FSMA

FINANCIAL SERVICES AND MARKETS AUTHORITY

Communication

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Risks associated with issues of convertible bonds and equivalent equity lines by listed companies in need of financing

Summary/Objectives:

The FSMA has noted that listed companies in financial difficulty are increasingly issuing financial instruments that are convertible into shares in order to meet their financing needs. The holders of these instruments are mostly parties that do not intend to become shareholders of the company.

The FSMA wishes to draw the attention of investors to the risks associated with this form of financing. It also wishes to remind listed companies of their responsibilities when they issue such instruments, and lastly, to inform holders of such instruments of the applicable market rules.

1. What are the features of this form of financing?

It often consists of a company issuing convertible bonds to one or more financiers, whether or not in combination with the issue of subscription rights or warrants.

A convertible bond is a financial instrument with the same features as a regular bond[1], but the holder also has the right, during a given period and under certain conditions, to convert the bond into shares in the issuer rather than recovering the capital in cash. The value of the bond can be converted into shares in exchange for the payment of a conversion price that is agreed in advance between the financier and the issuer.

Convertible bonds are normally issued at a conversion premium over the market price at the time of issue. A company whose share price is € 22, for example, will issue a convertible bond with a conversion price of € 25 per share. If they issue a bond with a nominal value of € 100,000, the bondholder can exchange that bond for 4000 shares in that company.

However, it has emerged that there is also another use of such instruments by issuers in financial need that are unable to access other forms of financing (such as bank financing or the issue of shares or ordinary bonds). In such cases, they issue convertible bonds with a conversion price that may, for instance, be 10% lower than the market price at the time of conversion.

1 Bonds are financial instruments that represent a loan from the bondholders to the issuing company. Bonds are usually issued for a fixed period, at the end of which the amount borrowed by the company has to be repaid to the bondholders. In the meantime, the bondholders receive interest payments.

Applied to the example described above, the following scenarios may, for instance, occur at the time when the conversion becomes contractually possible:

	Scenario 1: **The share price rises by 25%**	**Scenario 2:** **The share price remains unchanged**	**Scenario 3:** **The share price falls by 25%**
Share price at the time of conversion	€ 27.78	€ 22.22	€ 16.67
Conversion price (market price with 10% discount)	€ 25	€ 20	€ 15
Number of shares issued	4000	5000	**6665**
Financial profit if share price is unchanged[2]	≅ € 11.00 (11% of the bond's face value)		

The lower the market price at the time of conversion, the greater the dilution for the existing shareholders.

This mechanism, by which new shares are issued at a price below market price, has become simpler since the entry into force of the Code on Companies and Associations (CCA) in 2020. Under the previous Code on Companies, a minimum issue price set by law had to be respected when issuing shares for which preferential rights were restricted or cancelled in cases where the issue was made to benefit one or more specific persons. In the old code, this mechanism could be used only where the beneficiaries were not previously known. The FSMA has noted that whereas before 2020, this mechanism was used only in transactions structured as accelerated book buildings (ABBs), that is no longer the case since 2020: since then, the mechanism has been used only for issues to specific persons. The FSMA has, moreover, observed that since 2020 such instruments have been used more frequently.

In addition to offering a discount on the market price upon conversion, the issuers of such financial instruments must for the most part also pay high fees to the financiers for their provision of financing (known as 'commitment fees').

Certain financiers, often investment funds, focus specifically on this sort of financial instrument with a view to immediately selling the shares acquired through conversion and in this way to treat the discount off the market price as a profit.

2 This would be the profit to the financier if he or she were to sell all the shares immediately at the same share price as the one in effect at the time of conversion. In reality, it would normally take a few days before the shares were listed and the financier could sell them on the stock market, during which time the market price could rise or fall.

2. What risks are associated with this type of financing?

For existing shareholders, the most significant risks of this type of financing are as follows:

- **Dilution**
  The conversion into shares often leads to a significant dilution of the existing shareholders' interest. Thus, the shares in a Belgian listed company were recently increased ninefold, which amounts to a dilution for the existing shareholders of around 90%. By way of illustration, after the dilution, shareholders who had held 10% of the shares in this company now owned only 1% of the company's shares.

