Lessons from Country Experiences in Issuance Regulations of Corporate Bonds

Clemente del Valle – World Bank

Africa Bond Market Conference

November 7-8, 2011
Outline

- Overview of bond markets
- Particularities of corporate bond markets
- Importance of introducing flexibility into primary market regulations
- Measures to introduce flexibility
- Hybrid regime study
- Conclusion
Bond markets in emerging market economies (EMEs) are expected to grow significantly.

Projected evolution of debt markets

Significant growth is expected in EME bond markets due to:

- Increased economic growth of EMEs
- Narrowing of income gaps between EMEs and developed markets
- Broadening and deepening of capital markets leading to diversified sources of funding
- Greater local and foreign investments to fund large scale projects (e.g., infrastructure)
EME corporate bond markets are most underdeveloped

Findings based on EME respondents to the IOSCO Survey:

- Government bond markets are 2.7 times larger than corporate bond markets
- Combined size of EME bond markets is approx. USD 5.6 trillion
- EME bond market size equal to almost ¼ and ½ of US and Japanese bond markets, respectively – reflecting the potential for further growth
- As a % to GDP, EME bond markets range from 0.2% to 130%
## Difference between equity and corporate bonds

<table>
<thead>
<tr>
<th></th>
<th>Equity</th>
<th>Corporate Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Heterogeneity</strong></td>
<td>One form of equity per issuer</td>
<td>Many different types of bonds per issuer</td>
</tr>
<tr>
<td><strong>Fungibility</strong></td>
<td>New issues fungible with outstanding shares</td>
<td>New issues not fungible with previous issues: different amount, coupon, maturity, and (possibly) credit rating.</td>
</tr>
<tr>
<td><strong>Issuance</strong></td>
<td>Less frequent</td>
<td>More frequent</td>
</tr>
<tr>
<td><strong>Price Discovery</strong></td>
<td>Trades carry significant info about firms’ prospects</td>
<td>Trades carry some firm-specific info. Price movements mostly respond to macroeconomic developments.</td>
</tr>
<tr>
<td><strong>Maturity</strong></td>
<td>Infinite</td>
<td>Finite. Most &lt; 20 years</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>Depends on stock type</td>
<td>Similar pattern across bonds: high post issuance, but eventually buy-and-hold and illiquid</td>
</tr>
<tr>
<td><strong>Type of Investor</strong></td>
<td>Retail, mutual funds, hedge funds</td>
<td>Dominated by institutional investors (especially pension funds and insurance companies)</td>
</tr>
</tbody>
</table>

* Regulations drafted for equity may not be relevant for corporate bonds.*
Key features of corporate bond markets

- Low liquidity, in part due to:
  - Low fungibility
  - High fragmentation
  - Value less affected by firm-specific information because future cash flows are predefined, which results in lower trading activity

- Dominance of professional investors
  - Low liquidity entails higher risk of investing
  - Larger portfolios allow greater diversification of risk

- Given the relatively illiquid nature of corporate bonds, primary market development – i.e., increasing supply of instruments – is a key building block of developing corporate bond markets
Importance of flexibility in primary market regulations

Flexibility is fundamental:

- For facilitating the growth of corporate bond markets
- For both supply-side (issuance) and demand-side (investment) regulations
- To facilitate easy and cost-effective access to the market, providing a viable alternative to loans

However...

- Needs to happen with increased accountability and professionalism of key players (*institutional investors* and *intermediaries*)

→ Flexibility with Responsibility
The need for flexibility: supply-side and demand-side considerations

**Supply Side**
- Issuers demand fast and cost-effective means of accessing the market
- Flexibility and choice in offer mechanisms help meet diverse needs of issuers
  - recurring
  - first time
  - one-time (e.g., project)

**Demand Side**
- Investors demand different levels of protections depending on their sophistication
- Investment guidelines should match flexibilities introduced in issuance regulations

Financial & Private Sector Development
How to introduce flexibility in primary markets?

1. Increase efficiency of the Public Offer regime

Streamline Registration Process
- Reduce regulatory fragmentation (# of authorities involved)
- Streamline excessive documentation requirements

Reduce Approval Time
- Approval time ranges from 5 days to 3 months. Average: 25 days
- Adopt disclosure based approval regime
- Build staff technical skills to effectively review corporate bond issuance applications

Introduce Fast-Track Options
- Shelf-registrations
- Well-known seasoned issuers (WKSI)
- Integrated disclosure
How to introduce flexibility in primary markets?

2. Introduce alternative issuance options

Private Placements

Hybrid Regimes

targeted at institutional and/or high net worth (HNW) investors

Together with:

→ Building **professionalism** of institutional investors

→ Adjusting **investment guidelines** to allow institutional investors to take advantage of new offering channels
Hybrid issuance regime

Philosophy

Combines and tailors key elements of public and private offering frameworks to:
- Minimize the time and cost of accessing bond financing for issuers
- Maximize securities’ appeal for target investors

Definition

Large variety of regimes, but two main attributes:
1. Exemption from submission of a full prospectus
2. Relatively easy access to secondary market trading (OTC), subject to investor eligibility conditions
Crisis context: two important considerations

1. Reduced requirements do not contradict global trend towards increased regulations
   - Developed markets are moving towards increased regulatory disclosures for previously unregulated, highly sophisticated instruments (e.g., OTC derivatives)
   - EMEs tend to overregulate simple, unsophisticated instruments (e.g., plain vanilla bonds) and have much room to increase flexibility to stimulate market growth

