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INTRODUCTION TO THE SECOND EDITION

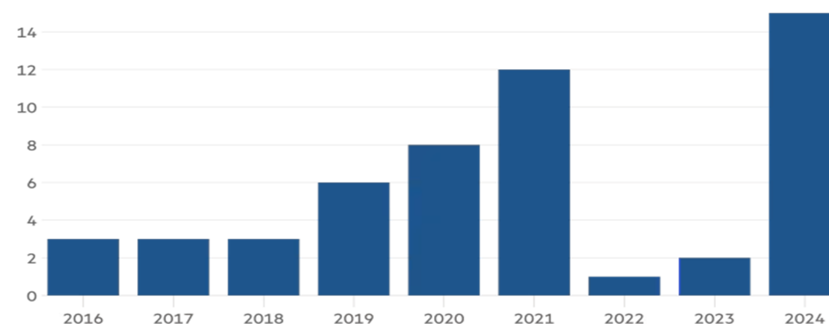
We are pleased to present the Second Edition of the Clifford Chance *Guide to Equity-Linked Products in Asia-Pacific*.

Much has changed since the publication of the First Edition in May 2020, just as global financial markets began their remarkable recovery from the COVID-19 pandemic. Albeit for markedly different reasons, the economic backdrop and market conditions for the continued resurgence of equity-linked securities issuance from companies across the Asia-Pacific region remain constructive. These include a number of complex and interrelated factors, and mainly, elevated interest rates that are likely to remain "higher for longer"; continued inflationary pressures; stresses on supply chains and amplifying global trade tensions; stalled primary equity markets and – critically for equity option values – the increase in market volatility.

Equity-linked securities – used in this guide as short-hand for convertible and exchangeable bonds – have proven to be an elegant and sophisticated tool for public companies looking to raise capital as a materially cheaper form of financing by taking advantage of the option value of their underlying stock to reduce their cost of debt, or monetising their position in other publicly listed companies. Chinese companies, in particular, have accessed equity-linked markets to great effect in 2024, with issuance reaching record volumes (as reflected in the graph below) and we expect to see Southeast Asia follow suit in 2025.

Chinese companies have issued record levels of dollar convertibles

USD convertible bond issuance by Chinese companies ($bn)



Does not include Taiwanese companies or private deals
Source: Dealogic

(From the Financial Times, 28 November 2024)

As with the First Edition, the aim of this guide is to provide existing issuers (and arm potential ones) with the technical information underlying what can often appear to be impenetrable and daunting commercial terms, and to outline the nature and purpose of market practice behind this form of financing.

This Second Edition also aims to expand on the liquidity and anti-dilution strategies that are increasingly being deployed alongside equity-securities issuance, as well as to outline certain U.S. federal securities laws considerations and alternatives relating to the use of equity-linked securities in an Islamic finance context.

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Singapore

February 2025

WHAT ARE EQUITY-LINKED SECURITIES?

As the name implies, "equity-linked" (also referred to as "hybrid") securities are essentially debt-based securities which include contractual features that link their overall return to investors to the performance of the underlying share price. At their most fundamental economic level, equity-linked securities provide investors with access to the upside associated with an increase in the underlying share price of the security, while also providing downside protection in the form of interest payment and principal repayment of the debt obligation constituted by the bond. Structurally therefore, equity-linked securities are usually comprised of a "host" debt security and an embedded equity option.

Equity-linked securities can broadly be categorised as follows:

Convertible bonds

Convertible bonds are the most common form of equity-linked security, and are debt securities issued by a company which, during a period between the issue date and the maturity date of the bond, can be surrendered by the holder in exchange for shares in the capital of the same company (or its parent) which issued the convertible bond. [1] This process is called "conversion" and, typically upon conversion, the principal amount of the convertible bond is applied in subscribing for shares in that company based on a pre-determined conversion price or ratio. Simplifying, on conversion of the bond into equity, the principal amount of the bond represented by the debt component is extinguished to the value of the equity so converted at the pre-determined conversion price or ratio. Conversion is usually at the holder's option, although occasionally conversion may be mandatory on a specified future date.

The underlying shares into which the bonds are converted into are ordinarily of a class that is already admitted to trading on a stock exchange, although the issuer will usually have the flexibility to determine whether or not to deliver new or existing shares in order to satisfy the holder's conversion right.[2] Companies

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[1] In the Japan market, for Japanese companies act reasons, the product comprises "bonds with stock acquisition rights", but as the product is basically the same as convertible bonds issued elsewhere, they will be referred to "convertible bonds" here also.

[2] For issuers that have an American depositary receipt ("**ADR**') or global depositary receipt ("**GDR**") programme, it may be the case that, for reasons of liquidity, the convertible bonds are structured to convert into the ADR or GDR rather than the ordinary shares. This is particularly

may also seek to raise capital for expansion prior to conducting an IPO by placing "pre-IPO" convertible bonds that convert into the listed stock of the company upon going public, and admission of the shares to trading. In the event an IPO does not materialise within a given time frame, investors will typically have the right to redeem the bonds at a premium.

Exchangeable bonds

An exchangeable bond is different from (although similar to) a convertible bond. An exchangeable bond is a debt security issued by a company which, during a period between the issue date and the maturity date, can be surrendered by the holder in exchange for shares in the capital of a company which is different from the company (or its parent) that issued the exchangeable bond. A company might issue an exchangeable bond as a way of realising value from a holding of shares in a third-party entity, without immediately disposing of the economic interest. If the exchange rights relating to the bond are exercised, the terms and conditions of the bonds will oblige the issuer to deliver a fixed number of underlying shares (together with a *pro rata* share of any additional property derived from those underlying shares in the period between the issue date of the bonds and the exercise of the exchange rights).

Although in some exchangeable bonds the issuer will create security over the underlying shares in order to provide investors with added protection as to the issuer's ability to satisfy the exchange right, in many cases the bonds will be issued on an unsecured basis and the issuer has no formal obligation to hold the underlying shares during the lifetime of the bonds. The issuer may instead elect to satisfy the exchange rights by making market purchases at the relevant time or by paying equivalent cash (including hedging the share delivery obligation through derivative transactions) rather than maintaining physical ownership of the relevant assets.

Both convertible and exchangeable bonds will typically pay a lower interest rate than a conventional debt security (or be structured as zero coupon), as the equity option provides investors with additional consideration. From the issuer's perspective, therefore, the funding costs of issuing a convertible or exchangeable bond are usually lower than issuing a conventional debt security, but the cost is instead reflected in the grant of the equity option which, in the case of a convertible bond, means a cost to existing shareholders in the form of a dilution of their equity stake. This trade-off between the direct costs to the company and the costs to its shareholders means that shareholder engagement, or wall- crossing key institutional shareholders to ensure support, is often a key part of the preparation process for a convertible bond offering. This is less of a concern in the context of an exchangeable bond as there is no dilution of the issuer's own shareholders, although the reduction of the funding

common for emerging market issuers where there may be more limited liquidity in their domestic markets or limitations on the ability of international investors to hold the ordinary shares directly.

cost is instead offset by the obligation to surrender assets in the form of securities at the point of exchange.

Regulatory Capital

Convertible securities are also an important source of financing for bank issuers, as the requirements of the Third Basel Accords, or "Basel III", as implemented by law or regulation in a particular bank issuer's jurisdiction, allow part of the regulatory capital obligations imposed on credit institutions to be met through the issuance of contingent convertible securities or "CoCos".

In particular, additional tier 1 ("**AT1**") capital may comprise instruments that automatically convert into equity in the issuer when a pre-determined regulatory trigger is met, i.e., when the issuing institution's Common Equity Tier 1 ratio (the ratio of a bank's core equity capital to its total risk exposure) drops below a certain threshold. Instruments qualifying as AT1 capital are designed to absorb losses on a going-concern basis, thereby protecting depositors and other unsubordinated investors in banks and investment firms against the risk of loss and, upon conversion into equity, the liability represented by the CoCo bond is discharged and the issuer's share capital is increased. While AT1 securities and convertible bonds share similar legal and contractual characteristics, this guide is focused on equity-linked securities issued by corporate, non-bank issuers.

WHY ISSUE EQUITY-LINKED SECURITIES?

Equity-linked securities are instruments that offer a significant amount of flexibility to both issuers and investors in the international capital markets, primarily as they combine the features of a conventional debt security with those of an equity derivative (i.e., the option on the underlying shares that is embedded in the host debt security), thus allowing for a broad range of capital structure and investment objectives to be achieved, depending on its structure.

From an issuer's perspective, equity-linked securities can provide the following benefits:

A lower cost of capital

The cost of an issuer's capital when raising debt finance will be equivalent to the interest rate, or coupon, that it pays on the debt instrument issued. When raising equity finance, the cost of capital is equivalent to the dividend yield to be paid on the shares issued, and indirectly, the rate of capital growth implied in the appreciation of the relevant share price.

For a convertible bond, which combines elements of both debt and equity, the rate of interest payable in respect of the debt component is typically materially lower compared to conventional debt (owing to the embedded equity option) although it can be more costly from an equity perspective if the issuer's share price is anticipated to appreciate steeply during the tenor of the bond. To the extent that the share price appreciates above the conversion price of the bond, the debt component "converts" into the value of the shares which is "in the money". Convertible holders are therefore likely to exercise their conversion right, so the debt does not need to be repaid, and is effectively extinguished on conversion.

In most jurisdictions, the interest payments would remain deductible from the issuer's taxable income, and to the extent there is volatility in the issuer's share price, a convertible bond will provide an issuer with an opportunity to effectively monetise its price volatility. In addition, and if efficiently priced, the issuance of a convertible bond could also allow issuers to effectively raise equity at a significant premium to the prevailing market price of its shares by receiving an "advanced payment" (upon the issuance of the convertible bond) for shares to be issued at a later date, and typically at a premium.

Achieving a desired capital structure

The flexibility of equity-linked instruments, the features that can be included and the various structures employed can be a useful and sophisticated tool for issuers to achieve the desired mixed of debt and equity in their capital structure.

For example, by issuing an "equity neutral" convertible bond, companies can offer investors the potential upside of the embedded equity option without having to account for the dilutive effects of future share issuance on their shareholders. See "*Structuring Alternatives – Dilution Mitigation Alternatives – Equity Neutral Convertible Bonds*", below.

Accessing a broader investor base

Unlike conventional debt or equity capital raising exercises, the nature of equity-linked securities appeals to a cross-section of the investor community, from traditional hedge funds to purely long-only equity investors, thereby diversifying the funding sources at an issuer's disposal. Introducing new debt and ultimately, on conversion of the bond, equity investors, also has the long-term effect of raising a company's profile in both the debt and equity capital markets.

Execution efficiency

Given the existence of the embedded equity option, it is often vital to the success of a convertible bond offering that issuers are able to issue and place the securities in a very short timeframe. Being nimble in relation to the documentation and execution process is particularly important in a scenario where the price of the underlying shares is volatile and the issuer wishes to access the market in a window during which the stock is subject to positive price pressures.

Accordingly, for listed issuers with a substantial amount of good quality public disclosure available in the market, convertible bonds are often (other than in the Japan market) executed on an "accelerated bookbuild" basis, where the offering is launched on the basis of a term sheet and without the need for a preliminary offering circular for marketing purposes and investor education. This process means that convertible bonds are frequently documented within a few days and launched and priced intra-day. The bookbuilding process therefore takes place overnight (between the close of markets on one day and prior to the open of markets on the next) while the equity markets on which the conversion are listed are closed, as the shares cannot be trading at the time that the convertible bond is being marketed. While due diligence is conducted, this usually only occurs after pricing (with a limited pre-launch due diligence exercise taking place), with the managers relying instead on a more fulsome suite of representations and warranties, conditions precedent and termination rights in the subscription agreement. This execution expediency is however subject to the particular listed issuer having obtained all necessary regulatory

and corporate approvals prior to the launch of any such transaction, e.g., foreign debt registration approval for PRC-based listed issuers.

In addition, a number of listing venues, particularly in Europe, allow for convertible bond listings without the need for compliance with detailed disclosure requirements on the equity component of the offering, which facilitates fast execution without the need for an extensive commentary and approval process from a listing authority. See "*Execution Considerations: Listing*", below.

In Japan, on the other hand, convertible bonds issued by Japanese issuers in the Euro market are more likely to be issued either with a fulsome preliminary offering circular or on the basis of a preliminary information memorandum (without disclosure except financial statements) at launch; due diligence procedures would in either case have been completed prior to launch (transaction announcement). As with other jurisdictions, launch and pricing (signing) will typically occur on the same day after the market closes and closing will occur two weeks after pricing (due to Japanese companies act requirements).

