Time to re-open the UK bond markets to retail investors?

Frank Daly *takes a look at the pull back of high-quality fixed rate investments found in retail investors' portfolios due to regulatory change in the wake of a series of high-profile mini bond collapses and whether there is now change on the horizon in re-opening the UK's listed securities market to more participants.*

During the summer, the FCA published an engagement paper (EP4) reviewing the current offering and listing regimes for non-equity securities to see if there are any areas that could be improved.

Unlike the proposals in CP23/10 – which represent a major overhaul of the UK listing regime – the proposals for non-equity securities are framed as targeted improvements with two preferred outcomes in mind: (i) minimising costs for issuers, and (ii) encouraging participation of a wider range of investors.

Both of these developments would be very welcome given the languishing state of the UK's retail bond market and we would fully support the recent whitepaper published by Winterflood Securities on the subject which set out a lucid analysis on how this unfortunate situation has precipitated.

The FCA is seeking market views on a number of possible changes:

- Allowing future financial information to be incorporated by reference without the need for a supplementary prospectus
- Extending the validity period of base prospectuses beyond the current 12 months
- Removing the current dual standard of disclosure
- Creating a new simplified disclosure regime for seasoned corporate issuers to issue in-scope low denomination bonds
- Introducing different disclosure requirements for certain structured financial products
- Simplifying the rules around tap issuances for non-equity securities
- Requiring additional disclosure obligations for ESG labelled debt
- Cease new listings on the Professional Securities Market (PSM)

Background

As we reported on 9 June 2023, the changes proposed in CP23/10 have been welcomed as a step forward in opening up the UK's listed securities market. Notwithstanding, adopted regulation over the last 15 years has offered little incentive to issue non-equity securities with retail investors in mind.

Bonds are a great way to raise debt capital; they offer a more stable return compared to dividends from stocks which tend to fluctuate, and, on insolvency, bondholders will rank above shareholders of the company, meaning there is a greater chance that they will receive some, if not all, of their money back.

Although investing in bonds has many advantages over equity, UK bond markets have suffered greatly from a series of mini-bond scandals, most notably the collapse of mini-bond provider London Capital & Finance.

The FCA have since updated their regulatory framework with onerous obligations to the extent that it now deters issuers from listing their bonds on the market. Currently, only 50 listed bonds are available for retail investors to invest in; compare that to 2008, when retail investors had access to approximately 500 listed bonds.

If bonds are not made freely transferable and fall outside of the eligibility requirements for the listing of securities, the bonds must then comply with the COBS rules which restrict the type and level of market promotions that can be made in relation to these bonds. These circumstances have left market participants in a tricky situation.

With this in mind, the FCA intend to relieve bond issuers of some of the current regulatory obligations, striking a balance between the need for regulation and accessibility.

The proposed changes

In the FCA's view, the current prospectus regime functions relatively well for issuers of, and investors in, non-equity securities and does not require a major overhaul.

The FCA also acknowledge the cross-border nature of the debt capital market and is keen to ensure that any new regime preserves issuers' ability to raise debt on a global basis.

With both these factors in mind, the proposals in EP4 represent adjustments rather than radical changes.

Making the debt programme regime more efficient

Under the current regime, issuers need to publish supplementary prospectuses to incorporate information that is published after the publication of a prospectus. Prospectuses are already somewhat cumbersome and involve significant cost by issuers to produce them. As such, the FCA propose an amendment to the rules to permit a statement that specific named items of financial information are deemed to be incorporated by reference into the prospectus at the point those items are published.

This would mean, however, that investors would not be granted withdrawal rights when new financial information is incorporated. Under the current regime, when financial information is incorporated by reference in a base prospectus via a supplementary prospectus, investors who have already agreed to purchase securities have a right to withdraw their acceptances.

The FCA will have to strike the right balance between minimising costs for issuers and maintaining investor protection.

EP4 also proposes to extend the validity period of a base prospectus beyond the current 12 months. The FCA notes that certain US shelf registration statements are valid for three years.

Dual disclosure standards for 'wholesale' versus 'retail' issuances

Under the current regime, greater disclosure is required for non-equity securities with a denomination below €100,000 ('retail' securities). The rules were designed this way to provide additional investor protection to retail investors who are thought to be more likely to invest in low denomination bonds. In practice, the rules create an incentive to issue high denomination securities ('wholesale' securities) to avoid extra disclosure obligations, thus excluding smaller scale investors from the best products.