2. Lighter regulatory requirements do not mean absence of all disclosures
   - Most hybrid regimes require some limited disclosures
   - Issuers provide information to target investors on a contractual basis
# Comparison of public, private, and hybrid regimes

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Pure Public</th>
<th>Pure Private</th>
<th>Hybrid (Professional)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor eligibility</td>
<td>No restrictions, open to all</td>
<td>Typically restricted in number</td>
<td>Typically restricted according to level of professionalism Often only qualified or institutional investors</td>
</tr>
<tr>
<td>Offer documentation to the regulator / SRO</td>
<td>Full prospectus</td>
<td>Typically none</td>
<td>Exemption from full prospectus Sometimes short-form prospectus or basic information notice</td>
</tr>
<tr>
<td>Regulatory approval</td>
<td>Required</td>
<td>None</td>
<td>Typically none If required, typically automatic or only a few days</td>
</tr>
<tr>
<td>Secondary market trading</td>
<td>Unrestricted Exchange and OTC</td>
<td>Highly restricted If any, OTC.</td>
<td>Typically restricted to qualified investors, but freely tradable among this group. Usually OTC</td>
</tr>
<tr>
<td>Continuous disclosure</td>
<td>Full requirements</td>
<td>None</td>
<td>Typically simplified requirements</td>
</tr>
<tr>
<td>Antifraud provisions</td>
<td>Apply</td>
<td>None</td>
<td>Typically apply</td>
</tr>
</tbody>
</table>
Key considerations of the study

Hybrid Regime

- Does not legally exist as an official regime. Each jurisdiction has its own official law or regulation.

- Variation of either public or private offer regime

- Key elements are not always contained in one regulation
  - Combination of specific conditions stipulated in various laws and regulations that satisfy the definition is what constitutes a hybrid regime

- In the context of specific requirements and available protections, focus is on non-public issuers utilizing the hybrid offer channel
## Overview of hybrid regimes in select countries

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>EU</th>
<th>Brazil</th>
<th>Chile</th>
<th>India</th>
<th>Israel</th>
<th>Malaysia</th>
<th>Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nature of regime</strong></td>
<td>Private placement</td>
<td>Exempt public offer</td>
<td>Exempt public offer</td>
<td>Exempt public offer</td>
<td>Listed private placement</td>
<td>Private placement</td>
<td>Private placement</td>
<td>Private placement</td>
</tr>
<tr>
<td><strong>Key Conditions</strong></td>
<td>QIBs</td>
<td>5 possible conditions</td>
<td>Max. 20 QIBs</td>
<td>Qualified investors</td>
<td>Max. 50 investors</td>
<td>Qualified investors</td>
<td>HNW and sophisticated investors</td>
<td>HNW and institutional investors</td>
</tr>
<tr>
<td><strong>Full prospectus approval by regulator/SRO</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No*</td>
<td>No*</td>
<td>No*</td>
</tr>
<tr>
<td><strong>Conditions for trading</strong></td>
<td>QIBs</td>
<td>Same as initial exemption conditions</td>
<td>QIBs after 90 day holding period</td>
<td>Qualified investors</td>
<td>None, but typically large denominat.</td>
<td>Qualified investors on separate trading syst. within exch.</td>
<td>HNW and sophisticated investors</td>
<td>HNW and institutional investors</td>
</tr>
<tr>
<td><strong>Continuous disclosure</strong></td>
<td>No</td>
<td>Yes if listed, but lighter if denominatio n is €50,000</td>
<td>Yes, but lighter</td>
<td>Yes, similar to public offers</td>
<td>Yes, similar to public offers (to exch.)</td>
<td>No</td>
<td>Yes, but lighter</td>
<td>Yes, but lighter</td>
</tr>
<tr>
<td><strong>Antifraud provisions</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* Issuers have to submit a simplified document to the regulator, which is subject to review in Malaysia but is automatically approved in Thailand.

QIB = Qualified institutional buyer; HNW = High net worth
Notably, in the US, 70% of high yield issues over the last 15 years have been occurring through the hybrid channel.

Hybrid issuance regime - summary

Key features:
- Reduced initial and ongoing disclosure requirements
- Limited role of the regulator, if any, in the approval process
- Unrestricted secondary market trading for eligible investors, usually OTC
- Continued provision of antifraud protections by the regulator

Place increased responsibility on institutional investors deemed to have sufficient know-how and resources to assess fixed-income investments.

Place increased responsibility on intermediaries who carry added accountability for ensuring truthful and accurate information disclosure.
Important considerations when adopting hybrid regimes

- Efforts to develop and professionalize institutional investors and intermediaries, given their increased role

- Measures to prevent retail investors from purchasing securities offered via a hybrid regime

- Matching flexibilities in regulatory frameworks for institutional investors to allow them to purchase hybrid securities

- Hybrid regimes may be more appropriate for EMEs with a limited or bad experience with pure private regimes
Conclusion

- Increasing the supply of corporate bonds requires introducing flexibility into the primary market framework by both:

  1. Increasing efficiency of the public offer regime
  2. Providing a range of issuance options that include alternative offer mechanisms, such as hybrid regimes

- There is no one-size-fits-all model
  - regulations need to be tailored, taking into consideration a country’s economic, market, and overall regulatory context
Thank You

Clemente del Valle

cdelvalle@worldbank.org