A flexible acquisition financing tool

Equity-linked securities have traditionally been an attractive tool for European and North American private equity sponsors, owing to the lower cost of debt allowing for reduced cash flows in the post-acquisition consolidation period, with the conversion premium on the underlying stock mitigating against potential dilution of their stake in the acquired target.

Exchangeable bonds, in particular, allow a sponsor or group parent company to issue an instrument with an exchange option for shares in a subsidiary. The parent (or its other operating subsidiaries) can provide a guarantee to give investors effective credit recourse to the group (and enable it to price the bond on that credit), while the equity upside is dependent on the performance of the subsidiary. Credit recourse can also be shifted to the subsidiary, by the parent or sponsor pledging its shares in the subsidiary in favour of holders. These techniques allow sponsors to forward-sell their shares in the subsidiary at a premium and, in the latter case, to realise a higher selling price for the subsidiary without taking on additional risks by offering recourse to the parent or sponsor.

THE BOND: FEATURES OF THE DEBT SECURITY

Both convertible and exchangeable bonds share similar characteristics to a standard fixed-maturity bond, in that the host debt security will usually have similar events of default and negative pledge protection to a conventional senior unsecured debt instrument. For an issuer that already has outstanding bonds or medium term notes, the core "bond" terms of the convertible or exchangeable bond will usually be conformed to those already in issue, as this provides a convenient and familiar framework for both issuer and investors.

Although convertible and exchangeable bonds may be issued in either bearer or registered form, it has become increasingly common in recent years for Asian and European convertible bonds to be issued in registered form, particularly where Regulation S Category 1 is available (see "*U.S. Securities Law Considerations*", below), as it avoids the restrictions imposed by the U.S. Tax Equity and Fiscal Responsibility Act of 1982 ("**TEFRA**") and can assist the marketing process by allowing offshore U.S. investors the opportunity to participate in the offering.

Convertible and exchangeable bonds will usually include both tax redemption and issuer optional redemption, or "call" features, similar to a standard debt security. However, the nature of the embedded equity option does give rise to certain specific considerations for each.

Tax Redemption

In a conventional bond it is universal practice to provide that (1) all payments by the issuer are made without withholding or deduction on account of taxes in the issuer's tax jurisdiction unless such withholding or deduction is required by law, and (2) if such withholding or deduction is required by law then the issuer will "gross up" the relevant payments – that is, subject to certain standard exceptions, the issuer will pay such additional amounts as will result in the receipt by each relevant bondholder, after the required withholding or deduction, of a net amount equal to the gross amount it would have received in the absence of such withholding or deduction. If an issuer agrees to grant such a gross-up provision, it will normally also require an option to redeem the bonds in such circumstances to limit its potential exposure, known as a tax redemption option.

However, in the case of a convertible bond, investors are (assuming the company's share price is performing as expected) generally more interested in the value of the embedded equity option than they are in the value of the interest payments on the bond. Consequently, they are reluctant to grant the

issuer the ability to redeem the bond earlier than they were expecting, and thus shorten the period during which the conversion right in the bond may be exercised. For this reason, some convertible bonds do not have a tax gross-up or tax redemption (tax redemption being the *quid pro quo* for the tax gross-up). However, in many cases, particularly where there is a relatively high coupon on the convertible bond, tax gross-up and tax redemption provisions are included but only on the basis that if the issuer should ever seek to exercise its right to redeem the bonds early for tax reasons, the bondholders would have the option to elect not to have their bonds redeemed, provided that they agree that thereafter they will also lose the benefit of the tax gross-up provisions and receive future interest payments net of any applicable withholding required by law.

Optional Redemption – Issuer's "Soft Call"

Typically the optional redemption feature of a convertible bond allows the issuer to redeem the convertible bond (usually at 100% of the principal amount) if the market value of the shares reaches a certain percentage of the conversion price (typically 120% to 130%) or if the aggregate value of the shares to which a converting bondholder would be entitled on conversion of the convertible bond (known as the "**parity value**") exceeds a certain percentage (again, typically 120% to 130%) of the principal amount of the convertible bond. In these circumstances, the convertible bonds are "in the money" and holders can realise the value of their investment. Typically, such clauses are drafted so that the market value must reach the relevant level on at least 20 days out of a 30-day period to minimise the risk of the issuer taking advantage of a temporary "spike" in the share price.

This redemption right is often referred to as an issuer's "soft call" feature, the economic effect of which is to limit the equity upside that holders may have to 130% of the conversion price or principal amount of the bond, as the case may be. While the feature does help issuers to mitigate against the convertible bond bearing a cost of capital that exceeds a direct equity issuance in a rising share price environment, careful consideration should be given to including the feature given the effective cap that is being placed on an investor's upside in the embedded equity option. However, the market accepted approach is that, if the embedded equity option is so far "in the money" (i.e., in excess of 130% of the conversion), it becomes economically equitable to permit the issuer to take back some of the realised upside potential in its ordinary shares by redeeming the bonds. The result of the exercise of this redemption option in practice is to force the remaining holders to convert (as they can receive greater value by converting the convertible bonds into shares, and selling the shares for cash in the market, than they would receive by allowing the convertible bonds to be redeemed) and the issuer will redeem any remaining bonds. Usually this redemption right will only apply after a specified time period (normally at least 2 to 3 years) has elapsed since issue.

Clean-up Call

The issuer is also typically provided with a "clean-up" or "sweep-up" right which will be exercisable to the extent that the substantial majority of the convertible bonds have been converted or are otherwise no longer outstanding. Typically, this particular call right would be exercisable if more than 85% or 90% of the convertible bonds originally issued are no longer outstanding. This call right in practice allows an issuer to force redemption (or conversion) of what would otherwise potentially be a small, illiquid, and (from the issuer's perspective) somewhat awkward rump of an issue which has largely been converted (or otherwise ceased to be outstanding). The clean-up feature is also seen in conventional bond terms, however, in equity-linked securities, holders can still convert their bonds prior to the forced redemption in order to avoid losing value if the equity option is "in the money" when the clean-up call is exercised.

Other Redemption Options

Bonds may have other redemption options, including an issuer's early redemption option with no conditions such as share price thresholds (a so-called "hard call" option), or a right of bondholders to have the bonds redeemed early (a put option). Note that a put option has the effect, from a convertible bond equity option pricing perspective, of setting a "virtual maturity date" on the put option date.

Other redemption options may be found depending on the jurisdiction, such as redemption on the occurrence of certain corporate events. These redemptions would typically be structured to be redeemed at a redemption price that attempts to protect the equity option value at the time of redemption.

CONVERSION: FEATURES OF THE EMBEDDED EQUITY OPTION

The embedded equity option in an equity-linked security is found in the conversion price and conversion premium mechanics in the terms. In addition, the manner in which the right is settled (either in cash or physically) is an important component of how the conversion rights are realised. The manner in which interest on the debt security is treated is also an important component of the holder's rights, as it transitions from being a senior creditor of the issuer to a shareholder.

Conversion Price and Conversion Premium

The price at which the bonds may be converted or exchanged into the underlying equity is set on issue and will usually be set at a premium to the market value of the underlying equity on the pricing date, typically based on the volume weighted average price of the underlying shares at that date (or for a certain period of time before and up to that date). This is to ensure that the share price will need to appreciate relative to the bond value in order for conversion or exchange to be economically attractive to the investor. The investor will only be incentivised to convert or exchange their bonds when the equity option is "in the money", i.e., when the value to be derived from converting and selling (or holding) the shares exceeds the remaining scheduled payments of principal and interest in respect of the bonds.

The level of the conversion premium will vary depending on the tenor of the bonds, the anticipated share price performance and share price volatility, the issuer's coupon expectations and the structuring of the equity option. The number of shares to be received by the investor when exercising its conversion rights will usually be calculated by dividing the principal value of the bond by the prevailing conversion price. Where the bond is denominated in a different currency to the underlying shares, a fixed exchange rate is also often incorporated into the bond terms. In an exchangeable bond, although the number of shares to be delivered may be determined by dividing the principal value of the bond by a fixed exchange price in similar fashion to a convertible bond, it is more common for the investor to have a *pro rata* entitlement to the exchange property.

In a well-priced convertible or exchangeable bond, the expectation is that the equity option will be "in the money" towards the end of the bond's term, so that the issuer is not giving away value by selling the equity option too cheaply. Equally, however, it is very important to note that both convertible and exchangeable bonds (mandatory convertible and exchangeable bonds aside)

will provide for the bonds to be redeemed at par (save in certain limited and unlikely events such as corporate events) if they are not exchanged or converted prior to maturity. If the equity underperforms expectations, the issuer will be obliged to redeem the bonds in cash, and so cannot simply assume at issue that the debt obligation will never have to be repaid, but instead will need to take prudent steps to hedge the liability in the event that the share price does not meet expectations.

For a traditional "long" investor, the issuer's obligation to redeem the bonds at par provides a minimum rate of return and limited downside risk if the shares underperform. Not all investors however follow a traditional long-only model, and it is very common for investors to acquire a convertible or exchangeable bond while at the same time taking a short position in the underlying equity.[3] See "*Structuring Alternatives – Liquidity-related Alternatives – Stock Lending Arrangements*", below. This allows the investor to arbitrage any pricing differences between the bonds and the shares, although this can prove unwelcome for long-only investors as the short selling can have a negative impact on the prevailing share price.

Cash or Physical Settlement

In their simplest form, the conversion or exchange rights attaching to convertible and exchangeable bonds are typically satisfied by physical delivery of the underlying equity, although it is also possible for both types of bonds to be cash settled (either mandatorily or at the election of the issuer). A converting or exchanging bondholder is usually required to complete a conversion or exchange notice (containing their delivery and payment details) and deliver this to a paying and conversion or exchange agent together with the bonds or bond certificates. In most cases, however, where the bonds are in global form in a clearing system, these procedures are completed electronically rather than in paper format.

In a physically settled bond, upon exercise of the conversion right, the debt obligation represented by the bonds is surrendered in exchange for the delivery to the bondholder of the relevant shares or other exchange property calculated as described above. The underlying equity or other property will be delivered to the custody account or other delivery address specified in the holder's conversion or exchange notice, and any cash entitlements will be delivered to the bank account details specified in the notice. In a mandatory convertible or mandatory exchangeable bond, the terms and conditions will contain a mechanism providing for the relevant shares or other property to be sold on arm's length terms, and for the net proceeds to be paid out to those investors who do not submit a conversion or exchange notice and do not therefore provide delivery details for the underlying shares or other property.

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[3] The practice of "going short" involves a seller selling securities it does not currently own in the anticipation (or expectation) that the price of those securities will fall and can then be repurchased at a lower price in future. Regardless of whether the underlying security price rises or falls, the seller will need to repurchase those securities at a later date in order to close out its position.

The issuer may, however, reserve the right to settle the bonds either wholly or partly in cash; for example, in order to minimise dilution to existing shareholders. Where limits on authorisations prevent the issuer from settling wholly in shares, the bonds may also be "net share settled", whereby the principal amount of the bond is settled in cash and only the equity value in excess of the principal amount of the bond is settled in shares. As a result, issuers will need to give careful thought to the tax and accounting considerations relevant to cash and/or physical settlement before determining the optimal structure for each particular transaction. Cash settlement options are also a useful mechanism to back-stop any regulatory issues that may arise in the course of executing the transaction. For example, cash settlement options can be used where: (i) admission to trading and listing of the conversion shares will not be obtained by the closing date, so an "automatic" cash settlement is put in place as a safeguard against the underlying shares not being admitted to trading or listed; or (ii) the conversion and delivery of any new shares upon conversion of the bonds would have the potential to exceed the maximum number of new shares that could be issued by the listed issuer under general or specific mandate granted by its shareholders.

When considering the inclusion of a cash settlement feature, issuers need to consider mark-to-market accounting principles as they apply to derivative instruments, and the impact that may have on an issuer's financial statements, as the embedded equity option is generally considered a "derivative instrument" for accounting purposes that may be subject to mark-to-market accounting. In summary, the fair market value of a derivative instrument is measured at the end of a reporting period with any change in the fair value since the end of the preceding reporting period being recorded as a gain or loss in the issuer's profit and loss account, under mark-to-market accounting principles. Accordingly, as this could introduce a material degree of variation in the income that an issuer reports between periods, this should generally be avoided.

In the Japan market, net share settlement for convertible bonds occurs (again for Japanese companies act reasons) as an option exercised by the issuer to acquire the bonds being converted by the bondholder and to deliver cash (plus any in-the-money portion in shares) as consideration for such acquisition.