  In addition, there is also a potentially significant financial dilution, given that the shares are issued below market price.

- **Pressure on prices**
  The issue of new shares at a price below market price, followed by an immediate sale of these shares on the market, will lead to significant negative pressure on the listed company's share price. On this matter, please see the study published by the French AMF (*Autorité des Mar*chés *Financiers*) of October 2022. For 57 of the 69 issuers covered by the study, the average fall in share price was 72%; 20 of them saw a fall in the share price of more than 90%.[3]

3. How do things stand with Belgian listed companies?

The FSMA has identified this type of financing at 9 companies under its supervision.

The main observations by the FSMA are:

- The majority of the issuers that use this sort of financing are biotech or medtech companies in financial difficulty.
- Parties who offer this type of financing are chiefly foreign investment funds that specialise in this type of transaction.
- Often, issuers issue these sorts of instruments by making use of the authorized capital, with prior authorization given by the general meeting to the board of directors to increase the capital.
- The financing is provided with a component that can be converted into shares, mostly by means of the issue of convertible bonds. Such bonds can often be converted into shares immediately after being issued, at the request of the financier.
- The terms and conditions for conversion provide that, in the event of conversion, shares will be issued to the holders of convertible securities with a discount on the market price[4] at the time of conversion. The discounts are usually around 5 to 8%, but higher discounts of around 20% have been observed.
- The goal of the transaction is mostly to provide financing. In such an operation the financiers, which may benefit from the conversion, thus rarely build up a share in the listed company in

[3] For more information on this topic: October 2022 – étude sur les financements dilutifs de type OCABSA ou equity lines

[4] This is often a discount on the lowest 1-day *Volume Weighted Average Price (VWAP)* over a period of around ten days before conversion.

which they invest. Only in a few cases was a transparency threshold crossed, and for the most part the share is quickly (i.e. a few days later) reduced again.

- The amount of the financing provided is often significant in comparison to the issuer's market capitalization. The financing provided is generally 30% of the market capitalization when the financing is granted. In a few cases, the financing in question is equal to the issuer's market capitalization at the time when a contract is entered into with the financier.
- For the most part, the issuer cannot draw down the entire agreed amount of financing in one stroke. Often, the contract between the issuer and the financier includes waiting periods that must be observed. The issuer then has the option to issue a certain number of convertible bonds once a month over one year. In such cases, the amount of financing in the contract is in fact a maximum amount that may not necessarily be drawn down in full.

4. What do investors have to look out for with this type of financing?

The FSMA recommends that investors take note of the information made available by the issuer. This information is available on the issuer's website, in the board of directors' report on the issuance, and in any accompanying press releases and, where applicable, in a listing prospectus.

What should you look out for?

- What **type of financier** is providing the financing? Does the financier plan to become a shareholder of the issuer (for example, is he or she in the same sector)? If the financier plans to sell shares directly on the stock market after conversion, the risk of pressure on the share price is greater.
- To what extent can existing shareholders' interest be **diluted**? The lower the market price at the time of conversion, the greater the dilution. The market price used by the issuer in its scenarios to estimate the potential dilution may provide insight here. According to the above-mentioned study by the AMF of France, a 70% decrease in the market price is not unusual.
- What is the **conversion price** at which the holders can convert their bonds into shares? The higher the discount off the market price, the higher the potential negative impact on the market price.
- What is the **amount of the financing** as compared to the issuer's market capitalization? A more sizeable financing may be expected to have a sharper impact on the market price, assuming that the company can use the full amount of the financing.
- Does the contract contain **covenants** between the financier and the issuer? Sometimes, for example, a condition is included in the contract concerning the minimum volume of shares in the issuer that must be traded on the stock market. Another condition that is sometimes included is that the price may not be suspended. If these conditions are not met, the issuer runs the risk of being unable to draw down the rest of the financing.
- **When** can the issuer **draw down** the financing amount? Can he or she draw down the entire amount of the financing in one stroke (one-time issue of convertible bonds for the entire amount of the financing)? Or does he or she have to draw it down in tranches, spread over a specified period (various issues of a limited number of convertible bonds, in each case with a waiting period between them, during a predetermined period)?

