MAYER | BROWN

Convertible Bonds

An Issuer's Guide

Contents

If you have any questions about convertible bond offerings, please contact any of the listed partners from our capital markets practice listed on page 50 of this guide.

Introduction

What are convertible bonds?

Convertible bonds are, customarily, fixed rate debt instruments issued by a company (the "issuer"), the terms of which allow the holders of the bonds to convert them into ordinary shares (common stock) of the company at a prescribed conversion price and during a prescribed conversion period.

Convertible bonds may be seen as a combination of two separate financial instruments – namely:

- a fixed rate bond, and
- an embedded equity call option.

This combination of features provides investors in convertible bonds with certain distinct advantages over a similar investment in plain vanilla bonds or the ordinary shares of the company. In very general terms, convertible bonds are capable of offering investors equity upside potential in the ordinary shares of the relevant company as a result of the equity call option and, at the same time, capped downside risk as a result of the fixed rate bond's periodic coupon payments and the ultimate return of principal on the final maturity date. This equity upside potential and capped downside risk is often termed "Optionality" by convertible bond practitioners.

Convertible debt allows companies to minimize interest expense and dilution.

Bond	+	Call Option	=	Convertible Bond
Issuer agrees to... • Pay periodic cash coupons • Repay principal in cash at maturity		**Issuer agrees to...** • Sell an embedded call option struck at a fixed price set at a premium to the stock price when the bond is issued		**Result...** • Debt security with lower coupon cost relative to straight debt • Ability to issue common stock at a premium to minimize dilution • Principal amount issued must be repaid in cash at maturity if not converted
Straight Debt Cost = X (Example: 7.50%)		**Option Value = Y (Example: 5.00%)**		**Convertible Coupon = X – Y (7.50% - 5.00% = 2.50%)**

What are some reasons for and against issuing converts?

In deciding whether or not to issue convertible bonds, a company should examine its rationale and objectives for the planned capital raise as well as other related considerations.

ADVANTAGES	DISADVANTAGES
• Unsecured debt	• Classified as long-term debt on the balance sheet
• No incurrence or maintenance covenants	• Periodic cash interest payments
• Lower coupon cost relative to straight (non-convertible) debt	• Principal amount must be repaid in cash if not converted prior to maturity
• Ability to issue equity at a premium	• Potential for share dilution upon conversion
• Maxed out on senior leverage	• IFRS/GAAP accounting
• Lack of rating prohibits access to the high-yield market	• No increase in the public share float/ liquidity prior to conversion
• "All-in" cost of capital including purchase of the derivative compares favorably to high-yield debt	• Limited or no equity credit provided by credit rating agencies (mandatory convertible preferred is an exception)
• Sizing and structure provide more flexibility than other debt alternatives	
• Time to market/management marketing commitment is minimal	
• Fixed coupon rate eliminates interest rate risk	
• Settlement flexibility and conversion premium minimizes dilution, plus, the option to "buy up" premium and minimize dilution via derivative purchase or other dilution mitigation options	
• Typically structured with issuer call option after 3 or 4 years to place "ceiling" on dilution	
• Commonly issued via Rule 144A (no prospectus filing with the US Securities and Exchange Commission (SEC)) or pursuant to Regulation S only	
• Broadens long-term investor base (long only convertible investors, income funds, sector buyers, arbitrage investors)	

Advantages and disadvantages of convertible bonds from investor's perspective

There are a number of benefits for investors in convertible bonds. There are, of course, downsides also to consider.

	ADVANTAGES	DISADVANTAGES
Investor	• Bonds continue to provide a fixed rate of income for investors through the coupon, and a protected return of principal on their final maturity date, irrespective of the performance of the ordinary shares of the company • If company were to become insolvent or be liquidated, an investment in convertible bonds would have equal ranking with the company's unsecured debt and rank ahead of an investment in the ordinary shares of the company in insolvency proceedings • Investor has upside potential in the performance of the ordinary shares of the company, as its option to convert its holding of the bonds into ordinary shares is set at a fixed conversion price, and the holder of the bonds therefore benefits from any increase in the market value of the ordinary shares above that fixed conversion price	• If ordinary shares of the company do not perform, the investor will have achieved a poor return on its investment (represented by the lower coupon payable on convertible bonds as against the coupon payable on plain vanilla bonds of a similar credit) as at the final maturity date; opportunity cost may be partially offset by gains made by shorting the ordinary shares • Value of convertible bonds can be eroded by corporate actions taken by the company or negative events which occur in the life of its business; it is not possible to protect the investor from all events which might erode the value of their convertible bonds, even though certain customary protections are contained in the terms of convertible bonds

What are examples of convertible bond structures available to companies?

While "plain vanilla" convertible debt is the most popular security of choice, companies may also have access to structured solutions and convertible preferred options. In this Guide, we will focus on plain vanilla convertible bonds that are publicly marketed to a large group of investors, or what we refer to as "public convertible notes" from time to time herein.

	TYPICAL CHARACTERISTICS
Plain Vanilla Convertible Debt	• Senior unsecured • No financial covenants • Cash coupon below comparable maturity non-convertible debt • Conversion price set at a premium to market (option to buy-up premium via "call spread" or "capped calls") • 3–7-year maturities; 5 years most common • Flexible settlement upon conversion (cash or shares) to minimize dilution • Issued as private placement via Rule 144A and marketed publicly to Qualified Institutional Buyers ("QIBs") or on a Regulation S basis only
Structured Convertibles	• Similar to plain vanilla convertible debt • 3–5 year maturities • Likely to contain conditions and structural features that enhance investor protections, for example, certain restrictive covenants, conversion price reset, secured vs. unsecured, etc.
True Private Placement Convertible Debt	• Highly structured agented private placement • Structure and terms determined by investors through a competitive process • Typically placed with small group of investors including dedicated convertible, fixed-income crossover funds, and/or private capital providers
Plain Vanilla or Debt-backed Mandatory Preferred Securities	• Equity substitute • Cumulative dividends higher than convertible debt • 3-year automatic conversion into shares

How are convertible bonds priced and how do they convert into ordinary shares?

There are many technical methods of valuing convertible bonds (and, in particular, of pricing the embedded equity call option) and it is beyond the scope of this Guide to explore pricing methodologies in detail. Pricing consists of two elements – the initial conversion price and the coupon. In the UK, the initial conversion price of a convertible bond is, customarily, based on the sum of (a) the volume weighted average price of the ordinary shares of the company ("VWAP") between announcement of the offering ("Launch") and either: (i) the pricing of the convertible bonds ("Pricing") or (ii) the close of the trading day on the venue on which the ordinary shares of the company trade and (b) a conversion premium thereto (the "Conversion Premium"). In the US, the initial conversion price is customarily based on the sum of the last reported sales price of the common shares on the day of Pricing on the principal US national securities exchange on which the common shares of the company trade and a Conversion Premium.

The correlation between the coupon payable on a convertible bond and the Conversion Premium is important. In summary, investors will expect to receive a correspondingly higher coupon on a convertible bond if the Conversion Premium is set at the higher end of its pricing range. Investors will, in these circumstances, expect to have to wait a longer period before the market price of the ordinary shares of the company exceeds the conversion price of their bonds, at which point it becomes economically viable for the bondholders to convert. Investors will, accordingly, treat convertible bonds with a high Conversion Premium as more "debt-like" and require, as a result, a coupon more in line with that payable on a plain vanilla bond of a similar credit. Alternatively, if the Conversion Premium is set at the lower end of its pricing range, it is likely that investors will be amenable to a correspondingly lower coupon on the instrument.

Remember that the Conversion Premium reflects the value of the embedded equity call option in the convertible bond. The value of the convertible bonds is also comprised, however, of (i) the value of the bonds themselves (represented by the discounted value of the coupons and their redemption price and known as the "Bond Floor") and (ii) the value of the ordinary shares of the company underlying the convertible bonds from time to time (and known as "Parity"). These features will be discussed in more detail later on in this Guide.