Interest on Conversion or Exchange

Convertible and exchangeable bonds both work to the principle that an investor will usually be entitled to receive either interest on the bonds or dividends accrued on the underlying equity during a particular accrual period, but not both. Therefore, when the bond is converted or exchanged, the usual position is that the holder foregoes the right to accrued interest on the bonds, and so it would be logical for an investor to convert their bonds at the start of an interest period in order to minimise the lost interest (as interest is typically paid in arrears). In theory, however, an issuer could manipulate the exercise of the early redemption rights described above, in order to minimise the amount of interest it must pay on the bond. By setting an early redemption

date which falls after the relevant record date in respect of the underlying shares (i.e., the date on which the shareholder must be on the register in order to receive the relevant dividend) but prior to an interest payment date in respect of the bonds, the holder may be forced to exercise the relevant conversion rights if the equity option is "in the money", thereby surrendering its entitlement to a full (or close to full) period of interest and being deprived of dividend payment since the record date has passed. A convertible bond will usually provide protection against this so-called "coupon screw" by requiring the issuer to pay accrued interest in these circumstances, notwithstanding the usual provision that states that a converting bondholder foregoes interest accrued from the last interest payment date. A similar concern, and similar protections, are also to be found in exchangeable bonds.

Contingent Conversion

In the Japanese convertible bond market, a popular feature within the equity option is the "contingent conversion", or CoCo, feature. Note that this usage of the term "CoCo" is different from the usage in the European regulatory capital context.

Put simply, a CoCo feature allows bondholders to convert the bonds within any calendar quarter only if the average of the share price for a certain period in the prior calendar quarter exceeds the conversion price by a certain percentage (typically 30%). This restriction on conversion would be lifted in the last few months of the life of the bond, as well as upon the occurrence of certain events, such as a rating downgrade, the exercise of a call option by the issuer or a corporate event. This feature serves to limit dilution during the life of the bond if the share price is not outperforming.

THE EQUITY OPTION: ANTI-DILUTION PROTECTION AND PRESERVING THE CONVERSION PRICE

The economics of a convertible or exchangeable bond are determined, among other things, by the relationship between the market price of the shares and the conversion price or exchange price/ratio of the bonds. There are many factors which may affect the market price of the shares. Some of these represent risks that the bondholders are willing (or eager) to accept, such as the risk of the economic or other policy of the government of the issuer's jurisdiction or the risk of the commercial decisions taken by the issuer's (or underlying share issuer's) management.

However, some of these factors represent risks that the bondholders are not willing to accept and, consequently, the bondholders will expect to benefit from an appropriate adjustment to the conversion price should any of them occur. Typically, these will be factors which affect the relationship between the issuer and its existing shareholders, such as bonus issues, rights issues, dividends or extraordinary distributions of capital, or the relationship between the issuer and holders of other securities convertible into, or exchangeable for, shares.

As a result, both convertible and exchangeable bonds contain detailed adjustment provisions which require adjustments to the conversion price or the exchange ratio in the event of dilutive actions affecting the underlying shares. Typically, the issuer of a convertible bond will be the issuer of the underlying shares and is therefore assumed to have control over any corporate actions that may affect the value of the shares and, in turn, the convertible bonds. In a convertible bond therefore, the adjustment provisions are intended to preserve the value of the underlying conversion right through adjustments to the conversion price and will, in principle, aim to ensure that the bondholder is able to convert into the same proportion of the company's share capital that it would have been able to acquire by exercise in full of the conversion right on the issue date of the convertible bond (assuming that the option was "in the money" as at the issue date).

In an exchangeable bond however, the usual assumption is that the issuer will not have control over the issuer of the underlying equity and therefore the anti-dilution protection is commensurately more limited. Usually the holder's entitlement upon exercise of exchange rights will (as noted above) include any distributions, whether in cash or in kind, derived from ownership of the underlying shares during the period for which the bond is outstanding, and therefore the exchange right is typically expressed as the right to acquire

pro rata share of the exchange property (being the initial shares and any derived rights, assets or entitlements). If corporate actions or other dilutive events affect the exchange property, the bond issuer is usually not obliged to expend its own funds in order to ensure a *pro rata* ownership interest in the underlying share issuer but is only obliged to take those actions which it can undertake without additional expense. This is colloquially referred to as a "pot system" of adjustments to the exchange price.

This results in different mathematical outcomes between a convertible and exchangeable bond depending on the nature of the dilutive event. In the case of a stock split both instruments should be adjusted equally. However, in the case of a rights issue the convertible bond issuer will be expected to make a full adjustment to the conversion price (subject to customary *de minimis* thresholds and rounding provisions to avoid the nuisance value posed by fractional entitlements) whereas the exchangeable bond issuer is only obliged to sell its nil paid rights in the market and apply the proceeds to take up as many remaining rights as it can. This difference stems from the fact that the convertible bond issuer has control over the pricing of the rights issue. Without the protection of the relevant conversion price adjustment, the only way for the convertible bondholder to protect against dilution would be to convert the bond and participate in the rights issue, thereby surrendering the time value of the equity option. In an exchangeable bond this is less of a concern however, as the equity issuer is less obviously incentivised to act in a manner which could be detrimental to the creditors of a third-party entity.

There are equity-linked bonds in the market structured as exchangeable bonds, but where the bond issuer does, directly or indirectly, retain control over the issuer of the underlying equity (e.g., as a result of both the bond and share issuer being subsidiaries under common control with the same parent company). In such a scenario, the anti-dilution and related adjustment provisions of the exchangeable bond will more closely resemble those found in a pure convertible bond.

Convertible bond adjustment provisions

The principles set out above help explain the typical formulaic adjustments that appear in most convertible bonds. The events that would typically give rise to an obligation to adjust the conversion price in a convertible bond offering, and the technical adjustments that follow, are summarised below.

Consolidation, reclassification or sub-division and capitalisation of profits and reserves

The consolidation, reclassification or sub-division of the ordinary share capital into which the bonds are convertible is a largely technical event that should not affect the company’s value but results in a different number of shares in issue. To take a very simple example, if the company sub-divides each ordinary share into two, there will be double the number of ordinary shares in issue and the holder of the convertible bond will require a *pro rata* reduction of the

conversion price in order to avoid a loss of value given that, following the sub-division, each new share will be worth only one half of each old share.

The reverse would be true in the event of a share consolidation; if each share doubles in value, then it would not be fair for the convertible bondholder to be able to convert at a conversion price that was set when double the number of shares were in issue. The consolidation of share capital is a rare example of a situation when an upwards adjustment to the conversion price will be permitted; most adjustments are downwards, as they are there to protect the convertible bondholders against dilution.

The adjustment formula in this situation is therefore very simple, and consists of multiplying the conversion price immediately before the consolidation, sub-division or reclassification by the result of:

$$\frac{A}{B}$$

where "A" is the number of ordinary shares in issue prior to the consolidation, sub- division or reclassification and "B" is the number of ordinary shares in issue immediately afterwards. The adjustment to the conversion price is typically expressed to take effect on the day that the relevant sub-division, consolidation or adjustment takes effect, in order to ensure that the convertible bondholder is immediately restored to its original position.

The same mathematical formula is used where an issuer issues shares fully paid to shareholders as a class, by way of capitalisation of profits or reserves. In this situation value is not leaving the company. Instead, the profits or reserves are being reclassified as share capital. In principle, the *pro rata* claim of each ordinary shareholder upon the company's assets is unaffected by the capitalisation. The exception to this principle is the scrip dividend, whereby shareholders can make differing elections as to whether or not to receive the distribution in cash or in shares, and therefore there is likely to be a distribution of value from the company in which the convertible bondholder is unable to participate. On a capitalisation of profits or reserves, the adjustment to the conversion price will take effect on the date on which the new share capital is issued.

Dividends and other distributions

The treatment of dividends for these purposes will typically depend on whether or not the issuer of the shares underlying the convertible bond has an established dividend history. If a company has historically paid regular cash dividends then it is common to carve these out of the anti-dilution protection and only adjust for extraordinary payments, as bond investors are able to factor the typical dividend payments into their analysis prior to investing. By contrast, if the company has no, or a more limited, dividend history, convertible bond investors are more likely to expect full dividend protection, which means that any dividend payment will result in an adjustment to the conversion price, typically referred to as "full" dividend protection.

The adjustment formula for full dividend protection is simpler, because no account needs to be given of the assumed dividend payment. The conversion price prior to the payment will be multiplied by the result of:

$$\frac{A-B}{A}$$

where "A" represents the current market price of one ordinary share on the effective date of the adjustment, and "B" represents the fair market value of the dividend per ordinary share. This formula simply measures the proportion of the company's prior value that is being distributed to shareholders and makes a corresponding adjustment to the conversion price.

For cash dividends, the determination of the dividend's value is usually very straightforward as most companies will declare their dividends as a cash figure on a per share basis. The situation becomes more complex where the dividend is payable in a currency that does not match the currency of the bonds, or where the dividend is in the form of property or assets (including a spin-off of a division or business unit) rather than cash. Although mathematically the formula does not differ if the distribution is a distribution in kind rather than a distribution in cash, the timing and method of valuation can become more complicated where a distribution occurs in kind, and detailed provisions are usually included as to how and when the valuation will occur, depending on the type of distribution and whether or not the asset is publicly traded. Usually the calculation agent and/or independent adviser (where appointed) will assist in making these determinations in order to reassure bondholders that the valuation will be determined impartially. A repurchase of ordinary shares will typically also be treated as a non-cash dividend for these purposes, as it represents an alternative to a dividend as a method of returning capital to shareholders.

Wherever possible, the dividend adjustment will be implemented on the ex-dividend date, i.e., the first day on which the shares trade without the benefit of the relevant dividend entitlement on the relevant stock exchange where they are listed and traded. This is the point at which the value of the dividend as a proportion of the prevailing share price can be determined most clearly, i.e., when the share price should be reflective of the mathematical reduction in value arising from the dividend rather than other extrinsic factors. In the case of a share buyback, the effective date will be the date on which the relevant purchase or buyback is actually made.

In a bond where dividend protection is only given for "extraordinary" dividends, the principles remain similar although the formula is amended to take account of the assumed reduction in value which is permitted as a "regular" distribution before an adjustment to the conversion price is required. In this case, the conversion price immediately prior to the dividend is multiplied by the result of:

$$\frac{A-B}{A-C}$$

where "A" represents the current market price of one ordinary share on the effective date of the adjustment, and “B” represents the fair market value of the extraordinary dividend (rather than **any** dividend as was the case in the previous example) per ordinary share. An extraordinary dividend will be any dividend in a fiscal year of the issuer which, when aggregated with all other dividends paid in the same fiscal year, exceeds the pre-determined threshold amount for that fiscal year. So for a company that pays an annual dividend of 35 cents per share in any given year, the convertible bond will not be adjusted unless the dividend payments exceed those levels.

“C” denotes the difference between the threshold level and any dividends previously paid during that fiscal year, which effectively measures the use that the issuer has already made of the relevant dividend threshold. So in the example given above, if the issuer has paid an interim dividend of 15 cents for the first half of the year, and pays a final dividend of 30 cents, “C” would be 20 cents to reflect the fact that the first 15 cents of the threshold was already “used” at the time of the interim payment. At the time of the interim payment itself, “C” would have had a value of zero, reflecting the fact that the full threshold for that fiscal year remained available.

Typically, only cash dividends permit the deduction of the dividend threshold in this way, as few (if any) companies have an established pattern of non-cash distributions. As with other dividend adjustments, adjustments for extraordinary dividends would usually take effect on the ex-dividend date of the relevant dividend. The threshold amount, whether set on a per share or a per bond basis, is usually set as a monetary amount on the issue date and is therefore subject to adjustments on the same basis as the conversion price in the event of dilutive or concentrative events affecting the underlying shares. This is in order to ensure that the threshold continues to reflect the proportionate dilution in value that the convertible bondholder agreed to assume at the time the terms were struck.

Rights issues

If the share issuer conducts a rights issue, whether directly or through the issuance of warrants or options to subscribe for ordinary shares, whereby shareholders as a class are entitled to subscribe further shares at a discount (in a typical case) of more than 5% to the prevailing market price per ordinary share, the convertible bondholder will be entitled to a reduction in the conversion price.

This reflects the fact that the right to acquire further equity at a discount to market value is a valuable right or entitlement that is not available to the convertible bondholder (absent conversion). The adjustment is determined by multiplying the conversion price in effect immediately prior to the granting of the relevant rights by the result of:

$$\frac{A+B}{A+C}$$

where "A" represents the number of ordinary shares in issue on the effective date, "B" represents the number of shares that could be purchased at the current market price with the consideration that the issuer will receive from the rights issue, and "C" represents the maximum number of shares that will be issued upon exercise in full of the relevant rights.