As such, the FCA propose to remove the current dual standard of disclosure – which acts as an impediment to the preferred outcome of creating a regime that encourages wider participation – and adopt a single standard for bond disclosure with the current wholesale disclosure regime as a starting point.

Since the dual standard of disclosure was introduced into non-equity securities, there have been a number of developments in retail investor protection, which will ensure good consumer outcomes even if the extra disclosure obligations for 'retail' securities are removed. This includes:

- the EU packaged retail and insurance-based investment products (PRIIPs) regulation which came into force in the EU including the UK in 2018; and
- marketing restrictions on certain investment products which have features that pose significant risks to retail investors.

Facilitating broader access to listed bonds

The FCA also propose creating a new simplified disclosure regime which encourages the issuance by seasoned corporate issuers of in-scope low denomination bonds aimed at a wide range of investors, retail and wholesale.

The FCA anticipate the following securities in scope to be debt securities which are:

- issued by a company with premium listed equity (or similarly seasoned) or by a subsidiary;
- unsubordinated and unsecured (though benefiting from a parent guarantee if issued by a subsidiary, and from a negative pledge);
- denominated in low denominations;
- issued in GBP and bearing either fixed rate interest or a floating rate interest linked to SONIA;
- additionally, the securities in scope would be issued using a trust structure, with an FCA regulated firm acting as trustee.

Structured finance and investment products

Different disclosure requirements will be introduced for certain structured financial products such as securitised derivatives and the FCA will revisit the eligibility rules to ensure organiser/manufacturer entities are appropriately regulated.

When formulating these requirements, the FCA might draw on the disclosure requirements developed for closed-ended funds, particularly as concerns investment managers.

Secondary issuances

The FCA propose simplifying the rules around tap issuances (issuances of further debt securities that are fungible with existing issued securities).

Tap issuances avoid the fragmentation of liquidity among multiple lines of securities that occurs when new non-fungible lines are issued and, therefore, contribute to depth and quality of markets.

Under the current regime, tap issuances are exempt from the requirement to publish a prospectus, provided they represent, over a period of 12 months, less than 20% of the securities already admitted.

EP4 considers the following options for non-equity securities:

- Revising the threshold for non-equity securities in line with the approach taken for secondary issuances of equity securities and funds as discussed in the Engagement Paper 2 on further issuances.

- A simplified prospectus bespoke for non-equity securities, or a much more reduced document more akin to the final terms documents used in issuance programmes when a base prospectus has been published, perhaps with a 'cleansing statement' in the document.

Green, social or sustainability labelled debt instruments

The FCA are concerned about the gaps observed in some instances between the information provided to investors in prospectuses and in other documents, such as bond frameworks. There is a risk that issuers may indicate an approach in the bond framework which differs materially from that which they have committed to through the prospectus. Such bonds may also be regarded as a form of greenwashing, undermining trust and the integrity of the market.

As such, EP4 considers strengthening the connection between the prospectus and bond framework documents by requiring additional disclosure obligations for ESG labelled debt. The FCA is currently exploring two potential approaches:

1. A focus on the connection between the prospectus and the bond framework at a high-level. This could entail requirements to disclose information around matters such as the bond framework and whether that framework has been issued in line with specific industry principles or been verified by a second-party.

2. In addition to the disclosures on bond frameworks, the requirement for more specific disclosures on Use of Proceeds bonds and Sustainability-linked bonds.

Professional Securities Market

The FCA is proposing to cease new listings on the Professional Securities Market as a result of the changes detailed above.

In summary

The proposals in EP4 represent the FCA's attempt to revive the retail bond market for UK listed companies after years of subdued activity.

Allowing future financial information to be incorporated by reference without the need for a supplementary prospectus would minimise costs for issuers and streamline the due diligence process for investors.

The proposals to adopt a single standard for bond disclosures and alleviate the burden for 'retail' securities is also particularly welcome.

Next steps

The FCA is keen to engage with interested groups of market participants and, subject to feedback received, expects to publish consultation papers in 2024 to develop the specific rule proposals.

If you would like to discuss any aspects of the proposed changes as they relate to your business, please feel free to reach out to us: enquiries@blears.com

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