Conversion price and conversion rate

Conversion Price = amount (e.g., in dollars, euros or another currency) needed to receive one ordinary share upon conversion; effective price paid per underlying ordinary share

Conversion Rate = number of shares into which a specified amount of bonds is convertible

Example:

- Reference price: $20 per share
- Initial Conversion Price at e.g., 25% premium over reference = $25 per share
- Initial Conversion Rate = $1,000 principal amount of notes divided by conversion price
  - = $1,000 divided by $25 per share = 40 shares per $1,000 principal amount of bonds

When can holders convert their convertible bonds and how does the Company settle its conversion obligation?

The terms of the convertible bonds will specify the periods during the life of the bonds and the conditions, if any, that would enable holders to convert their bonds. At the same time, the terms will also specify the manner and periods by and during which the Company can satisfy its conversion obligation and the form of conversion consideration to be delivered to the holders.

Typically, US public convertible bonds are convertible at the option of holders upon the satisfaction of specified conditions or triggers and during certain periods. For example, a holder may convert if the last reported sale price of the Company's common stock for at least 20 trading days during a 30-consecutive trading day period that ends on the preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day. This is commonly referred to as a "Common Stock Sale Price Condition". A holder may also convert during the five business day period after any 10 consecutive trading day measurement period in which the trading price per $1,000 principal amount of its convertible bonds for each trading day of the measurement period was less than 98% of the product of the last reported sale price of the common stock and the conversion rate on each such trading day. This is commonly referred to as a "Note Trading Price Condition." A holder may also convert upon the occurrence of certain specified corporate events, such as certain significant distributions to all or substantially all holders of common stock, redemptions, or the happening of a "fundamental change" or "make-whole fundamental change."

Conversely, the typical terms of US public convertible bonds would specify the settlement method for conversion. For instance, the issuer may choose to settle its conversion obligation in the form of all shares (physical settlement), all cash (cash settlement), or a combination of shares and cash (combination settlement). In a form of combination settlement called "net share settlement," a company would settle its conversion obligation by paying the principal amount of convertible bonds in the form of cash, and by delivering the conversion premium in excess thereof in the form of shares and/or cash.

Credit and Equity Protection in European Transactions

What protections do investors expect in the terms of convertible bonds in European transactions?

(A) Credit Protection

The convertible bond market in Europe has, conventionally, been a senior, unsecured bond market which has followed the terms of plain vanilla senior, unsecured Eurobonds in respect of the fundamental credit protections expected by investors. This might, at first, sound counterintuitive, given many of the companies which issue convertible bonds are "crossover credits" or non-investment grade companies. It is, however, a combination of the embedded equity call option and the types of investors in this asset class (and, in particular, hedge funds which hedge their credit exposure) which mitigates any related concerns as to the nature of the bonds' limited credit protections. Whilst the terms of each issue of convertible bonds will vary, it would be customary to find few (if any) covenants in their terms, other than a negative pledge and a series of events of default.

(i) **Negative Pledge:** An example of the negative pledge which might appear in the terms of a convertible bond is set out on page 43 of this guide (a "Eurobond Negative Pledge"). In summary, a Eurobond Negative Pledge is by no means as restrictive as an "all monies" negative pledge customarily found in credit facilities. A Eurobond Negative Pledge seeks only to protect the marketability of the convertible bonds in the secondary markets by ensuring that, should the company (or, if agreed, all or some only of its subsidiary companies) seek to issue in the future a secured bond or other form of secured indebtedness which is capable of being listed or traded on the same or similar markets to the convertible bond, the holders of the convertible bonds will be entitled to the same or a similar security package.

Despite the inherent limitations of a Eurobond Negative Pledge, the company may wish to restrict its scope to only the company itself, or a defined number of principal subsidiaries. The company may also consider tailored exceptions (including for exempt pre-existing financing arrangements).

Any such exceptions would, of course, need to be discussed in detail with the relevant underwriting banks to assess their effect on the pricing and marketability of the convertible bonds.

(ii) **Events of Default:** The events of default set out in the terms of a convertible bond will reflect the credit quality of the relevant company and will be broadly aligned with the events of default set out in the terms of other Eurobonds (if any) issued by the relevant company (or similar to the events of default of other companies of similar credit standing and industry), including, amongst others, default on failure to pay, cross acceleration, and insolvency. The related grace periods and other carve-outs to the Events of Default which benefit the relevant company will also closely track similar mitigation provisions found in the terms of other Eurobonds or, if no such Eurobonds have been issued, will be specifically structured to meet the company's business needs. A summary example of a customary package of events of default found in the terms and conditions of a convertible bond are set out on pages 44–45 of this guide.

(B) Protecting the Equity Call Option's Value

As mentioned earlier in this Guide, investors in convertible bonds forego a higher coupon for the benefit of an equity call option. The investors have bought this equity call option, however, with a conversion price which is set at a premium to the market price of the ordinary shares of the company. If the value of the equity call option is negatively affected by actions taken by, or events in the life of, the company, then investors will require compensation by an effective return of their Conversion Premium.

This "plays out" in practice in the terms of convertible bonds by a downward adjustment to the bonds' conversion price. As the number of ordinary shares deliverable on the exercise of conversion rights by a bondholder is determined by dividing:

(i) the principal amount of each convertible bond by

(ii) the conversion price of the bond in effect immediately prior to its exercise,

the reduction in the denominator in (ii) yields for an investor, on conversion, a greater number of ordinary shares per bond – thus compensating the investor for loss of value in the equity call option purchased by it at a premium at pricing. This compensation by means of anti-dilution provisions in the terms of convertible bonds (also known as "E") is best seen in a series of examples:

1. Mechanical Adjustments

Easiest perhaps to understand are mechanical adjustment provisions, which are triggered when the company takes corporate actions which have a "mechanical effect" on the price of an ordinary share. Let's say, for example, the market price of a company's ordinary share is 10 pence and, at pricing, the conversion price of its convertible bonds is set at 12 pence (i.e., at a 20% Conversion Premium). Assuming the market value of the company is stable, if the company later decides to subdivide its ordinary shares of 10 pence by undertaking a "stock split" at a ratio of 1:2, each existing ordinary share of 10 pence will now be worth 5 pence only and the conversion price of 12 pence will also need adjusting (halving) to protect Parity.

Summary of Formula:

If and whenever there shall be a subdivision affecting the number of Ordinary Shares, the Conversion Price shall be adjusted by multiplying the Conversion Price in force immediately prior to such subdivision by the following fraction:

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

where:

A *is the aggregate number of Ordinary Shares in issue immediately before such subdivision; and*

B *is the aggregate number of Ordinary Shares in issue immediately after, and as a result of, such subdivision.*

Other examples of mechanical Adjustment Provisions in the terms of convertible bonds include consolidation and reclassification of the company's ordinary shares and the issue of bonus shares by the company by means of capitalisation of reserves.

2. Parity Adjustments

In addition to corporate actions of the company which result in mechanical adjustments to the conversion price, a company may negatively affect Parity by distributing cash and non-cash assets of the company to existing shareholders and/or issuing further securities to other persons at an undervalue.

The company may, for example, make a rights issue of ordinary shares (i.e., a new issue of ordinary shares to shareholders pro rata) or options, in each case, below the current market price of the ordinary shares (as is almost invariably the case in order to encourage shareholders to subscribe the rights).

As a result, the market price of the ordinary shares and, accordingly, Parity, will drop, because the company has not received full value for the rights. However, the holders of convertible bonds will have not been able to participate in the rights issue, unlike the existing shareholders of the company. The conversion price of the convertible bonds is, accordingly, adjusted downwards to compensate bondholders, by reference to the value of the rights that are given to shareholders.