If the share issuer launches a rights issue with a simple 1-for-1 entitlement, whereby shareholders have the right to subscribe for one additional ordinary share for each ordinary share currently held, at a 10% discount to the current market price, "B" should theoretically be 10% lower than "C", resulting in a 5% reduction in the conversion price. The effective date of the adjustment will be the first date on which the shares trade without the benefit of the relevant rights or other entitlement on the relevant stock exchange.

Grants to shareholders of securities, rights or options convertible into assets other than ordinary shares

If the share issuer issues securities or grants warrants, rights or options to shareholders as a class by way of rights, which carry an entitlement to acquire securities (other than ordinary shares), or if the share issuer gives shareholders the rights to purchase or subscribe any such securities, warrants, rights or options, the conversion price will be adjusted to reflect the value attributable to such securities or rights. The conversion price will be adjusted by multiplying the conversion price currently in force by the result of:

$$\frac{A-B}{A}$$

where "A" is the current market price of one ordinary share, and "B" is the fair market value of the relevant right or entitlement granted to shareholders (on a per share basis). The adjustment will take effect on the first date on which the shares trade without the benefit of the relevant right or entitlement.

Non pre-emptive issues

If the share issuer issues ordinary shares, or rights to subscribe for ordinary shares (such as other convertible bonds, exchangeable bonds or warrants), wholly for cash or for no consideration, at a price per share which is less than 95% (or, in certain circumstances, 90%) of the prevailing market price per share, the conversion price will be similarly adjusted. Although there are a small number of convertible bond transactions where adjustments are required for any non pre-emptive issue, not just those where the consideration is either wholly cash or for no-consideration, the more usual approach is to limit the adjustment to these two circumstances.

The reason for this limitation lies in the underlying provisions of the English Companies Act 2006 ("**Companies Act**") which only confers pre-emption rights on existing shareholders in circumstances where a company proposes to issue ordinary shares either wholly for cash or for no consideration.[4] The

[4] See Section 564 (*Exception to pre-emption right: bonus shares*) and section 565 (*Exception to pre-emption right: issue for non-cash consideration*) of the Companies Act.

position under the Companies Act, Chapter 50 of Singapore (the "**Singapore Companies Act**") is similar, however, rights of pre-emption are not conferred on shareholders by statute but rather provided for within the issuer company's constitutive documents.

Accordingly, in circumstances where the shares are to be issued in exchange for other valuable consideration, no such pre-emption right is afforded. As a result, most convertible bonds, especially those issued by English companies, do not extend adjustment protection in such circumstances to convertible bondholders given that they would have had no ability to subscribe additional equity or vote on the disapplication of pre-emption rights had they been shareholders of record on the date of the relevant proposal. To do otherwise would put the convertible bondholder in a better position than ordinary shareholders, which is generally not the purpose behind convertible bond adjustment provisions.

In the Japan market, where such pre-emption considerations are not relevant, there would be adjustments of the conversion price for any issue of ordinary shares at less than fair market value (typically calculated as an average of the closing share price for 30 days, commencing 45 days before the announcement of the share issuance).

The adjustment is calculated by multiplying the conversion price in effect prior to the non pre-emptive issue by the result of:

$$\frac{A+B}{A+C}$$

where "A" represents the number of ordinary shares in issue immediately prior to the further issuance of shares or the grant of warrants, options or entitlements, "B" represents the number of shares (if any) that could be purchased at the current market price with the consideration that the issuer will receive from the non pre-emptive issue, and "C" represents the maximum number of shares that will be issued pursuant to the terms of such non pre-emptive issue. The effective date of the adjustment is the date of issue of the further ordinary shares, or the date on which the relevant rights or options to subscribe for such ordinary shares are issued.

Modification of existing conversion or subscription rights

If any securities, rights or options carrying rights of conversion or exchange into ordinary shares are modified so that the consideration per share payable upon conversion or exercise is less than 95% of the prevailing market price as at the date of modification, the conversion price will be adjusted to take account of the fact that holders of such other securities, rights or options can acquire ordinary shares at a discount to their market value.

The adjustment is calculated by multiplying the conversion price in effect prior to the modification by the result of:

$$\frac{A+B}{A+C}$$

where “A” represents the number of ordinary shares in issue immediately prior to the modification, “B” represents the number of shares that could be purchased at the lower of (i) the current market price with the consideration that the issuer will receive from the exercise of the right of conversion, exchange or subscription (if any) and (ii) the conversion, exchange or subscription price under the terms of such alternative securities, rights or options, and “C “ represents the maximum number of shares that will be issued pursuant to the terms of such securities, rights or options. The effective date of the adjustment is the date on which the relevant rights or options to subscribe for such ordinary shares are modified.

Other offers to shareholders as a class

If, in any other circumstances not already covered above, the issuer offers securities in which shareholders as a class have a right to participate, the conversion price will be adjusted by multiplying the conversion price in force immediately prior to the effective date by the result of:

$$\frac{A-B}{A}$$

where “A” represents the current market price of one ordinary share on the effective date, and “B” represents the fair market value of the portion of the relevant offer that is attributable to one ordinary share. The effective date for the adjustment is the first day on which the shares trade without the benefit of the relevant right or entitlement on the relevant stock exchange.

Other circumstances giving rise to adjustments

A change of control of the share issuer will also typically give rise to an adjustment. This is one of the more important protections for bondholders in any convertible bond and triggers other rights in addition to the conversion price adjustment. The change of control is therefore discussed separately (see “*Change of Control Protection*”, below).

In addition to the specific events listed above, the bond issuer, the trustee and the calculation agent also maintain a broad discretion to determine whether further circumstances may require an adjustment to the conversion price in order to cater for unforeseen situations that might have a dilutive effect on the theoretical value of the shares. The bond issuer will normally be required to appoint an independent adviser to make the determination. An independent adviser may also be required if the relevant facts or circumstances trigger more than one adjustment event, in order to ensure that the adjustments are implemented in the right order and that bondholders are fully compensated without a risk of double counting.

Share issues arising from a dividend reinvestment plan or executive or employee share option schemes are not usually treated as giving rise to conversion price adjustments.

Implementation of adjustments

All conversion price adjustments are required to be notified to bondholders in accordance with the terms and conditions of the bonds. They are also subject to *de minimis* provisions which do not require a conversion price adjustment to be implemented immediately if the adjustment would be very small (typically less than 1% of the prevailing conversion price, or less than 1 unit of the currency of the conversion price). Minor adjustments are instead carried forward until the cumulative effect of any adjustments exceeds the *de minimis* threshold, in order to avoid a multitude of minor technical adjustments being required.

Although it is theoretically possible for a bond issuer to operate adjustment provisions itself (with a number of issuers in Asia preferring to do so), it has become increasingly common in the European market over the last few years for an independent calculation agent to be appointed to assist the issuer in making these determinations. The calculation agent will typically also be involved in the preparation of the terms and conditions in order to ensure that the adjustment provisions will work smoothly when called upon. The presence of the calculation agent means that the issuer is not required to make detailed calculations and also provides bondholders with the reassurance that determinations are being made by an independent party, as well as helping to ensure consistency between transactions. Any determinations made by the calculation agent or an independent adviser are binding on the issuer, trustee and bondholders.

Change of Control Protection

A change of control of the share issuer will also often give rise to an adjustment to the conversion price. The circumstances which constitute a change of control can be the subject of detailed negotiations, but would usually contemplate the following situation:

- an offer to acquire shares, however expressed, in circumstances where the offer is available to all shareholders (or all shareholders other than any shareholder who is the person making such offer (or any associate of such person) or who is excluded from the offer by reason of being connected with one or more specific jurisdictions (e.g., some offers exclude U.S. shareholders to avoid onerous U.S. requirements)); and
- the offer has been recommended by the board of directors of the issuer, or the offer has become or been declared unconditional in all respects and the issuer becomes aware that the right to cast more than 50% of the votes which may ordinarily be cast on a poll at a general meeting of the shareholders has or will become unconditionally vested in the offeror and/or any associate(s) of the offeror, or an event occurs which has a like or similar effect.

More recently however, the requirement for an “offer” to be made to shareholders as a class has not been a condition to the change of control protection being triggered, and instead the change of control protection has

focused solely upon the acquisition of a majority interest (either economic or voting) in the share capital of the issuer. The key distinction is whether or not the issuer intends to offer bondholders protection against any change in majority ownership, or whether bondholders can only reasonably expect to be put in the same position as the ordinary shareholders whose ranks they will join upon exercise of their conversion right. The traditional requirement for an "offer" to be made to shareholders as a class clearly operates to establish a level playing field between the ordinary shareholder and the holder of the convertible bond. By contrast, offering the convertible bondholder protection against a reverse takeover or other transaction that falls short of constituting an "offer" would arguably put the convertible bondholder in a better position than ordinary shareholders who would typically not have any pre-emption rights or right to reject the transaction.

Why should a change of control lead to an adjustment to the conversion price?

As discussed above, on issue, the parity of the bond will be set some way below the redemption value of the bond. However, as the conversion period elapses it will become clearer how the share price is going to perform during the conversion period and whether the parity of the bond will, by the end of the conversion period, equal or exceed the redemption value of the bond. The more likely this becomes, the more the market value of the bond will tend to be influenced by its equity characteristics – and at some stage (unless it becomes clear that the parity of the bond will never, by the end of the conversion period, equal or exceed the redemption value of the bond) as maturity of the bond approaches and its debt characteristics become increasingly irrelevant, the market value of the bond will become the parity of the bond.

If the parity of the bond rises up to and beyond the redemption value of the bond well before the end of the conversion period, then the issuer may feel that it has "lost" in the sense that it has given away the shares too cheaply. If the parity of the bond fails to rise up to the redemption value of the bond before the end of the conversion period, then the bondholders may feel that they have "lost" in the sense that their option to buy the shares has proved to be more expensive than they bargained for. In a well-priced convertible bond, the parity of the bond should rise up to the redemption value of the bond shortly before the end of the conversion period, and the market value of the bond should become the parity of the bond.

However, these pricing calculations can be rendered irrelevant if a successful offer is made for control of the issuer during the conversion period. At that time it is likely that there will cease to be any (or any meaningful) market for the shares because all or most of them will have come into the hands of the offeror and/or any associate(s) of the offeror. Consequently, to realise value from their equity option without taking risk on the new management and direction of the business, bondholders may be forced to convert at the time of such offer rather than waiting until the end of the conversion period.

However, this value may be very different from the value the bondholders anticipated they would realise at the time of issue of the bond. While the offer is likely to be made at a premium to the market price of the shares at the time of the offer, there is no reason why this offer price should bear any relation to the price which the economics of the convertible bond assumed the shares would reach by the end of the conversion period.

In recent years it has become common to provide for bondholders to be compensated for any loss of the time value of the equity option that they bargained for when buying the bonds, which is caused by such a change of control. However, the principle of preservation of parity does not help in the case of change of control because there may not be any meaningful market in (or market value for) the shares following the change of control.

One method that is commonly adopted is to give bondholders an option to convert their bonds at a conversion price which is adjusted by way of a straight line amortisation of the conversion premium (i.e., by means of a "ratchet" table, if the change of control occurs halfway through the life of the bonds, the conversion premium would be reduced to 50% of the original conversion premium to reflect the lost time value). This option is typically only available for a short (30 to 60 day period) after the offer becomes unconditional and majority control has passed to the offeror and/or any associate(s) of the offeror.

The conversion price can also be adjusted by means of a "ratchet" formula, whereby a change of control conversion price is adjusted by the result of:

$$\frac{OCP}{1+(CP\times\frac{c}{t})}$$

where "OCP" represents the conversion price in effect on the relevant conversion date, "CP" is the conversion premium, "c" is the number of days from and including the date that the change of control is effective to (but excluding) the maturity date of the bonds and "t" is the number of days from (and including) the issue date of the convertible bonds, to (but excluding) the maturity date of the bonds.

The principle behind this is that the bondholders and the issuer originally bargained that the market value of the bond would, by the end of the conversion period, become the parity of the bond. However, as the conversion period has been effectively shortened by the change of control, this is an attempt to put the bondholders, at the time of the change of control, in the economic position that they and the issuer bargained would subsist at the end of the conversion period. Quite how adequate this compensation is will depend upon the factors that were influencing the market value of the bonds immediately before the offer.

Bondholder put upon change of control

In addition to the downwards adjustment to the conversion price described above, it is also common to grant bondholders the option to put their bonds

back to the issuer at par if a change of control occurs. This protects bondholders in a situation where the equity option is not “in the money” and the bond is trading on the basis of the host debt security rather than the value of the equity option. In this respect it provides change of control protection similar to that in a conventional debt security (save that, in conventional debt securities, the redemption price is set above par, for example, at 101% of the principal amount of the securities), giving the holders an exit at par if they do not feel that the new management or ownership will run the business in a manner consistent with their original expectations. Bondholders therefore have the ability to elect to put their bonds, convert into shares at a discounted price, or do nothing and simply hold onto their security notwithstanding the change of control.