- In the latter case, the amount of the financing included in the contract between the issuer and the financier is in fact a maximum amount. In practice, it may be that the issuer cannot or does not wish to draw down the entire financing amount, for example because not all covenants in the contract between the issuer and the financier have been fulfilled. There is a risk that the issuer may be unable to use the full amount of the financing.
- In the latter case, the financier will acquire convertible bonds at several different points. If he or she converts these bonds into shares and then sells the shares on the stock market, this will cause downward pressure on the share price. Such pressure may well last throughout the financing period.

Companies may issue these sorts of instruments by making use of the **authorized capital**, with prior authorization being given by the general meeting to the board of directors to increase the capital. Shareholders are advised to be critical if such authorizations are put on the agenda of the general meeting.

5. What should listed companies look out for?

Responsibility
The FSMA asks listed companies and their directors to think carefully before they issue these sorts of instruments and to be aware of the responsibility they are assuming by doing so.

Inside information
The FSMA also reminds companies of the obligation to inform the market in a timely and correct manner, with particular attention to the publication of any inside information that may arise as soon as possible.

Information
The FSMA also reminds listed companies that when issuing convertible bonds to specific persons, whether or not using authorized capital, their board of directors must draw up a report. This report explains the transaction and the issue price, with particular attention to the company's financial situation, the identity of the holders and the nature and amount of their contribution.

The report must therefore contain the following elements, according to the FSMA:
- a clear description of the terms and conditions of the agreement;
- the illustration of the total potential dilution for shareholders according to various scenarios;
- an explanation of the objective sought by the financier in question.

Compliance with the transparency legislation
If a financier undertakes several conversions within a short period, this will lead over that time period to as many changes in the total number of voting rights in the company. Because that number, i.e. the denominator, is necessary in order to be able to make correct transparency notifications, the FSMA urges companies in this situation to publish a change in denominator in good time, i.e. after every share issue, and not to wait until the end of the month to do so. If this is not possible, the FSMA asks that it be informed of the new denominator after each issue, so that it may update the TR-1 BE notification form.

Potential prospectus obligation
Issuers also have to take into account the obligation to publish a prospectus, including where the threshold of 20% as provided for in Article 1(5)(a) of Regulation (EU)2017/1129, can no longer be used. If that threshold is exceeded, the issuer must draw up a listing prospectus and submit it for approval, taking into account all the information requirements that apply.

6. What do financiers have to look out for?

Market manipulation
The providers of financing in the form of convertible bonds or in other forms with equivalent characteristics must be aware that if they sell the shares they acquire, they may not carry out any activities or engage in any behaviour that could be considered market manipulation.

At the time of conversion, the holders usually acquire a large number of shares. If they then wish to sell those shares quickly on the stock market, this will exert downward pressure on the price. At that point, there is a risk of market manipulation, in particular if the financier has a financial interest in impacting the price or the traded volume of the share (for example, on the basis of the terms and conditions of the contract).

In order to determine whether there has been market manipulation, one relevant indicator is the extent to which the sales carried out constitute a significant portion of the daily volume of transactions in the share. The extent to which the sales lead to significant changes in the share price is also taken into account.

Inside information
Moreover, it should be remembered that no one is permitted to trade with inside information. That is, inside information may arise at the point when the parties in question are in negotiations about the financing contract they wish to enter into.

Reporting obligation: net short positions and major shareholdings
In conclusion, the FSMA reminds the parties concerned of the obligation to report both any net short positions and major shareholdings. This information ensures that other investors have a comprehensive view of the shareholding that the financier may or may not have built up in the listed company, to ensure that those other investors are not misled.