Summary of Formula:
If and whenever the Issuer shall issue Ordinary Shares to Shareholders as a class by way of rights at a price per Ordinary Share which is less than 95% of the Current Market Price per Ordinary Share on the Effective Date, the Conversion Price shall be adjusted by multiplying the Conversion Price in force immediately prior to the Effective Date by the following fraction:

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

where:

A *is the number of Ordinary Shares in issue on the Effective Date;*

B *is the number of Ordinary Shares which the aggregate consideration (if any) receivable for the Ordinary Shares issued by way of rights would purchase at such Current Market Price per Ordinary Share; and*

C *is the number of Ordinary Shares to be issued.*

Other examples of Adjustment Provisions relating to Parity relate to the making of non-cash distributions, spin-offs, share buy-backs at a premium, and the payment of cash dividends. A separate section on "Dividend Adjustments" is set out below in this Guide.

3. Optionality Adjustments

Optionality and time value: As described above, a key feature of a convertible bond is Optionality. To recap, Optionality is the value attributable to the capped downside risk provided by the Bond Floor and the equity upside potential provided by the embedded equity call option. Just like any other option, the embedded equity call option's "time value" diminishes over the tenor of a convertible bond. As the conversion price is set at a premium to the market price of the ordinary shares at Pricing (when the embedded equity call option is said to be "out of the money") and a bondholder will only convert its bonds from a point in time at which its conversion price is lower than the market price of the ordinary shares (when the embedded equity call option is said to be "in the money"), the closer the bond moves towards its final maturity date with the embedded equity call option "out of the money", the less time value can be attributed to the embedded equity call option.

Optionality and volatility: Let's say, however, that the embedded equity call option is "in the money". This will have happened, of course, because the price of the company's ordinary shares has appreciated. So the attractiveness of a convertible bond depends on volatility of share prices and, in particular, the price of the ordinary shares underlying the relevant bond. Take away this volatility, and the embedded equity call option can become worthless, so Optionality is protected by means of Adjustment Provisions.

Cash takeovers represent the most obvious choice to highlight the above, as cash has little or no volatility. Delisting of the ordinary shares underlying the bonds (which results in a material drop in their liquidity) might also serve as an example of an event that would remove, in whole or in part, the volatility in the ordinary shares. In each case, the Optionality in the bonds is materially reduced and a downward adjustment to the conversion price of the bonds is effected by means of Adjustment Provisions to return, in whole or in part, Conversion Premium to bondholders.

The downward adjustment to the conversion price of the bonds is more significant the further the bonds are from their final maturity date, as the embedded equity call option retains greater time value.

The nearer the bonds are to their final maturity date, the smaller the downward adjustment to the conversion price of the bonds on the occurrence of the above events, as the embedded equity call option retains less time value and less Conversion Premium needs to be returned to bondholders. To ensure the right compensations for bondholders at any time, protection of the time value of the embedded equity call option is customarily effected by straight line amortisation of the Conversion Premium, which can be provided for in the terms of the bonds by a "Ratchet Table" or by means of formula.

For example, a convertible bond with the following economics:

Ordinary Share Price at Pricing: EUR 10.1716 per share

Initial Conversion Price of Bonds: EUR 13.9859 (37.5% premium to reference price)

Issue Date: 28 August 2024

Final Maturity Date: 28 August 2027

CONVERSION DATE	CONVERSION PRICE (EUR)
On or before 28 August 2024	10.17
Thereafter, but on or before 28 August 2025	10.72
Thereafter, but on or before 28 August 2026	11.26
Thereafter, but on or before 28 August 2027	11.81
Thereafter, but on or before 28 August 2028	12.35
Thereafter, but on or before 28 August 2029	12.90
Thereafter and until the Final Maturity Date	13.44

If a cash takeover occurs on or before 28 August 2024, then the initial conversion price of the bonds is adjusted downwards to equal the price of the ordinary shares of the company at Pricing – so the Conversion Premium is returned to the bondholders in full, reflecting the significant time value of the embedded equity call option at this early stage in the tenor of the bonds. If we then take a similar occurrence of a cash takeover in the last year of the bonds' tenor, you will see that the adjustment to the conversion price of the bonds is much less significant, as the embedded equity call option's "time value" has, broadly, run its course by this time. This straight line amortisation of the Conversion Premium can be, and is frequently represented by, a formula in the terms of convertible bonds.

For example:

"*If a Change of Control shall occur, then upon any exercise of Conversion Rights where the Conversion Date falls during the Change of Control Period, the Conversion Price (the "Change of Control Conversion Price") shall be determined as set out below:*

$$\frac{\mathrm{NCP} = [RP \; x \; (N - n)] + [(OCP \; x \; n)]}{N}$$

where:

NCP *is the new Conversion Price;*

RP *is, customarily, VWAP between Launch and Pricing;*

OCP *is the current Conversion Price on the relevant Conversion Date;*

N *is the number of days from (and including) the Closing Date to (but excluding) the Final Maturity Date; and*

n *is the number of days from (and including) the Closing Date to (but excluding) the date of the Change of Control"*

or

"If a Change of Control shall occur, then upon any exercise of Conversion Rights where the Conversion Date falls during the Change of Control Period, the Conversion Price (the "Change of Control Conversion Price") shall be determined as set out below:

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

where:

COCCP *is the Change of Control Conversion Price;*

OCP *is 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 the Change of Control occurs to but excluding the Final Maturity Date; and*

t *is the number of days from and including the Closing Date to but excluding the Final Maturity Date."*

4. Dividend Adjustments

Investors will, in their assessment of a company's convertible bonds, almost certainly focus on the dividend yield of the company's ordinary shares which they will forgo, until conversion, if they choose to invest in the company's convertible bonds instead of its ordinary shares. If a company has, historically, paid regular ordinary dividends to shareholders, then investors may assess the time period for them to "break even" on their investment in the convertible bonds by comparing the convertible bonds' yield against their fair estimate of the company's ordinary dividend yield. Investors may "price" their investment in the convertible bonds against this backdrop, and will, in these circumstances, be prepared to forego ordinary dividends without any consequential adjustment to the conversion price – in other words, investors may be willing to give the company a certain level of "dividend credit" in respect of ordinary dividends, but will continue to expect that "extraordinary dividends" will lead to a conversion price adjustment.

If, however, a company has never paid a dividend previously, investors will price their investment in the convertible bonds on this basis, and may expect any dividend to result in an adjustment to the conversion price – such a position is often referred to as "full dividend protection".

These different outcomes are replicated in the terms of convertible bonds as follows:

(i) Full Dividend Protection:

"If and whenever the Issuer shall pay or make any Dividend to the Shareholders, the Conversion Price shall be adjusted by multiplying the Conversion Price in force immediately prior to the Effective Date by the following fraction:

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

where:

A *is the Current Market Price of one Ordinary Share on the Effective Date; and*

B *is the portion of the Fair Market Value of the aggregate Dividend attributable to one Ordinary Share, with such portion being determined by dividing the Fair Market Value of the aggregate Dividend by the number of Ordinary Shares entitled to receive the relevant Dividend."*

In effect, the value of any dividend is given in full to holders of the convertible bonds on conversion by means of a consequential downward adjustment to the conversion price.

(ii) Dividend Credit:

As mentioned above, a company may regularly make or pay cash or non-cash dividends and may have in place a progressive dividend policy. Investors in the company's convertible bonds will, accordingly, be in a position to "price" such ordinary dividends into their assessment of the value of the convertible bonds. The investors will not, however, be able to plan for extraordinary dividends which exceed a particular monetary or yield threshold in a particular year. In such circumstances, the terms of the convertible bonds may grant to the company a certain degree of "dividend credit" for ordinary cash dividends (the making of non-cash dividends by companies are rarer, in general, and are normally adjusted for in full), so that the Adjustment Provision is not triggered below the relevant monetary or yield threshold attributable to a particular fiscal period. This is customarily reflected in the terms of convertible bonds in a formula, with "C" reflecting the dividend credit aspect of the formula:

"If and whenever the Issuer shall pay any Extraordinary Dividend to the Shareholders, the Conversion Price shall be adjusted by multiplying the Conversion Price in force immediately prior to the Effective Date by the following fraction:

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

where:

A *is the Current Market Price of one Ordinary Share on the Effective Date;*

B *is the portion of the Fair Market Value of the aggregate Extraordinary Dividend attributable to one Ordinary Share, with such portion being determined by dividing the Fair Market Value of the aggregate Extraordinary Dividend by the number of Ordinary Shares entitled to receive the relevant Dividend; and*

C *is the amount (if any) by which the Threshold Amount in respect of the Relevant Year exceeds an amount equal to the aggregate of the Fair Market Values of any previous Cash Dividends per Ordinary Share paid or made in such Relevant Year (where C shall be zero if such previous Cash Dividends per Ordinary Share are equal to, or exceed, the Threshold Amount in respect of such Relevant Year). For the avoidance of doubt "C" shall equal the Threshold Amount in respect of the Relevant Year where no previous Cash Dividends per Ordinary Share have been paid or made in such Relevant Year."*

Worthy of note is, in addition, the definition of dividend, which will be widely construed to capture any dividend or distribution to shareholders whether of cash, assets, or other property (including spin-off securities and share buy-backs at a premium).