Statutory protections and other considerations

In some jurisdictions, existing statutory and other protections will also address what is expected to happen upon the occurrence of a change of control. In the United Kingdom, for example, the City Code on Takeovers and Mergers requires that an “appropriate offer” is made to holders of convertible securities in a company which is subject to a takeover offer, which applies in parallel to the contractual protections described above. In some jurisdictions, however, the contractual protections described above require adjustment to cater for local law issues which depart from the typical English law scheme that provides the foundation for most convertible bond provisions. Accordingly, the regulatory environment in the issuer’s jurisdiction, and how this may impact convertible bondholders’ position upon a change of control, will need to be carefully considered when structuring the change of control protections.

In Singapore, the position under the Singapore Code on Take-overs and Mergers (the “**Singapore Code**”) is similar to that in the United Kingdom. Rule 19 of the Singapore Code requires an offeror for “offeree companies with outstanding instruments convertible into … securities being offered for or which carry voting rights” to make an appropriate offer or proposal to the holders of those securities, and expressly requires an equality of treatment between ordinary shareholders and holders of convertible securities. The notes on Rule 19 of the Singapore Code apply a “see-through” price to determine what such an appropriate offer price should be. This see-through price is the excess of the offer price for the underlying securities over the exercise or subscription price of such subscription rights or options. For instruments convertible into securities being offered for or which carry voting rights, the see-through price is the offer price for the underlying securities multiplied by the conversion ratio (or price) in the convertible bond.

It is important to take account of such local law issues when structuring the change of control protection in a convertible bond.

By contrast, in an exchangeable bond, because of the limited control that the bond issuer can exercise in respect of the underlying equity, the adjustment is much more straightforward, and the exchange property is typically replaced

with the relevant consideration delivered upon completion of the offer. However, many exchangeable bonds provide that bondholders who exchange their bonds within a short period (e.g., 60 days) after a change of control of the share issuer, the bond issuer is obliged not only to deliver a *pro rata* share of the exchange property but also to pay a cash compensation amount. Exchangeable bond investors are no less focused on the loss of time value of the equity option caused by a change of control in respect of the underlying shares but, from an issuer's perspective, offering compensation in an exchangeable bond represents a real economic cost in respect of an event which may be largely outside of the bond issuer's control (whereas, in a convertible bond, the cost will ultimately be borne by the new owners of the share issuer). From a Singapore perspective, it is worth bearing in mind that the definition of "convertible securities" in the Singapore Code expressly includes exchangeable bonds.

Issuer covenants in convertible bonds

The terms and conditions of a convertible bond will typically contain a detailed suite of covenants, or undertakings, intended to protect the bondholder's conversion right and ensure that the company does not undertake any action that would damage the value thereof, for so long as the bonds remain outstanding.[5]

There are also a number of negative undertakings which are typically included in the terms and conditions of a convertible bond. The issuer will usually commit not to issue or pay up any securities by way of capitalisation of profits or reserves unless the same would give rise to an adjustment to the conversion price (ignoring the effects of any *de minimis* provisions and rounding adjustments). There are, however, a number of common exceptions to this restriction, including certain schemes of arrangement, issues required by the terms of outstanding securities, issues in lieu of cash dividends, and issues in connection with employee and executive share remuneration schemes.

The issuer will also give a broad commitment not to modify the key rights and entitlements attaching to the shares, such as voting rights, dividend entitlement, and entitlement to capital on liquidation, or to issue any other equity share capital carrying more favourable rights than the current ordinary shares, subject again to a number of customary exceptions. These include employee and executive share schemes, modifications that are not materially prejudicial to bondholders, issues of equity share capital already catered for by the existing adjustment provisions, conversion of shares from certificated to uncertificated form and amendments to cater for the consequences of a change of control. The issuer must also undertake not to take any action that

[5] As there is a possibility that some of these undertakings could represent a fetter on the statutory rights of the company's directors in terms of how they organise the company's share capital, it is common for legal opinions in respect of convertible bond offerings to contain a reservation as to whether or not all of these restrictions would be fully enforceable in all circumstances.

would prevent any shares arising upon conversion of the bonds from being issued as fully paid.

Another customary restriction is an undertaking by the issuer not to confer rights of conversion into ordinary shares upon any existing securities where the conversion or exchange may take place at a consideration per ordinary share of less than 95% of the prevailing market price, unless the event gives rise to a conversion price adjustment pursuant to the adjustment provisions outlined above.

The other key negative undertaking that an issuer of a convertible bond will assume is an obligation not to reduce its issued share capital, premium account or reserves. As with other negative undertakings, however, this is subject to a detailed list of exceptions, including a reduction provided for by the terms of issue, purchases and redemptions permitted by applicable company law, reductions to create distributable reserves or write off goodwill, and reductions that would lead to an adjustment to the conversion price or are not materially prejudicial to bondholders.

In addition to the aforementioned negative undertakings, the issuer also makes a number of positive undertakings to protect the conversion option. These include using all reasonable endeavours to ensure that a successful change of control offer is extended to holders of the convertible bonds on substantially similar terms to those afforded to holders of the ordinary shares, and ensuring that in the event of a “newco” scheme of arrangement (whereby a new “clean” company is interposed between the issuer and its shareholders to facilitate an acquisition or reorganisation) the terms are adjusted appropriately to ensure that the bond covenants and conversion rights are binding on the new entity.

The other more obvious point that is covered by the issuer undertakings is a commitment to ensure that the ordinary shares arising upon conversion of the convertible bonds are admitted to listing and trading on the same stock exchange as the current outstanding shares of the same class, and a commitment to maintain the listing of its shares on that stock exchange for so long as any of the bonds remains outstanding. The issuer will also be required to covenant that it will maintain sufficient authority to issue and allot, on a non pre-emptive basis, such number of ordinary shares as it would need to have available in order to be able to satisfy in full the conversion rights attaching to the bonds. The authorisations required for the issuance of a convertible bond are slightly more extensive than those attaching to a conventional bond issue, as we discuss further below.

AUTHORISATIONS

Convertible Bonds

An issuer of a convertible bond must be able to deliver shares on conversion of the bond, unless the issuer always has the right to deliver cash instead.

An issuer may be able to deliver shares:

(a) by issuing new shares;

(b) by transferring shares from treasury (if applicable, subject to the relevant company laws and listing rules permitting the issuance and holding of such treasury shares by the particular listed issuer); or

(c) by purchasing shares in the market for transfer to bondholders.

The ability of an issuer to use one or more of these options will depend on the laws of its jurisdiction of incorporation and its own corporate position.

Singapore

Generally, an issuer would require prior approval of shareholders in a general meeting under its constitutive documents, the Singapore Companies Act and/or the Listing Manual (the "**SGX Listing Manual**") of the Singapore Exchange Securities Trading Limited (the "**SGX-ST**") (if applicable) to issue convertible bonds and the shares to be issued upon conversion of the convertible bonds.

Under the SGX Listing Manual, for issuers with equity securities which are listed on the SGX- ST, approval to issue convertible bonds will not be required if shareholders have, by ordinary resolution in a general meeting, given a general mandate to the directors of the issuer to issue convertible securities. Such general mandate must limit the number of convertible securities that may be issued, and the limit must not be more than 50% of the total number of issued shares excluding treasury shares and subsidiary holdings in each class, of which the aggregate number of shares and convertible securities issued (other than on a *pro rata* basis to existing shareholders) must be not more than 20% of the total number of issued shares excluding treasury shares and subsidiary holdings in each class.

The determination of the total number of issued shares excluding treasury shares and subsidiary holdings is based on the issuer's total number of issued shares excluding treasury shares and subsidiary holdings at the time of the passing of the resolution approving the mandate, after adjusting for:

(a) new shares arising from the conversion or exercise of convertible securities;

(b) new shares arising from exercising share options or the vesting of share awards, provided the options or awards were granted in compliance with the SGX Listing Manual; and

(c) any subsequent bonus issue, consolidation or subdivision of shares.

Adjustments in accordance with paragraphs (a) and (b) above are only to be made in respect of new shares arising from convertible securities, share options or share awards which were issued and outstanding or subsisting at the time of the passing of the resolution approving the mandate.

Hong Kong

For a Hong Kong listed issuer, any new issue of shares (including securities convertible into shares) by an issuer on a non-pre-emptive basis must be approved by shareholders. Shareholder approval may be obtained by either a specific mandate (i.e., an approval of a specific transaction in general meeting) or a general mandate granted via an ordinary resolution in a general meeting in accordance with the Hong Kong Stock Exchange Listing Rules.

Under the Hong Kong Stock Exchange Listing Rules, a general mandate granted by shareholders will be valid from the date of the grant of such general mandate by shareholders at a general meeting up until the conclusion of the next general meeting of that listed issuer or where such general mandate is revoked or varied by ordinary resolution of the shareholders in a general meeting. The general mandate is subject to the restriction that the aggregate number of securities allotted or agreed to be allotted must not exceed the aggregate of:

(a) 20% of the number of issued shares of the issuer as at the date of the resolution granting the general mandate; and

(b) the number of such securities repurchased by the issuer itself since the granting of the general mandate (up to a maximum number equivalent to 10% of the number of issued shares of the issuer as at the date of the resolution granting the repurchase mandate),

provided that the existing shareholders of the issuer having by a separate ordinary resolution in general meeting given a general mandate to the directors of the issuer to add such repurchased securities to the 20% general mandate.

For the purposes of convertible bond issuances, if a Hong Kong listed issuer proposes to issue convertible securities under its general mandate, it must ensure that it has an unused mandate that is sufficient to cover all conversion shares. The Hong Kong Stock Exchange has expressed in its guidance letter concerning convertible bonds, that in its view it is generally acceptable for an issuer to "issue these convertible securities under a general mandate if, at the time of the issue of the convertible securities, (1) the unutilised portion of the general mandate is sufficient to cover the number of conversion shares based on full conversion of the convertible securities and (2) where the convertible securities are issued for cash consideration, the initial conversion price is not lower than the benchmarked price of the issuer's shares". The listed issuer should pay particular attention that the applicable terms of the convertible bonds in respect of the conversion price adjustment provisions will remain in compliance with the general mandate requirements.

Japan

In Japan, rather than looking at the percentage of issued shares that can be issued without shareholder consent, the question of whether or not shareholder consent is required for a convertible bond issuance pivots on whether the issuance constitutes an issuance of (underlying) shares at a "specially-favourable price" (in Japanese, "*yuri hakko*").

Under Japanese law, a Japanese company may issue shares (or options to issue shares, such as convertible bonds) without shareholder consent by way of special resolution (however large the dilution so long as it is within the authorised capital), if the offering process and terms are "fair" and the price at which they are issued is "not-specially-favourable" to the persons to whom they are being issued. Most public convertible bond issuances are priced on the basis of bookbuilding, which is generally considered to achieve a "not-specially-favourable" price, and as such, are issued only with the approval of the board of directors (and not of shareholders). As one of the procedures designed to achieve "fairness", the companies act mandates a two-week period between pricing and closing of convertible bonds in order to allow shareholders to seek suspension of the issuance should the pricing be deemed "specially-favourable".

In the case of third-party allotments of convertible bonds which do not undergo a bookbuilding process, Japanese listed company issuers would, if issuing such bonds without a special resolution of shareholders, be required to provide detailed disclosure of the rationale for the allotment, accompanied by the board's assessment of the pricing based on an independent third-party valuation letter.

Exchangeable Bonds

An exchangeable bond does not typically involve the issue or allotment of fresh equity in the bond issuer and so the company law issues described above would not ordinarily apply to the issue of an exchangeable bond, although care should always be taken to ensure that any local law issues are fully considered. The relevant authorisations are normally very similar to those obtained for a conventional, non-convertible debt securities issue, and would not require authority to allot further share capital, or the disapplication of pre-emption rights.

TAX CONSIDERATIONS[6]

The tax considerations for Singapore corporate issuers of convertible and exchangeable bonds are broadly the same as those which apply to conventional debt securities. Convertible and exchangeable bonds are treated as debt for accounting and tax purposes in Singapore.

Section 12(6) of the Income Tax Act 1947 of Singapore (the "**Singapore Income Tax Act**") provides that income is deemed to be derived from Singapore if it is (i) interest or any other payment in connection with any loan or indebtedness or with any arrangement, management, guarantee, or service relating to any loan or indebtedness that is either (a) borne, directly or indirectly, by a person resident in Singapore or a permanent establishment in Singapore (except in respect of any business carried on outside Singapore through a permanent establishment outside Singapore or any immovable property situated outside Singapore) or (b) deductible against any income accruing in, or derived from, Singapore; or (ii) income derived from loans where the funds provided by such loans are brought into, or used in, Singapore.

