSE hopes to build on the success of the group's established Italian retail bond market operated by the Borsa Italiana.¹⁶ It does not expect the new trading platform to affect existing wholesale bond or gilt trading and reporting, or to change established practices in the institutional fixed income markets.¹⁷

Secondary Trading and Primary Issuance

The new LSE platform will mark the beginning of a new UK secondary market for retail bonds. As the secondary market grows, it is natural to expect the number of primary issues in retail denominations to increase. Indeed, on 11 January 2009 the FSA published two new practitioner's guides – Listing Wholesale Debt in London¹⁸ and Listing and Offers of Retail Debt in London.¹⁹

Why It Matters?

The consequences of the LSE's new retail bond market could be significant and positive for the UK, matching investor appetite with the increasing need for non-bank corporate finance. The Government is alert to this and, on 12 January 2010, HM Treasury published a Discussion paper on non-bank lending²⁰ that seeks responses from business and investors

on non-bank lending channels and the barriers to the development of alternative sources of finance for large and mid-size firms. It appears that the LSE's new retail bond trading platform will be launched in the nick of time.

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¹ Section 5.2.1 of the Prospectus Rules (PR) in the FSA Handbook.

² *Id.* Section 3.4.

³ Rule A5.4.9 Schedule 5: Retail Securities Note Checklist (Annex V) to the FSA's Listing and Offers of Retail Debt in London – A Practitioner's Guide, January 2010.

⁴ Electronic Order Book for the UK Retail Bond Market, London Stock Exchange – Service and Technical Description, November 2009.

⁵ Trading transparency in the UK secondary bond markets – Financial Services Authority Discussion Paper DP05/5 of September 2005, Section 2.13.

⁶ *Id.* Section 2.14.

⁷ *Supra.* note 6.

⁸ *Supra.* note 5.

⁹ Trading transparency in the UK secondary bond markets – Financial Services Authority Feedback Statement FS06/4 of July 2006, Sections 4.6 and 4.16.

¹⁰ *Id.* Section 4.3.

¹¹ *Id.* Section 9, Annex 2.

¹² EuroWeek, Issue 1113 of 17 July 2009.

¹³ *Supra.* note 4.

¹⁴ *Id.* para .1.1.

¹⁵ Migration of securities to the Order Book for Retail Bonds – London Stock Exchange Service Announcement of 11 December 2009.

¹⁶ *Supra.* note 4, para 1.

¹⁷ *Ibid.*

¹⁸ See http://www.fsa.gov.uk/pubs/ukla/wholesale_debt.pdf.

¹⁹ See http://www.fsa.gov.uk/pubs/ukla/retail_debt.pdf.

²⁰ See http://www.hm-treasury.gov.uk/fin_non_banking.htm.