5. Undertakings (Covenants)

The terms of a convertible bond will also include certain positive and negative (restrictive) covenants. These covenants are included in the terms of convertible bonds to enhance the Adjustment Provisions by requiring the company to take certain positive actions or prohibit the company from taking certain negative actions if the relevant act/omission could adversely impact the market price of the company's shares and is not capable of being compensated for by an adjustment to the conversion price. The covenants are, therefore, mutually exclusive with the Adjustment Provisions. Typical examples (though the undertakings themselves are somewhat extensive) of such covenants are as follows:

Summary examples of positive covenants:

- The company must maintain sufficient authorised but unissued share capital to be able to deliver shares on conversion of the bonds at any time.
- The company must maintain the listing of its shares and list any new shares issued on conversion of the bonds.

Summary examples of negative undertakings:

- The company must not undertake a bonus issue of its shares, share capital reduction, or other transaction affecting share capital absent a corresponding adjustment to the conversion price.
- The company must not modify the economic and voting rights attached to its shares.

Credit and Equity Protection in US Transactions

What protections do investors expect in the terms of convertible bonds in US transactions?

(A) Credit Protection

In the US, public convertible bonds do not generally include restrictive or negative covenants that are typically included in high-yield straight debt issuances, nor any maintenance or financial covenants that are typically included in secured credit agreements. Hence, unlike Eurobonds, it would not be common to see a negative pledge covenant in the terms of a typical US public convertible bond. Quite often, however, a merger covenant would be included in the terms of public convertible bonds, which would allow the merger of the issuer with or into a successor company, as long as the successor is incorporated in the US or another specified jurisdiction and assumes the issuer's obligations under the bonds, and no event of default has occurred or will occur under the indenture as a result of the merger. The terms of a convertible bond will also typically include certain positive undertakings or covenants, including the issuer's obligations to pay not only interest and principal due, but also any other amounts due with respect to the bonds (such as any repurchase price, redemption price, or conversion consideration, as applicable), to preserve and maintain its corporate existence and to provide periodic indenture compliance and no default certificates to the trustee for the benefit of the bondholders.

Events of default typically include the issuer's failure to pay interest, principal, or other amounts due on the bonds, failure to comply with its obligation to convert the bonds upon a bondholder's exercise, failure to send required notices such as those in connection with a fundamental change, make-whole fundamental change or specified corporate events, in each case, with any applicable grace or cure periods, the cross-default or cross-acceleration of the issuer's other principal corporate debt meeting specified trigger thresholds, and customary bankruptcy events. A summary example of a customary package of events of default found in the terms and conditions of a US public convertible bond are set out on pages 46–47 of this guide.

(B) Protecting the Equity Call Option's Value

As mentioned earlier in this Guide, investors in convertible bonds seek to protect the value of the embedded equity call option and to preserve the Optionality and time value of the instrument. Hence, Adjustment Provisions in the terms of public convertible bonds are in place to compensate investors for certain actions taken by, or events in the life of, the company that would negatively affect the value of the equity call option.

In the US, the initial Conversion Rate of public convertible bonds is adjusted pursuant to the terms of the instrument, in order to mitigate dilution, compensate bondholders for distributions of value to others and, in the case of certain specified material, fundamental events, to make investors "whole." In addition, the occurrence of a fundamental change also give holders a customary put right, enabling them to require the company to repurchase their bonds in cash on account of the fundamental change. We discuss these protections and related features in more detail below.

What corporate events during the life of the convertible bonds typically result in adjustments to the initial or existing Conversion Rate?

The initial Conversion Rate is adjusted (and hence the conversion price too) as a result of specified corporate events that may occur during life of the convertible bonds. The terms of the convertible bonds will typically provide adjustment formulas for these events, where the initial or existing conversion rate is correspondingly increased or decreased, in order to preserve and protect as much as possible the holders' initial investment. Conversion Rate adjustments can be broadly categorized into three buckets: (1) anti-dilution adjustments, (2) value transfer adjustments, and (3) make-whole adjustments.

Anti-dilution adjustments seek to proportionally adjust the number of shares underlying the convertible bonds held by a holder, where as a result of certain corporate actions such as stock splits, reverse stock splits, stock dividends, or stock combinations, such holder's underlying shares are reduced or its original beneficial ownership becomes diluted. For example, a two-for-one stock split will result in an adjustment, effectively doubling the conversion rate. Value transfer adjustments are adjustments to the initial conversion rate designed to compensate bondholders for distributions by the issuer of value to others, such as cash dividends, issuance of rights and warrants, certain other in-kind distributions to holders of the issuer's common stock, spin offs, and issuer self-tenders. Make-whole adjustments, in turn, entitle holders of convertible bonds to a "make-whole" payment in connection with a fundamental change transaction that results in the early termination or significant loss of the embedded call option value in the instrument. Typically, holders will be entitled to an additional number of shares upon conversion of the bonds, to compensate them for this lost option value. For example, if the issuer is being acquired by another entity in all cash merger, this transaction would constitute a "fundamental change," that would have the effect of exchanging all of the issuer's common stock for cash, and would thus effectively terminate the embedded call option in the convertible bonds. In such a case, make-whole adjustments will be made to the conversion rate, such that holders will be entitled to receive an increased number of conversion shares, which the issuer may then choose to settle by paying cash.

What is a fundamental change?

Convertible bonds typically have "fundamental change" and "make-whole fundamental change" provisions. Events that typically qualify as a fundamental change in US public convertible bonds include: (1) a person or group acquires more than 50% of issuer's voting common stock unless at least 90% consideration received by shareholders in the transaction is in the form of common stock listed on a major US securities exchange, (2) sale of all or substantially all of issuer's assets to any person unless at least 90% consideration received by shareholders in the transaction is in the form of common stock listed on a major US securities exchange, (3) consolidation, merger, or transaction resulting in all of issuer's stock being exchanged or converted into securities, cash, or other property and there is a change in control, (4) stockholder approve plan for the issuer's liquidation or dissolution, or (5) delisting of issuer's common stock from US securities exchanges.

What is a fundamental change repurchase right?

The occurrence of a fundamental change gives bondholders a put right. Holders can require the issuer to repurchase their convertible bonds, typically, for cash, at a repurchase price equal to 100% principal amount of the convertible bonds, plus accrued and unpaid interest up to the repurchase date.

What is a make-whole fundamental change?

For US public convertible bond indentures, the term “make-whole fundamental change” is generally defined to include a “fundamental change.” Hence, almost always, a “fundamental change” is also a “make-whole fundamental change” under the indenture, that entitles a bondholder to convert the bonds at a higher adjusted conversion rate based on the make-whole table set forth in the indenture. In addition, in a number of such indentures, the sending by the issuer of an optional redemption notice for the convertible bonds will also be considered a make-whole fundamental change. This is consistent with the overall nature of these make-whole adjustments as they are designed to compensate the holder for events that effectively result in the early termination or significant loss of the embedded call option value in the instrument.

In the case of a make-whole fundamental change then, the bondholder has the option to either (1) exercise the put (and require the issuer to pay cash at the principal amount of notes), or alternatively, (2) convert the bonds at the make-whole fundamental change adjusted conversion rate. The issuer may, in turn, elect the method of conversion settlement, which may be in the form of physical, cash, or combination settlement.