Such payments are generally subject to Singapore withholding tax when made to non-residents of Singapore, which would include foreign investors. Given the frequently international distribution of debt securities by Singapore issuers, withholding tax would apply to interest payable by a Singapore issuer.

There are certain exemptions and exclusions from Singapore withholding tax available on interest and related payments falling under section 12(6) of the Singapore Income Tax Act and, principally, the Qualifying Debt Securities ("**QDS**") scheme. Under the QDS scheme, a withholding tax exemption is granted to certain qualifying income (including interest) derived by investors who are non-resident holders of debt securities that qualify as QDS.

The exact requirements depend on whether the QDS are issued under a programme or as a standalone issuance, and with convertible and exchangeable bonds typically being documented as standalone trades, these are:

- more than half of the managers for the issue of the QDS are Specified Licensed Entities[7]. This would probably include most investment banking houses who operate in Singapore;
- during the primary launch of the QDS, either (i) the securities are issued to

6 A detailed tax analysis is beyond the scope of this work. The summary of tax considerations applicable to convertible bonds in this section does not constitute definitive tax advice and the consequences of the treatment of convertible bonds may vary dependent on the circumstances of the issuer and the securities being issued.

7 "**Specified Licensed Entities**" means any of the following persons: (i) any bank or merchant bank licensed under the Banking Act 1970 of Singapore, (ii) any finance company licensed under the Finance Companies Act 1967 of Singapore, (iii) a person who holds a capital markets services licence under the Securities and Futures Act 2001 of Singapore to carry on a business in the regulated activities of advising on corporate finance or dealing in capital markets products, or such other person as may be prescribed by rules made under Section 7 of the Singapore Income Tax Act.

four or more persons, or (ii) less than 50% of the principal amount of the securities is beneficially held or funded, directly or indirectly, by related parties of the issuer; and

- the issuer has included in all offering documents certain statements relating to QDS, and a return on debt securities in respect of the QDS is submitted to MAS in the prescribed format within any period and along with any other particulars required by MAS.

In addition, subject to meeting certain requirements that are broadly in line with the above, the QDS scheme (i) grants companies or bodies of persons (each as defined in the Singapore Income Tax Act) in Singapore a 10% concessionary tax rate on their qualifying income derived from QDS, and (ii) exempts from Singapore income tax a holder of QDS which is not resident in Singapore for Singapore income tax purposes. Such benefits may be an important marketing element of the securities.

In respect of payments made from Hong Kong (which would likely include payments by Hong Kong resident listed issuers) there is no withholding imposed on payments of principal or interest with respect to any convertible or exchangeable bonds or payments of dividends in respect of the shares issued on conversion. Investors in Hong Kong will generally be subject to local profits tax (although there is a broad dividend exemption which is likely to be available in a post-conversion situation) and there are stamp duty implications to consider in relation to the issue and transfer of bonds and shares.

In Japan, the vast majority of convertible bonds are issued on the basis of zero coupon, which makes the analysis regarding withholding tax on interest practically irrelevant. To the extent the convertible bonds are interest-bearing, the same considerations as for conventional bond issuances apply.

LISTING, DISTRIBUTION AND DOCUMENTATION

Listing

A convertible bond will typically require the delivery of publicly listed equity at the point of conversion, and so consideration must be given not just to the listing of the host debt securities but also to the admission of the shares to trading (typically on a regulated market) at the point of conversion. Given that convertible bonds usually allow the holder the option to convert into equity during a relatively broad time period (assuming, of course, that the equity option is "in the money"), it would be impractical to structure a convertible bond that required the preparation of an equity prospectus at the point of conversion in order to ensure admission of the underlying shares to trading. Where the underlying shares belong to the same class as shares already admitted to trading on the relevant exchange, there will already be a prospectus or listing document for the original admission of those shares and the issuer will have been subject to continuous disclosure obligations in relation to the host debt securities pursuant to the applicable listing rules, such as the SGX Listing Manual for issuers listed on the SGX-ST or those prescribed under Chapter 37 of the Hong Kong Stock Exchange Listing Rules for issuers listed on the Hong Kong Stock Exchange.

As the timing of conversion is controlled by the investor rather than the issuer, the issuer needs to ensure that the maximum number of shares that may be allotted pursuant to the conversion right are capable of being listed. Typically, when a listing application is submitted to the SGX-ST of the Hong Kong Stock Exchange for the listing and quotation of convertible bonds, the application will include the listing and quotation of such number of shares to be issued upon conversion of the convertible bonds (assuming that there are no adjustments to the conversion price).

Generally, for SGX-ST listed issuers the Securities and Futures Act 2001 of Singapore (the "**SFA**") prohibits the making of an offer of securities unless the offer is accompanied by a prospectus prepared in accordance with the SFA. However, a prospectus will not be required for an offer of convertible bonds if it is made pursuant to one of the prospectus exemptions under the SFA. The following sets out some of the prospectus exemptions which are frequently used for offers of securities to sophisticated investors:

(a) Offers made to institutional investors under Section 274 of the SFA;

(b) Offers made to accredited investors and certain other persons under Section 275 of the SFA, provided that certain conditions are complied with; or

(c) Offers of securities that may only be acquired at a consideration of not less than S$200,000 (or its equivalent in a foreign currency) for each transaction, under Section 275(1A) of the SFA, provided that certain conditions are complied with.

Where the convertible bonds are to be listed on the SGX-ST and are being offered without a prospectus and primarily to specific investors under the prospectus exemptions in paragraphs (a) and (b) above, the SGX Listing Manual requires that the offering memorandum or introductory document relating to the convertible bonds must contain the information that such investors would customarily expect to see in such documents.

It should be noted that similar prospectus exemptions are available for offers of convertible bonds of a real estate investment trust ("**REIT**") under the SFA.

For Hong Kong listed issuers, the applicable regime is similar to that of the Singapore regime, where to the extent any offer of securities is being made to "professional investors" only (as defined under Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong)) or in circumstances which do not require any such offering to comply with the prospectus requirements as prescribed under the Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong) then subject to any such offering being advertised, offered and subscribed for by professional investors only in Hong Kong, a prospectus will not be required for such an offer of convertible bonds in Hong Kong. Under Chapter 37 of the Hong Kong Stock Exchange Listing Rules, a listing document setting out the particulars of the offering to professional only investors and containing all *"…information that the investors an issuer is offering the securities to would customarily expect it to contain*" must be produced as part of any professional only investor bond listing application submitted to the Hong Kong Stock Exchange.

Issues of convertible bonds by Japanese issuers (typically equity listed on the Tokyo Stock Exchange) are very rarely listed on the Tokyo Stock Exchange; instead, convertible bonds issued outside of Japan would often be listed on the SGX-ST under one of the prospectus exemptions mentioned above or be unlisted.

Largely to avoid complications with the requirements for equity disclosures in a convertible or exchangeable bond offering, the European convertible bond market has largely migrated to more convenient listing venues such as the Open Market (*Freiverkehr*) in Frankfurt, the Third Market in Vienna or the International Stock Exchange in Guernsey, and exchangeable bonds have tended to be listed on similar venues due to the inherent similarities of the products and their investor bases. These tend to have more limited (or in some cases no) disclosure requirements, both on an initial application for admission and on a continuing basis, and are therefore far more convenient and cost effective for issuers. Investors are broadly comfortable with this position given that the public equity listing will usually already require the issuer to disclose any material information relevant to an investment decision, although it can mean that technical information relating to the convertible bonds themselves, such as conversion price adjustments and the exercise of issuer call rights, need to be notified to holders through the clearing systems rather than published through the relevant listing venue or stock exchange. This can make information flows slightly less immediate than they would be for

securities that are admitted to trading on regulated or exchange-regulated markets. Nevertheless, investors have generally taken a pragmatic approach in accepting these minor limitations, rather than insisting that issuers prepare extensive disclosure documents when the information is already in the public domain.

Although certain of these European listing venues do provide an element of execution efficiency by foregoing the requirement to prepare an offering document or listing particulars when bringing a convertible bond to market, issuers in the Asia Pacific region – who may not be as familiar with EU securities regulation – should be cognisant that any such listing will bring them within the regulatory perimeter of the EU Market Abuse Regulation (Regulation (EU) No 595/2014) ("**MAR**") which is directly applicable in all EU Member States.

MAR has extended the prohibition on insider dealing, unlawful disclosure of inside information and market manipulation, as well as the related procedural requirements for controlling inside information, to issuers whose securities have been admitted to trading on multilateral trading facilities (MTFs) or organised trading facilities (OTFs) and to financial instruments whose price or value depends on or has an effect on securities traded on an EU regulated market, an EU MTF or an EU OTF. Accordingly, non-EEA issuers such as those in Asia Pacific with securities admitted to trading on an EU MTF will become subject to the requirements of the MAR regime which may not previously have applied to them, if listing their convertible bonds on EU markets. In addition, issuers with listings in their home markets in Asia should also consider whether complying with MAR-related disclosure obligations will trigger simultaneous disclosure obligations in their home market.

While European issuers, and those with securities already admitted on EU regulated markets, will be familiar with the MAR regime, the additional procedural requirements will be new to most Asia Pacific issuers, and their ability to comply with MAR on an ongoing basis after issuance will be an important consideration in their choice of listing venue.

Distribution and Offering Documents

Asian convertible and exchangeable bonds (other than Japanese convertible bonds) are typically issued in high denominations (US$200,000, the equivalent or more) in order to avoid the need to produce a prospectus in connection with a public offer in Singapore or Hong Kong. Similarly, such large denominations also help issuers avoid the need to produce a prospectus for offerings in Europe within the meaning of the EU Prospectus Regulation 2017/1129. Japanese convertible bonds issued outside of Japan tend to have denominations of JPY10 million (approximately US$65,800 as of February 2025) and would rely on another exemption from producing a prospectus (such as offers to professional investors only).

Other than in Japan, for convertible or exchangeable bond transactions listed on venues where listing particulars or a prospectus is not required (see

"*Listing*", above) and in order to ensure an efficient offering process, investors will typically not be provided with any form of disclosure document in connection with the offering. Instead, the equity instrument underlying most convertible or exchangeable bonds will usually be publicly traded on a regulated or exchange-regulated market, and therefore the credit-related information that the investors need in order to make an investment decision should already be in the public domain.

This position is widely accepted in the European market. Documents provided to investors during the offering process for convertible and exchangeable bonds are typically limited to a summary term sheet, a press release and the full terms and conditions. The execution process is normally completed extremely quickly (intra-day, and often within a matter of just a few hours) and therefore investors have very limited time to look at anything other than the technical details of the securities being offered. The term sheet and press release will usually contain extensive legends and disclaimers setting out who is able to participate in the offering and making clear that investors (or prospective investors) are fully responsible for undertaking a credit analysis of the investment.

For convertible and exchangeable bonds listed on the SGX-ST or the Hong Kong Stock Exchange, a listing document is still required, but it is not normally produced until at least a few business days prior to closing (or, in certain circumstances, after closing) and if the transaction was launched and priced on an accelerated book- building basis, is not therefore available to investors at the time of pricing (the point at which they decide whether or not to subscribe the bonds). Depending on the jurisdictions concerned and marketing impact, in some cases for equity-linked offerings, the issuer may be obliged to obtain the listing by no later than 90 days after the closing date, rather than immediately upon closing as is usually the case with conventional debt securities issues.

Accordingly, and unlike conventional debt securities, the venue for the listing of the host debt instrument of a convertible bond (as distinct from the underlying equity into which it converts or exchanges) is largely driven by the marketing strategy adopted for the securities. For issuers with equity shares listed on a recognised exchanged with significant amounts of information publicly available, the European markets (such as the *Freiverkehr* in Frankfurt, the Third Market in Vienna or the International Stock Exchange in Guernsey) may prove to be more efficient, dependent on the timing of the overall transaction. Whether or not investors will, in turn, expect to form an investment decision on the basis of an offering document, or will want to review one prior to closing, will largely be dependent on the nature of the issuer of the convertible or exchangeable bond.