Lost option value at different stock prices and points in time is estimated using an option pricing model and typically set out in a “make-whole” table in the indenture when the convertible bonds are issued. The exact number of additional shares is determined by reference to the make-whole table and depends on the effective date of the fundamental change and the then current stock price. If the stock price is below the stock price when the convertible notes were issued, holders would still have the right to require the issuer to repurchase the convertible bonds at par value.

Make-whole table example

If there is a fundamental change or the issuer exercises its provisional call option, convertible bond holders are entitled to a make-whole as compensation for the remaining option value that is lost because of the early extinguishment of the security.

- The value of the make-whole declines as time advances and as the stock price increases.
- The maximum value of the make-whole occurs if a fundamental change occurs immediately after pricing of the convertible bonds at a stock price that is equal to the conversion price.
- If a Make-Whole Fundamental Change occurs, the Conversion Rate applicable to such conversion will be increased by a number of shares ("Additional Shares") set forth in the table below corresponding (after interpolation as provided in indenture) to the Make-Whole Fundamental Change Effective Date and the Stock Price of such Make-Whole Fundamental Change.

Make-Whole Fundamental Change Effective Date (YEAR)	STOCK PRICE									
	$20.00	**$22.50**	**$25.00**	**$27.50**	**$32.50**	**$37.50**	**$45.00**	**$55.00**	**$70.00**	**$90.00**
Closing Date	20.0000	10.3911	8.3480	6.8000	4.6615	3.2987	2.0422	1.1309	0.4657	0.1044
1	20.0000	10.1956	8.0680	6.4800	4.3200	2.9787	1.7822	0.9455	0.3643	0.0633
2	20.0000	9.7956	7.5800	5.9491	3.8000	2.5173	1.4267	0.7109	0.2457	0.0233
3	20.0000	9.0356	6.7200	5.0655	1.4969	0.9226	0.4766	0.2145	0.0614	0.0000
4	20.0000	7.6000	5.1600	3.5345	0.8600	0.4466	0.1922	0.0772	0.0157	0.0000
5	20.0000	4.4444	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Assumptions

Issue Size		$240,000,000	Conversion Price	$	25.00
Make-whole Value Adjustment Factor		0.50	Conversion Rate		40.000
Reference Stock Price	$	20.00	Provisional Call Price	$	32.50
Conversion Premium		25%	Maximum Conversion Rate		60.000

Early Redemption Rights in European Transactions

What rights of early redemption for the company ("Call Rights") and for the bondholders ("Put Rights") are typically found in the terms of convertible bonds and why?

(A) Call Rights

There is a tension in the economics of convertible bonds between Optionality and Call Rights, because any election of the company to redeem the bonds early brings to an end the equity upside potential of the convertible bonds and, accordingly, caps Optionality. And any cap on Optionality could, in practice, adversely affect the marketability and price of the convertible bonds, which is a topic that will be explored on a case-by-case basis between the company and the relevant underwriting banks. The Call Rights typically found in the terms of convertible bonds are as follows:

- A Call Right at par if Parity is more than, customarily, 130% of the conversion price over a prescribed period, which forces conversion of the bonds by the bondholders at this 130% level (so called "Parity Value Call Protection"). Set out in the bond terms from their issue date, this Call Right caps Optionality at 130% of the conversion price and allows the company to "take back" upside potential in its ordinary shares from bondholders at a price above the 130% level. A company may, accordingly, consider this Call Right to be advantageous, but its effect on the marketability of the bonds and their pricing should be discussed at an early stage in the structuring of the bonds.

Summary example:

"On giving not less than 45 nor more than 60 days' notice to the Trustee and to the Bondholders, the Issuer may redeem all but not some only of the Bonds on the date specified in the relevant notice at their principal amount, together with accrued but unpaid interest to such date if the Parity Value on each of at least 20 dealing days in any period of 30 consecutive dealing days ending not earlier than 14 days prior to the giving of the relevant notice by the Issuer shall have exceeded 130 % of the conversion price in effect or deemed to be in effect on each such dealing day."

Parity Value means, in respect of any dealing day, the amount calculated as follows:

$$PV = N \times VWAP$$

where:

PV *is the Parity Value;*

N *is the number of Ordinary Shares that would fall to be issued or delivered on the exercise of Conversion Rights in respect of a Bond, assuming the Conversion Date to be such dealing day; and*

VWAP *is the Volume Weighted Average Price of an Ordinary Share on such dealing day.*

- A Call Right at par if there is a change or amendment to the laws or regulations of the tax jurisdiction of the company following Pricing, which would require the company to withhold or deduct taxes from payments of principal or interest to bondholders (a "Tax Call"). A Tax Call is customarily included in the terms of convertible bonds to the extent that the bond terms also include a provision which requires the company to pay additional amounts to bondholders on the relevant payment day to ensure that, notwithstanding any withholding or deduction of taxes, the relevant bondholders receive their payment of principal or interest gross (a "Gross Up Provision"). There is nothing extraordinary in a Tax Call and Gross Up Provision being found in the terms of a Eurobond, as the Eurobond market has developed over time as a gross-paying bond market and the provisions of a Tax Call are, as a result, standardised. It is worth noting, however, that:

- Not all convertible bonds are issued with the benefit of a Gross Up Provision or a corresponding Tax Call, and this is often said to relate to the lower coupon payable on convertible bonds as against conventional Eurobonds; and
- A Tax Call will, if exercised, cap the Optionality of the bonds and is, customarily, drafted with an "opt-out" for bondholders – bondholders can, therefore, elect, following notice of a Tax Call from the company, to not be redeemed at par, but to continue to hold their bonds and receive future interest and other amounts payable on the bonds net of any withholding or deduction of taxes (a "Tax Call Trump Card"). A Tax Call Trump Card may be attractive to holders of convertible bonds that are "in the money", as the associated loss of coupon yield as a result of any withholding or deduction of taxes on payments made on the convertible bonds may be set off adequately by the profit generated on conversion of the bonds into ordinary shares at a conversion price which is significantly lower than the market price of the company's ordinary shares.

- A Call Right at any time if the majority of the convertible bonds (customarily 85% to 90% of the originally issued principal amount of the bonds) have already been converted, redeemed, or purchased. This Call Right is typically included in the terms of convertible bonds to allow the company to remove an outstanding stub of a series of convertible bonds from the market when the majority of the series has been previously redeemed, repurchased, or converted.

(B) Put Rights

Put Rights are more of an "individual theme" for a series of convertible bonds and will be negotiated into their terms on a case by case basis. It is worth focusing briefly, however, on takeover protection in the form of a Put Right, commonly found in the terms of convertible bonds (a "Change of Control Put").

As mentioned above, cash takeovers will, typically, have a material adverse effect on the Optionality of convertible bonds and bondholders will expect, in these circumstances, to be compensated by a return of Conversion Premium. If, however, the convertible bonds are, prior to the announcement of a cash takeover, substantially "out of the money", it may be unlikely that a consequential downward adjustment to the conversion price on a takeover will trigger much interest among the relevant bondholders to convert during the relevant "Change of Control Period." In addition, given the sensitivity of the convertible bond price to the announcement of a takeover and the likelihood of significant downward pressure on the price of the convertible bonds in the secondary markets, bondholders may simply wish to recover their monies on the first sign of a takeover.

A Change of Control Put will typically be at par and will be available for bondholders during the same "Change of Control Period" as is their right to convert at the Change of Control Conversion Price. Bondholders may, accordingly, choose which takeover protection they wish to adopt, though the performance of the ordinary shares of the company at the time at which a decision has to be made by bondholders may make the ultimate election clear-cut.

Early Redemption Rights in US Transactions

Call Rights

What are common redemption features in US transactions?

Redemption enables a company to shorten the life of the convertible bonds directly (by repurchasing notes on a specified redemption date) or indirectly (by forcing the early conversion by holders). Redemption cuts the interest payment stream and reduces time value in an embedded option.

Redemption may or may not be subject to conditions or triggers, which will all be factored into the pricing of a convertible bond. For example, it is common for US public convertible bonds to have the following redemption features:

- The issuer cannot redeem during a certain "no-call" period, for instance, during the first 3 years of convertible bonds that mature in 5 years.
- After the specified no-call period and on or before the 40th scheduled trading day prior the maturity date, the issuer may redeem the bonds provided that the last reported sale price of the issuer's common stock is equal to or greater than 130% of the conversion price in effect on each of at least 20 trading days during a consecutive 30 day trading period that includes that trading day immediately before the redemption notice date. The redemption price will be equal to the principal amount of the notes to be redeemed, plus any accrued and unpaid interest

Moreover, as previously mentioned, most public convertible bond indentures treat the sending by the issuer of an optional redemption notice for the convertible bonds as a "make-whole fundamental change" in itself. Hence, such redemption constitutes a make-whole fundamental change, which leads to a higher conversion rate. Holders would typically have the option to convert their bonds, at the higher make-whole conversion rate, until the close of business of the day immediately preceding the redemption date.

What is the definition of "provisional call" in US transactions?

A provisional call is a feature that allows an issuer to redeem convertible bonds for par ($1,000) prior to maturity after two conditions are satisfied: (1) the passage of time, typically 3 years (the "Non-Call Period") for a bond that matures in 5 years; and (2) the stock price trades at or above a predefined price (the "Provisional Call Trigger Price"). A Provisional Call Trigger Price is typically set at a 30% premium to the conversion price, but this can be higher. At the Provisional Call Trigger Price, the intrinsic value, or equity value, of the bonds is substantially above par value ($1,000). If or when the company exercises its call option, rationale holders will typically elect to convert their bonds to receive maximum value (instead of surrendering their bonds at the redemption price of par). Since calling the bonds prior to maturity results in early termination of the conversion option, holders of the bonds are entitled to a make-whole payment, in cash or shares, to compensate for the lost option value.

Put Rights

Are there any customary put rights available for holders of US public convertible notes?

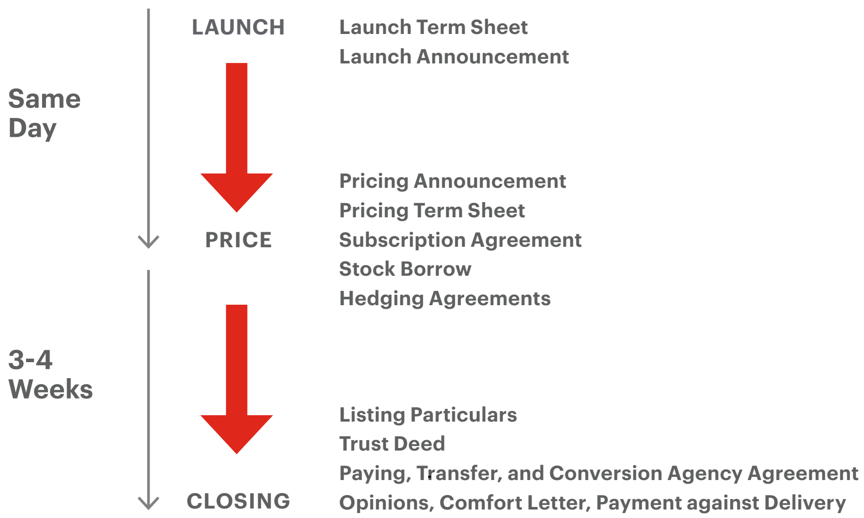
Yes, the occurrence of certain specified corporate events that constitute a "fundamental change" entitles the holders of convertible bonds the right to require the issuer to repurchase their convertible bonds, typically, at cash and for par.

See discussion under "*What is a fundamental change repurchase right?*" above.

Accelerated Book-Building: Indicative Transaction Timetable and Documentation Process In European Transactions

What is the process to offer convertible bonds to the market in Europe?

We've ignored until now another key advantage of convertible bonds over both plain vanilla debt and equity issuance – namely, the ability of debut issuers to access the capital markets on an "accelerated book-build basis". This ability is incredibly important at a time of ever-shrinking execution windows and at a time when material economic data is immediately available to, and analysable by, each and every investor and often has an immediate effect on the price of listed securities. The accelerated book build process allows a company to choose its execution window when there are positive pressures on its shares and to execute the placement almost immediately. A classic timetable for an accelerated book build is as follows:



- **Launch:** At Launch, a term sheet will be agreed, which will summarise the economic terms described in this Guide and will set out agreed upon pricing parameters for the coupon and the Conversion Premium, to be finalised at Pricing. The Launch Announcement will, in summary, introduce the offering to investors and include details of the issuer, reasons for the offering of convertible bonds, size of offering, pricing parameters, conversion and redemption features of the bonds, and the indicative date for the issue of the bonds. Each of these documents will refer investors to either:
  - a Listing Particulars, should an application for listing of the convertible bonds be planned and a Listing Particulars be required by the relevant listing venue (please see below); or
  - the terms and conditions of the bonds, if Listing Particulars are not to be prepared because the convertible bonds are to be unlisted or listed on a venue which does not require Listing Particulars,

  in each case, for a full description of the convertible bonds and their rights. Please see below for further information relating to Listing Particulars.

Launch will typically occur as soon as the markets open on a predetermined date and will be followed by a "book-build" process conducted by the relevant underwriting banks, with the aim of reaching Pricing at a later time on the same day.

- **Pricing:** Pricing will normally occur once the book is closed by the underwriting banks. At this stage, the syndicate desks of the relevant underwriting banks will convey to the company the coupon and Conversion Premium at which a sufficient book of investors is willing to purchase the principal amount of convertible bonds to be issued, as well as their judgment as to the right price and allocations of the bonds amongst investors. Once pricing is agreed with the relevant company, a Pricing Announcement will be made by the company to the market. This will not be dissimilar to the Launch Announcement, but will set out the agreed pricing and further details as to the issue and delivery of the bonds. The Pricing Term Sheet will also be finalised and sent to the investors, and a subscription agreement, described below in more detail, will be signed by the company and the underwriting banks. Other agreements, such as stock borrow and hedging agreements may also be signed at Pricing, and these agreements are also explored in more detail below.
- **Closing:** On the date of Closing, the convertible bonds will be issued by the company, and subscribed for by the underwriting banks, in each case, in accordance with their several underwriting commitments which will be set out in the subscription agreement.
  - **Settlement:** As is customary in the Eurobond markets, the convertible bonds will normally be issued into an international clearing system (such as Euroclear, Belgium and Clearstream, Luxembourg) and interests in the convertible bonds will be traded by bondholders as direct or indirect participants of these clearing systems. Closing typically occurs on a "delivery vs. payment" basis so the convertible bonds are delivered into the relevant securities account of the bank organising settlement against payment of the issue price for the bonds, less any agreed commissions and expenses.
  - **Listing:** Convertible bonds may or may not be listed at Closing. Typically, if listing is to be obtained for the bonds as a means of falling within an exemption from the requirement to withhold or deduct tax, then the listing of the bonds may occur at Closing or at any time thereafter prior to the first interest payment date on the convertible bonds. As a result, the subscription agreement will either specify listing (and, if required by the relevant listing venue, the preparation of an offering circular or listing particulars, "Listing Particulars") as a condition precedent to Closing or as an undertaking of the company which needs to be met prior to the first interest payment date on the bonds.
- A trust deed and paying, transfer, and conversion agency agreement may also be signed on Closing:
  - **Trust Deed:** In summary, a trust deed constitutes the bonds and is entered into by the company and a professional trustee which oversees the company's compliance with the terms of the bonds, interacts with the company in relation to any required modifications or waivers to the bond terms and their enforcement, in each case, acting in the best interests of the bondholders as a class.
  - **Paying, Transfer, and Conversion Agency Agreement:** This agreement is entered into by the company and professional bond agents who, acting as agents of the company, will help facilitate payments on the bonds and transfers, conversions, and redemptions of the bonds during their tenor.