The process for Japanese issuers issuing convertible bonds in the international market has evolved differently perhaps because the primary disclosure language is Japanese. Although there have been some term sheet only transactions, they have not gained market standard status. Japanese

issuers accessing the international market would typically take weeks or sometimes months of preparation before announcing a convertible bond issuance, and processes such as due diligence and documentation would be substantially complete prior to announcement. Where the convertible bonds are being listed, the disclosure document (the preliminary offering circular, which would contain all disclosure except pricing details) would be available upon announcement and would be completed (as the final offering circular) upon pricing. Where the convertible bonds are not being listed, often an information memorandum (containing the full terms and conditions of the convertible bonds and the issuer's financial statements, but not much more) would be produced, and the underwriters would rely on representations from investors as to their ability to make their own investment decisions. The bookbuilding process, as in other Asian jurisdictions, would take place intra-day while the equity markets are closed. If convertible bonds are issued in the domestic Japan market, Japanese issuers are subject to strict full disclosure requirements under the Japanese securities act.

Contractual Documents

In principle the documents required for a convertible or an exchangeable bond issue are the same as those for a conventional debt securities issue although, as discussed above, additional provisions are needed to address the greater complexity of equity-linked instruments.

Subscription Agreement

The subscription agreement for a convertible or exchangeable bond will be much closer in terms of style and content to an equity underwriting agreement than a debt underwriting agreement, as the investors are taking exposure to the underlying shares. This will affect the following key provisions in particular:

Representations and warranties

Similar to any underwriting agreement, the representations and warranties in a convertible bond subscription agreement serve the purpose of providing a level of contractual support for the underwriters' due diligence, a breach of which allows the underwriters to claim under the indemnity or terminate the underwriting obligations.

However, in transactions where no offering circular or prospectus is prepared, and due diligence is limited, underwriters will be particularly focused on ensuring adequate representation and warranty coverage on all aspects of the company's business, and obtaining a clean confirmation from the issuer that all "inside information" and other material facts relevant to an investor have already been publicly disclosed. This not only supplements the more limited due diligence investigation that is possible in a short timeframe (particularly where an accelerated bookbuild approach is taken) and when no offering circular is being produced, but also reflects the fact that the equity into which the bonds are convertible is typically admitted to trading on a public market, thereby making the shares and the convertible bonds subject to the provisions

of applicable market abuse regulations and legislation. For PRC-based listed issuers in particular, there may also be PRC law based regulatory approval requirements underwriters may wish to obtain representations and warranties and conditions precedent coverage on prior to the pricing of the transaction (e.g., foreign debt registration approvals granted by the Nation Development and Reform Commission of China). Underwriters will therefore be strongly motivated to ensure that the issuer has disclosed all inside information to the market in order to ensure that investors can make an informed investment decision and the bonds can be freely traded. The representation that there is no undisclosed material information will also be complemented by representations that the share issuer is in compliance and up-to-date with its continuous disclosure (for example, annual reports and regulatory announcements) obligations, and that such disclosures are complete, accurate and not misleading.

In addition, and in accelerated bookbuild transactions where an offering circular is produced after pricing and published and delivered to investors a number of days prior to closing, the representations and warranties will necessarily be forward-looking in nature, to capture the accuracy of the disclosure and associated due diligence issues on the date of publication.

Additional complexity can arise in relation to exchangeable bonds where the issuer has a substantial minority stake in the underlying equity issuer and potentially common directors. This can give rise to some quite complicated questions about what is actually known to the bond issuer and whether or not it is subject to obligations of confidentiality and fiduciary duties on the part of the relevant directors.

Indemnity

The underwriters will usually insist on a “transactional” style indemnity, protecting them against any losses incurred through acting on the transaction, rather than having to establish a breach of representation or warranty as they would in a traditional debt underwriting agreement. This reflects the greater risk profile of the equity security compared to a conventional debt securities, the speed of the execution process in order to enable the transaction to be executed when market conditions are most favourable, and the absence of a detailed disclosure document for the underwriters to review and scrutinise.

Conditions precedent and termination rights

For similar reasons, the conditions precedent and the rights of underwriters to terminate the subscription agreement will usually be more extensive, particularly in accelerated bookbuild transactions with a longer settlement period between pricing and closing, and where an offering circular is produced prior to closing.

These usually include a condition precedent that the underwriters have been able to conduct due diligence to their satisfaction, and have the right to terminate the subscription agreement in the event that an offering circular is

not produced, or that closing of the issuance does not take place by a particular date.

Lock-up agreements

The subscription agreement for an equity-linked offering will usually contain some form of lock-up undertaking, whereby the issuer and its subsidiaries and affiliates agree not to issue or dispose of any shares or other securities referencing the underlying shares within a short window (usually 90 or 180 days) following the closing date, in order to avoid competing with any distribution of the bonds. Sometimes (although not so commonly), similar lock-up requirements are imposed on major shareholders as well.

Types of investors

Due to their complex nature, convertible and exchangeable securities are rarely marketed to retail investors. Even prior to 2018, European convertible bonds were typically marketed to "qualified investors" within the meaning of the Prospectus Regulation, and the overlay of MiFID II[8] and the PRIIPs[9] regulation, with their detailed obligations around product governance and suitability, have only served to reinforce this approach.

In the London market, the general practice has been to treat convertible and exchangeable bonds as if they were packaged products, thereby excluding participation in equity-linked offerings by retail investors in order to avoid being subject to the obligation imposed by the PRIIPs regulation to produce a "key information document" (in essence, a short form summary of the bond, including performance scenarios) that must otherwise be provided to retail investors prior to sale. There are differing practices in other European jurisdictions, however, as the definition of a "packaged retail investment product" or "PRIP" is an investment where "*the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor*". Whether or not a convertible or exchangeable bond satisfies this test is potentially arguable, as the debt obligation (if repayable) is typically repayable at par, or not repaid at all if the instrument converts to equity and is satisfied through the delivery of shares. It is unclear from the face of the PRIIPS regulation if an instrument should be in scope where the question of whether or not it is repayable at all is related to the underlying share price performance, and therefore different approaches are seen in some European jurisdictions on this point.

Similarly, from a product governance standpoint under MiFID II, the typical London market practice is to exclude distribution to retail investors given the mathematical complexity of the instrument and the need to be comfortable that the features are suitable for the target market. Again however, in some jurisdictions where retail investment in debt securities and structured notes is

[8] Directive 2014/65/EU of 15 May 2014 (as amended).
[9] Regulation (EU) No 1286/2014 of 26 November 2014 (as amended).

more common, there is a greater level of comfort amongst manufacturers with regard to distributing convertible bonds to retail investors.

The UK Financial Conduct Authority has, since 2014, also introduced specific restrictions on the marketing of regulatory capital bonds with contingent conversion features to retail investors.

In addition, if a REIT is offering convertible bonds which convert into units in the REIT, an analysis of whether the units in the REIT to be issued on conversion are in-scope for purposes of the EU Directive 2011/61/EU on Alternative Investment Fund Managers ("**AIFMD**") will also be required. To the extent the units are in-scope, Article 23 of the AIFMD mandates the disclosure of certain information to investors before they can invest, and ensuring these disclosures are update prior to launch will be vital to the success of a transaction if a European investor base is being targeted.

LIQUIDITY AND DILUTION

Two of the key commercial considerations for issuers and bookrunners when bringing an equity-linked bond to market concern the degree of liquidity in the underlying shares (and whether this is sufficient for investors to hedge their long position on the convertible bonds). Similarly, and on the other side of the trade, potential investors will have an interest in understanding the extent to which they will have access to securities sufficient to be able to hedge their effectively "long" positions in the equity-linked bond.

Issuers of equity-linked bonds, mainly convertible bonds, will also be concerned with the likely dilutionary effect of a conversion on their existing shareholders' stakes.

Liquidity-related Alternatives

Delta Hedging and Stock Lending Arrangements

"Delta hedging" is a trading strategy employed by investors with the objective of reducing the directional risk, or sensitivity of the investment, associated with the movement in price of the underlying shares.

In its simplest form, investors in the equity-linked bond will short sell a certain number of the underlying shares, or otherwise seek to implement a short position in the shares. The magnitude of the short position, or number of shares that the investor will seek to sell, will depend on the extent to which the investor seeks to minimise the price sensitivity of the underlying stock. Investors will typically seek to either minimise all such risk (i.e., achieving a "delta neutral" position in the shares) or design a more limited hedge dependent on its overall view of the direction of the share price (be it bullish or bearish).

The ability of convertible bond investors to enter into short positions on the shares while effectively taking a long position on the convertible bond itself is an important component of the equity-linked bond market, because by taking these positions simultaneously on the shares and the bonds, investors can optimise their overall exposure to the company in accordance with their particular risk profile and investment objectives.

Short sales generally involve borrowing shares from a third party and on-selling them into the market. In practice, this can be affected in a number of ways, including through stock lending arrangements and other synthetic devices such as equity swaps.

In the Asia-Pacific region, stock lending is the most common form of providing investors with shares to create a short position, and involves the transfer of securities (in this case, shares of the issuing company) against a promise by the borrower of the securities to transfer an equivalent amount of securities, or an amount equal to the market value of those securities in cash, at the end of a predetermined period or on demand. Stock lending transactions provide a legal mechanism by which sellers of securities (the borrowers) can enter into

"short positions" in a given security without first acquiring or otherwise owning the shares.

As noted above, stock lending arrangements play an important role in giving investors access to the stock of a convertible bond issuer which is otherwise illiquid: without stock borrow arrangements in place, investors would not otherwise be able to go "short" for the purposes of their strategic position, and therefore potentially be less interested in investing in the convertible bond.

Stock lending arrangements for equity-linked bonds are usually documented under the terms of a modified Global Master Securities Lending Agreement ("**GMSLA**") which is a framework agreement that can be used for a number of trades between a stock borrower and lender, and which is published by the International Securities Lending Association. The stock lending agreement entered into the between the parties will look to ensure that the lender's economic position in the stock is maintained (i.e., as owner of the securities, accounted for as an asset of the lender), and provide for the stock borrower to pay interest, dividends and other distribution on the borrowed stock to the lender over the life of the loan.

Dependent on the nature of the underlying transaction, the stock lending agreement may also provide some form of best endeavours obligations on the borrower to ensure that any voting rights attaching to the underlying stock can be exercised at the lender's direction.

While stock lending is an important and useful mechanism for an equity-linked bond offering, particularly in respect of the stock of a company that is not particularly liquid, issuers and their advisers will need to carefully consider the regulatory environment around short positions and stock lending generally, to determine whether it is legally permissible.

In Singapore, there is a disclosure regime for short sell orders[10] which may apply. Generally, a person who makes a short sell order on an approved exchange must disclose to the approved exchange:

(a) that it intends to make or is making a short sell order; and

(b) the quantity, volume or value of the specified capital markets products in relation to which it intends to make or is making an order to sell but in which it does not have an interest,

before or at the time of the short sell order.

[10] For this purpose, a "**short sell order**" means an order to sell any specified capital markets products (which would include certain convertible bonds) where the person who makes the order does not, at the time of the order, have an interest in the specified capital markets products.

In addition, short position[11] reporting requirements apply where a person's ("**A**") short position in relation to specified capital markets products (including convertible bonds) is equivalent to or more than the short position threshold. A must, within two business days of the short position day and in the form and manner prescribed, report to the MAS directly or through another person ("**B**"):

(a) the prescribed information on (i) the identity and business activities of A and (if applicable) B; and (ii) A's short position in relation to the specified capital markets products; and

(b) any change to the information mentioned in paragraph (a).

Stock lending arrangements are less commonly used for exchangeable bond transactions, primarily on account of the bond issuer not necessarily having access to, or control over, a sufficient amount of shares in the underlying company to be able to facilitate the transaction.

Conversion Price Reset

For convertible bonds, and in scenarios where shorting the stock of the convertible issuer is not possible (for example, owing to prevailing illiquidity in the share price and an inability to enter into stock lending arrangements, or for other regulatory reasons), the bond conditions may include a conversion price "reset" provision which is designed to compensate holders for a decline in the trading price of the shares into which the convertible bond converts.

Typically, a reset condition will reduce the conversion price of the convertible bond to a price equal to the volume weighted average price of the shares over a specified period (usually 30 consecutive trading days) preceding the reset date. This adjusted conversion price will usually be subject to a floor below which the price cannot reduce, sometimes expressed as being not less than a percentage (usually 80%) of the conversion price immediately in effect prior to the reset date.

Conversion price resets are useful tools in the low liquidity scenario described above, as well as providing investors with some level of protection for the price of the embedded equity option without the added expenses and intricacy of entering into stock lending arrangements.