On Closing, conditions precedent to the issue of the bonds, as outlined in the subscription agreement, will be delivered to the relevant underwriting banks. These conditions precedent will typically consist of:

- **constitutional documents and board resolutions of the company:** authorising, in particular, the issue of the bonds, the issue and allotment of ordinary shares on conversion of the bonds, the disapplication (if necessary) of pre-emption rights of existing shareholders, and the execution of the bond documentation;
- any relevant **external consents or waivers** required in connection with the issue and offering of the convertible bonds;
- **customary legal opinions** which include, amongst others, opinions on the due incorporation of the company, due authorisation of the bonds, and the legal, valid, binding, and enforceable nature of the obligations of the company pursuant to the bond documentation; and
- if Listing Particulars are to be prepared in relation to the listing of the bonds, **customary auditors' comfort letters** which provide the underwriting banks with (i) comfort that the auditors have undertaken certain agreed-upon procedures in relation to the financial information contained in the Listing Particulars and (ii) "negative assurance" comfort as to the absence of material changes with regard to certain specified financial line items since the date of the most recent financial statements included in the Listing Particulars.

What are the risks of an accelerated book-build process and how are these risks mitigated?

The advantages of an accelerated book build also result in risks. These are both:

- **Disclosure risks:** as no Listing Particulars are available for investors between Launch and Pricing when the investors are making their investment assessment of the company and the convertible bonds; and
- **Diligence risks:** as only limited diligence can, given timing constraints, be conducted by the underwriting banks between Launch and Pricing.

In addition, the potentially long gap between Pricing and Closing itself creates market risk for the underwriting banks, which needs to be mitigated by the provisions of the subscription agreement. So how are these risks mitigated?

Disclosure and diligence risk: can be mitigated by the existence of quality public disclosure regarding the company and, in the subscription agreement, by an extensive package of warranties which are underpinned by an indemnity of the company for their breach. These warranties delve into all areas of the business of the company which would be typically disclosed in an offering circular for an equity offering and will include, amongst others, warranties on the company's accounts, its tax liabilities, its compliance with sanctions, anti-bribery and money laundering laws and regulations, any material legal proceedings, consents and licences, real estate, insurance policies, environmental liabilities, acquisitions and disposals, and labour disputes. The list of warranties will be focussed, specifically, on the company's business and will typically be no less detailed than the warranty package expected of a company in relation to an equity placement – with respect to potential liability of the underwriting banks, a purchase of convertible bonds is, *de facto*, a purchase of deferred equity.

Aside from the business-related warranties, the underwriting banks will require, as a matter of course, the company to confirm that, as at Pricing, there is no non-public price sensitive information in the possession of the company which, if made public, could be expected to have an effect upon the market price of the convertible bonds, the company's shares and/or its business. The company will also be required to confirm that (i) its filings with relevant regulatory authorities are up to date and are true and accurate, as it is this information on which investors rely when assessing the company and the convertible bonds and (ii) a Listing Particulars will, if prepared by the company, be true and accurate in all material respects and contain all material information about the company and the convertible bonds.

Market risk: The company will also be required to give the underwriting banks certain undertakings to reduce the market risk to investors in the period between Pricing and Closing and in the immediate period post-Closing, when a market in the bonds is developing. These undertakings include:

- **"Lock-Up" Agreement:** to be entered into by the company and, dependent on the structure of the company's group, by key shareholders, which prevents the relevant parties from, as applicable, issuing or selling an interest in shares and equity-linked instruments of the company in a manner which could affect the value of the embedded equity call option in the convertible bonds;
- **No Dilution Undertaking:** aimed at preventing corporate actions of the company which would have led to an adjustment to the conversion price of the bonds pursuant to their terms, had the bonds been in issue at Pricing (as opposed to Closing); and
- **Announcements Undertaking:** aimed at avoiding public announcements of the company that would be material to the offering of the bonds without the underwriting banks' review and approval.

Listing Requirements

Why might a listing be required of a company's convertible bonds and what are the listing and disclosure requirements for the company to list convertible bonds?

A company's convertible bonds may be more accessible to certain types of investors if they benefit from a listing. This is because:

- certain investors are constrained by their constitutional documents or internal policies from acquiring unlisted (or otherwise illiquid) securities or from allowing such securities to exceed a certain percentage of their investments; and
- a listing of the securities on an exchange may, as mentioned above, be a legal pre-requisite to the company's right to pay interest, principal, and other amounts on the convertible bonds gross of taxation or other withholding.

The listing and disclosure requirements to be met by a company and its convertible bonds will depend, broadly, on the relevant listing venue. In Europe, convertible bonds have been admitted to trading on an exchange-regulated market, such as the Luxembourg Stock Exchange's Euro MTF that require the preparation of a Listing Particulars as part of the admission to trading of the bonds. Investors have, to date, been comfortable with these venues in terms of the quantity and quality of disclosure required for Listing Particulars and the compliance regimes to which companies are held post-issuance of the bonds. Equally, there has been a widening trend of listing convertible bonds or multilateral trading facilities (MTFs) that do not require the preparation of a Listing Particulars in certain circumstances as part of the admission to trading of the bonds. These circumstances may include, for example, when the company already has its ordinary shares admitted to trading on an EEA regulated market.

Should the preparation of a Listing Particulars be required by the relevant listing venue, then the disclosure requirements will generally require Listing Particulars to include information on the company and the material risks related to an investment in its business and information on the convertible bonds (which will be represented, broadly, by the terms and conditions of the bonds set out in full in the Listing Particulars).

US Securities and Disclosure Considerations for Issuers

What are the common offering methodologies for convertible bonds in the US?

In the US, convertible bonds may be offered through an SEC-registered offering or in an unregistered offering made pursuant to Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"). For SEC-registered offerings, the issuer should have an effective shelf registration statement on file with the SEC and the convertible bond offering may be done pursuant to a "shelf-takedown." In addition, the indenture between the issuer and the trustee pursuant to which the SEC-registered bonds are issued, as well as the trustee itself, will need to comply with and be qualified under, the Trust Indenture Act.

Most public convertible bonds are, however, issued in a traditional unregistered offering made pursuant to Rule 144A, in which the issuer sells bonds to one or more investment banks acting as initial purchasers in a Section 4(a)(2) private placement, who then resell to qualified institutional buyers pursuant to Rule 144A. Among other requirements, Rule 144A would require that the 144A securities being offered are not of the "same class" as, or convertible into, securities listed on a US national securities exchange. For convertible bonds not to be treated as the same class as the issuer's underlying shares of common stock, the bonds must have an effective conversion premium of at least 10% over the last reported sale price per share of common stock on the pricing date. Since most public convertible bond deals in the US market feature conversion premiums in excess of this 10% threshold, this particular 144A requirement is typically satisfied without much difficulty.

The Rule 144A route allows issuers of convertible bonds to go to market relatively quickly and avoid any potential delays associated with an SEC-registered offering, including filing and maintaining an effective shelf registration statement on file or responding to SEC comments. In addition, for liquidity purposes, the 144A market in the US is a deep and active market consisting of a number of large US institutional investors or QIBs, which are large sophisticated investors that generally have at least $100 million of securities under management. Repurchase strategies can also be executed without raising Regulation M concerns. Regulation M generally prohibits distribution participants from purchasing a covered security (including a reference security to which the covered security may be converted into) during a specified restricted period, absent an exemption, in order to limit activities which may have a manipulative effect on the market. Transactions in Rule 144A securities are exempted from this general rule.

What is the general process to offer convertible bonds in a Rule 144A Offering in the US?

A standard transaction timeline for a Rule 144A public convertible bond offering is provided in the chart on the following page. We highlight below a few important features.