However, issuers do need to exercise caution when considering including resets in their convertible bond terms in light of IAS 32 (*Financial Instruments: Presentation* which applies a "fixed for fixed" test under which a derivative (the embedded equity option) will qualify for equity classification in the financial

[11] Generally, a "**short position**" means the amount by which the quantity, volume or value of any specified capital markets products in which a person has an interest is less than the quantity, volume or value of the specified capital markets products which the person is under an obligation to deliver, where:

(a) the quantity or volume of the specified capital markets products is determined (i) on the most recent position day on which the specified capital markets products are traded on an approved exchange; and (ii) at the close of trading of the approved exchange on that day; and

(b) the value of the specified capital markets products is determined (i) on the most recent position day on which the specified capital markets products are traded on an approved exchange; and (ii) with reference to the closing price of the specified capital markets products at the approved exchange on that day.

statements of an issuer only where it will be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. As such, issuers should be mindful that a conversion price reset could have the effect of disturbing the accountants' analysis and application of this test, with the result being that the convertible bonds are accounted for and presented in the issuer's financial statements in a materially different manner than was contemplated on issuance. This could also lead to inadvertent breaches of financial and other covenants that issuers are subject to as a result of the convertible bond issue.

In addition to accounting concerns, issuers should also pay particular attention to the manner in which conversion price reset mechanisms are treated by its regulators and the stock exchange on which the underlying shares are listed, as a reset mechanism may not always be permitted. For example, the Hong Kong Stock Exchange has in the past (and particularly in the context of pre-IPO convertible bonds) insisted on the limitation of, or restrictions placed on, the conversion price reset mechanism on the basis that it was in violation of the listing rules, and contrary to the principle of the equal treatment of shareholders. In Japan, multiple resets of the conversion price can trigger detailed disclosure requirements in the home market regarding the rationale for having such reset clauses.

Dilution Mitigation Alternatives

For convertible bond issuers, a primarily concern will be the potential dilution that will come about in the event that the conversion option is exercised and shares need to be issued. This issue will be of less relevance (if at all) to exchangeable bond issuers who hold a minority position in the company that issued the underlying shares that form the exchange property.

This risk can be managed, and in certain cases, eliminated, using a number of different techniques, some of which are outlined below.

Share Repurchases

The most direct manner of ameliorating the dilution risk associated with a convertible bond is to conduct and execute a share repurchase transaction on a substantially contemporaneous basis with the convertible bond offering. The price at which the shares are repurchased will be the last reported reference price used to price the convertible bond, with the bond offering and the share repurchase settling at the same time.

Ideally, shares will be repurchased from investors in the convertible bond who are also looking to establish a delta hedge by selling shares short, and the number of shares repurchased will be dependent on the amount of notes to be purchased by investors looking to establish that delta hedge. See "*Liquidity-Related Alternatives - Delta Hedging and Stock Lending Arrangements*", above.

Equity Neutral Convertible Bonds

Over the last several years, a number of highly rated European corporates have issued so-called "equity neutral" convertible bonds, which offer investors the equity upside of a convertible bond without the issuer having to account for the potentially dilutive effect of further share issuance on existing equity holders. Whereas a conventional convertible bond results in the physical delivery of ordinary shares upon conversion of the bond (or repayment at par if the option is "out of the money"), in an equity neutral structure the equity option is fully cash settled, thereby avoiding any potential dilution of existing shareholders by the issue of further equity. In order to hedge the equity exposure arising under the bonds, the issuer will purchase one or more cash settled call options referencing its own equity. This can give rise to complex financial assistance considerations, as the payment of the option premium means that the issuer is likely to be funding the purchase of its own shares by the option counterparty, in order for the counterparty to hedge its exposure under the call option.

The efficiency of the equity neutral structure relies on the ability of the issuer to purchase the call options at a cost which compares favourably to senior unsecured financing or the cost of conventional convertible bond issuance. In effect, the issuer is able to arbitrage the costs of buying and selling the equity option.

Although the equity neutral bond is sometimes described as a synthetic form of straight debt issuance, issuers need to bear in mind that because of the inter-relationship between the bond and option terms, the equity neutral convertible bond is terminable in a number of circumstances that would not apply to either conventional senior unsecured financing or a physically settled convertible bond. Whilst events such as delisting, nationalisation or change in law are all familiar termination events for users of equity derivatives, they would not typically result in the early redemption of other more conventional debt instruments.

Issuers may nevertheless be required to repay the full principal value of the bond in certain circumstances, even though the call option is only hedging the equity upside rather than the full principal amount of the bonds. The issuer of an equity neutral bond is also taking performance risk on its option counterparty (or counterparties) for the lifetime of the bond issue, and so if the option counterparty defaults the issuer remains liable to pay any equity upside under the bonds. The bond investor has no direct recourse to the option counterparty, but instead the issuer is expected to manage this risk.

Call Spread Overlays

A popular method of mitigating the dilutionary effect of a convertible bond, particularly in the U.S. and European markets, is to combine the convertible bond instrument with other equity derivative instruments, such as in a call-spread overlay. In summary, a call- spread overlay comprises a convertible bond issued in combination with a hedge purchased by the issuer from the

bank on its own stock and a European-style warrant sold to an affiliate of the underwriting bank on the company's shares.

The convertible bond is issued at a fixed conversion price, with the hedge transaction entitling the issuer to purchase from the bank a number of shares that are equal to the number of shares to be issued on conversion of the bonds, and at a price that is equal to the fixed conversion price in the convertible bonds. The settlement of the conversion can either be physical (delivery of conversion shares cash (delivery of the cash value of the conversion shares) or "net settled" (delivery of the cash value of the principal amount of the bonds, with the excess value of the conversion shares over the principal amount of the bonds delivered in conversion shares). The hedge transaction, documented as a call option under an ISDA confirmation, allows the company to completely offset the call option embedded in the bonds, and is exercised automatically every time that bondholders exercise their conversion rights under the bonds, with both the convertible bond and the hedge having identical maturity dates. The warrant gives the bank's affiliate the right to purchase the company's ordinary shares at a price materially higher than the conversion price of the bonds.

In combination, these transactions allow a company to mitigate the dilution of equity resulting from a conversion of the bonds and fix a conversion price lower than may otherwise have been the case (with the demand for the convertible bonds also placing downward pressure on the coupon). In addition, if the higher strike price of the warrants is reached, the company can use the proceeds paid out under the warrant to repurchase shares in the open market. the transaction price for the instrument will be its fair value. As convertible bonds comprise both a host debt instrument (an accounting liability) and embedded equity option, they are treated as "compound instruments" for purposes of IAS 39, which sets out specific rules for determining the fair value of the liability component of the instrument and, thereafter, the residual value of the equity component (after deducting the liability component from the fair value of the instrument as a whole). [12]

[12] IAS 39 (*Financial Instruments: Recognition and Measurement*) stipulates that, except where a financial instrument is quoted in an active market (such as a listed share), the transaction price for the instrument will be its fair value. As convertible bonds comprise both a host debt instrument (an accounting liability) and embedded equity option, they are treated as "compound instruments" for purposes of IAS 39, which sets out specific rules for determining the fair value of the liability component of the

U.S. FEDERAL SECURITIES LAW CONSIDERATIONS

As with any other debt or equity securities offering, equity-linked bonds are subject to the registration requirements of Section 5 of the United States Securities Act of 1933, as amended (the "**U.S. Securities Act**") where offered to U.S. investors, unless sold pursuant to an exemption from those registration requirements. As such, and most commonly, the offering of most equity-linked bonds from non-U.S. issuers are structured as unregistered securities pursuant to an exemption from the registration requirements of the U.S. Securities Act under the Regulation S "safe harbour" (i.e., offers made in offshore transactions outside of the United States), and less commonly, under the resale exemption provided by Rule 144A, which allows for offers and sales of unregistered securities (or private placements) to "qualified institutional buyers" (known as "**QIBs**") in resale transactions in the U.S.[13]

The vast majority of equity-linked bonds from Asia-Pacific based issuers are offered outside of the United States on a Regulation S only basis. This appears to be primarily because there is sufficient demand from specialist equity-linked investors who are outside of the United States to constitute a sufficiently sized market.

Nevertheless, Rule 144A remains an option for Asia-Pacific issuers of equity-linked securities if accessing a U.S. investor base is seen as key to the success of the overall offering. Where a Rule 144A resale is adopted, the following issues should be carefully considered:

Is the issuance of shares on conversion of the bonds a new offering subject to the registration requirements of the U.S. Securities Act?

In general, if convertible bonds are issued in a transaction exempt from registration (such as Rule 144A or Regulation D), any subsequent issuance of shares upon conversion of the bonds will not be considered a new offer and sale of securities for the purposes of Section 5 of the U.S. Securities Act, provided that the terms of conversion are fully disclosed, the right to convert is pre-set and automatic and that an appropriate conversion premium applies in order to avoid the fungibility issues prohibited by Rule 144A(d)(3)(i) under the U.S. Securities Act.

Fungibility and Rule 144A(d)(3)(i)

Rule 144A(d)(3)(i) provides that securities that are, on issuance, convertible into listed securities and that have a conversion premium at the time of issuance of less than 10% above the market value of the underlying listed securities, are not eligible for the exemption from U.S. Securities Act registration provided by Rule 144A. The purpose of this rule, commonly referred to as the "non-fungibility requirement", is to address concerns that a side-by-side public and private market would exist for the underlying

[13] QIBs tend to be large institutional investors, such as pension funds, mutual funds, banks and asset managers.

securities.[14] However, as the market has generally accepted conversion premia in excess of 10% over the prevailing market price of the underlying shares, this does not typically present an obstacle to a Rule 144A resale of equity-linked securities (particularly in the U.S. where Rule 144A resales of convertible debt are more common).

Further, many SEC-registered issuers who also seek to conduct a share repurchase contemporaneously with a convertible bond offering as part of an anti-dilution strategy will seek to use Rule 144A for their U.S. offerings of equity-linked securities in order to avoid the application of Regulation M, which is designed to prevent market manipulation and activities or conduct that may artificially influence the market for an offered security.

Legending and Rule 144

Where equity-linked bonds are sold under Rule 144A they become "restricted securities" for purposes of Rule 144 and will be required to bear the applicable legends. This legending will need to be removed after a fixed period of time (typically one year after issuance), and any failure by an issuer to do so will likely result in a requirement to pay additional interest on the bonds for so long as the failure is continuing or until the legend is removed. Rule 144 itself provides for an exemption from the registration requirements of the U.S. Securities Act for transactions in the equity-linked securities or underlying shares if at least one year has passed from the date that the bonds were acquired from the issuer or an affiliate of the issuer.[15]

[14] See SEC No Action Letter, *Contingent Convertible Securities* (March 28, 2019); SEC Release No. 33-6839 (July 1989).
[15] Rule 144(d)(3).

EQUITY-LINKED SUKUK

Sukuk is the Arabic name given to a financial certificate and its origins can be traced back to the Middle Ages where papers representing financial obligations originating from trade and other commercial activities were utilised within Muslim societies. Although *sukuk* are sometimes referred to as Islamic bonds because they essentially replicate interest bearing bonds in a *Shari'a* compliant manner, they are better described as an asset-based investment as the investors own an undivided interest in an underlying asset in proportion to their investment and as such take the risk in, and benefit derived from, the underlying asset. This ownership interest is evidenced by *sukuk* certificates held by the investors.

In simple terms, monies raised by the issue of *sukuk* certificates are used to invest in an underlying asset, a trust is declared over that asset as a result of which the certificate holders own a beneficial interest in that asset in proportion to their investment and are entitled to all of the benefits emanating from the asset including a proportion of the economic returns generated by that asset.

As with all Islamic financial transactions, *sukuk* are based on Islamic principles and jurisprudence (the *Shari'a*) which are derived from a number of sources, including the primary source of the *Qu'ran*. The basic Islamic principle is that money is not a commodity and, therefore, it is not possible to earn profit from its simple utilisation as it has no intrinsic value and is merely a means of exchange. Profit must be earned through trade and taking part in the risks of a transaction.

While a detailed analysis of different *sukuk* structures lies beyond the scope of this work, it is important to note that the bond component of equity-linked securities can – and has frequently – been structured as a *sukuk* with an embedded equity option (typically in the form of an exchangeable *sukuk* with essentially the same economic and legal features described herein), and with due regard for *Shari'a* principles.

As an example, any dividends received on the underlying shares are assessed by the issuer (in its capacity as an "asset manager") for impure income (e.g., income on interest bearing assets) which is then excluded from the underlying trust asset income or trust assets. In order to preserve the *Shari'a* compliant treatment of the *sukuk*, a cash amount equivalent to a proportion of that impure income is donated to a charity chosen at the discretion of the asset manager.

Accordingly, equity-linked *sukuk* remains a viable option for issuers who seek to access the benefits of the equity-linked markets, but to do so in a manner that preserves the compliance of their capital structure with *Shari'a* principles.

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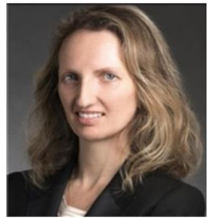

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