- **Parties**. The parties in a 144A public convertible bonds offering include: (1) the *Issuer*, which is the company offering and selling its convertible securities and whose underlying shares of common stock are listed on a US securities exchange, (2) the *Initial Purchasers*, which are the investment banking firms responsible for marketing the offering, managing the offering process, and "building the book" to distribute the securities, (3) the *Issuer's Counsel*, which acts for the Issuer and is primarily responsible for drafting the offering documentation and corporate governance documents, (4) the *Initial Purchasers' Counsel*, which represents the investment banks and is primarily responsible for drafting the purchase agreement and pricing term sheet and leading due diligence on the issuer, (5) the *Auditors*, which audit and review the issuer's financial statements and provide a comfort letter to the Initial Purchasers at pricing and closing, (6) the *Trustee*, which acts for the benefit of the ultimate beneficial owners of the bonds and enters into the indenture with the issuer in connection with the issuance and administration of the convertible bonds, and (6) the *Stock Transfer Agent*, which is the custodian and registrar for the Issuer's underlying common stock.
- **Documentation**. Principal deal documentation consists of the: (1) *Offering Memorandum*, which describes the issuer, its business and financial position, the terms of the convertible bonds being offered, issuer's financial information, and other material information for the offering, (2) *Purchase Agreement*, which is executed between the Issuer and the Initial Purchasers to document the offer and sale by the former to the latter of the convertible bonds for further resale to QIBs, and is typically similar to an underwriting agreement in a registered deal in terms of representations, covenants, closing conditions, and indemnities, (3) *Pricing Term Sheet*, which contains the material pricing terms of the bonds (including the coupon, conversion rate, conversion price, the make-whole table, among others) and finalized after the pricing call, (4) *Indenture and Global Note* certificates representing the bonds, (5) *Comfort Letters* provided by the auditors at pricing and closing, providing "cold comfort" or negative assurance with respect to financial information included or incorporated by reference in the offering memorandum and (6) *Opinions and Negative Assurance Letters* provided by the Issuer's Counsel and Initial Purchasers' Counsel with respect to the legality and enforceability of the bonds and deal related matters.
- **Due Diligence**. To assist with complying with US securities laws, mitigate securities law liability, and ensure that disclosure provided to investors does not contain material misstatements or omissions, the Initial Purchasers, their counsel, and the Issuer's counsel conduct due diligence on the issuer, its business, and financial position in connection with the bond offering. Legal due diligence (including documentary review of material agreements and information) is performed by counsel. Business due diligence sessions with management and auditor due diligence sessions with auditors are conducted prior to launching the deal and are brought down at pricing and closing. Additional diligence calls may also be conducted with additional subject matter experts as needed (e.g., regulatory or environmental diligence calls).

Timeline for 144A Convertible Bonds offering

ORGANIZATIONAL MEETING 3 days to 2 weeks	MARKETING ½ day to 2 days	PRICE	CLOSE 1–5 days
Pre-Launch Period • Organizational meeting • Due diligence • Draft preliminary offering memorandum • Draft and finalize: – Form of Purchase Agreement – Form of Lock-up Agreement – Roadshow presentation – Form of Pricing term sheet – Form of comfort letter – Form of opinions and 10b-5 letters	**Launch** • Due diligence completed • Conduct bring-down due diligence immediately before launch • Distribute Preliminary Offering Memorandum • Launch Roadshow • Build Book	**Pricing** • Conduct bring-down due diligence immediately before pricing • Price bonds • Finalize pricing term sheet • Execute purchase agreement • Deliver comfort letter	**Closing** • Prepare and distribute final offering memorandum • Prepare indenture, global bonds and closing documents • Conduct due diligence immediately before closing • Wire payment and Issue Bonds • Delivered at closing: – Bring-down comfort letter – Indenture and global bonds – Opinions and 10b-5 letters – Closing certificates – Cross-receipt

Can holders of convertible bonds freely transfer their securities? If not, is it common to ask for resale registration rights for convertible bonds issued in a Rule 144A Offering?

Securities acquired in Rule 144A transactions are deemed to be "restricted securities," which means they cannot be further resold or transferred to another party absent registration under the Securities Act or an exemption from SEC registration. Holders of Rule 144A convertible bonds may however immediately resell or transfer them to fellow QIBs under Rule 144A. In addition, they can resell or transfer them by complying with the requirements of Rule 144 under the Securities Act. Under Rule 144, restricted securities may be freely resold or transferred, among other conditions (1) if the debt security holder has satisfied the applicable holding period under Rule 144 (which is either 6 months or 1 year, depending on whether the issuer is an SEC reporting company and whether the holder is an affiliate of the issuer) and (2) as long as there is sufficient and current public information about the issuer. In light of these resale alternatives available to holders and the now relatively shorter holding period under Rule 144, it is not common nowadays in a Rule 144A offering for holders to ask for resale registration rights.

To facilitate resales of public convertible bonds by holders under Rule 144, the indenture for convertible bonds in a Rule 144A offering would typically contain provisions designed to ensure compliance by the Issuer with the Rule 144 requirements.

When does the issuer pay "Additional Interest" or "Special Interest" under the 144A convertible bonds indenture?

Convertible bonds issued under Rule 144A include a restrictive legend and have a "restrictive" CUSIP when issued. The issuer will typically covenant to provide "current information" about itself and agree to lift the restricted legend and move the Rule 144A restricted CUSIP on the bonds to an "unrestricted" CUSIP, on the one-year anniversary of issuance. Only the transfer agent in the transaction may lift the legend. The transfer agent will require an opinion letter from issuer's counsel in order to lift the restrictive legend. Once the transfer agent removes the legend, the securities may be moved to an unrestricted CUSIP and become freely tradable.

An issuer should take care to promptly lift restrictive legends once its securities become unrestricted. Failure by issuer to perform such covenants would result in the accrual by the issuer of "additional" or "special" interest under the convertible bonds indenture. For instance, an indenture could provide that "additional interest" of 0.50% per annum of the principal amount of bonds outstanding shall accrue each day that the issue has failed to move the note from the restricted CUSIP to an "unrestricted" CUSIP. Similarly, the indenture may also impose a "special interest" of 0.25% per annum for each day, subject to a ceiling, that the issuer fails to timely file any document or report that it is required to file with the SEC pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). This is commonly called a "Reporting Event of Default" under the indenture. The issuer should remember to monitor and observe these covenants, timely file its Exchange Act reports, and track the first anniversary of the issue, so that it can avoid being penalized to pay these additional interest amounts.

US Tax Considerations

Considerations for Holders

During the term of a convertible bond (i.e., prior to maturity or conversion), US holders take the coupons from the convertible bond into account as ordinary income in accordance with their usual method of accounting. No part of the purchase price is allocated to the conversion feature. In this way, holders of convertible bonds are taxed similarly to holders of regular bonds without a conversion feature.

However, phantom income can occur in certain circumstances. In particular, changes to the conversion price of convertible bonds that have the effect of increasing a holder's proportionate interest in the issuer's assets or earnings can give rise to "constructive dividends" for tax purposes. This rule does not apply to an adjustment to the conversion rate pursuant to a bona fide reasonable adjustment formula that has the effect of preventing the dilution of convertible bondholders. Thus, for example, rate adjustments arising from a stock split or a stock dividend generally do not result in a deemed dividend. However, a change in a conversion rate intended to compensate for dividends paid on the issuer's equity should be treated as a deemed dividend to convertible bondholders.

Considerations for Issuers

US issuers of convertible bonds must take into account a number of factors to determine whether payments on the convertible bonds give rise to tax deductions.

First, interest deductions on debt instruments are disallowed if principal or interest is required to be paid in the issuer's equity, or the debt is issued as part of an arrangement which is "reasonably expected" to result in such a transaction. Furthermore, principal and interest is treated as required to be paid in equity if it is so payable at the holder's option and "there is substantial certainty the option will be exercised." Generally, issuers of convertible bonds ensure there is a reasonable "conversion premium," so that the stock must increase before holders are economically incentivized to exercise their conversion option.

Second, interest deductions on convertible bonds may be limited if the proceeds of the offering are used by the issuer to acquire a target company and the convertible bonds are subordinated to certain other creditors. For these purposes, subordination can include structural subordination. Issuers of convertible debt must carefully navigate these rules in circumstances where one possible use of the debt proceeds is to make acquisitions, and the debt is issued by a holding company resulting in structural subordination.

Finally, repurchase premium on convertible bonds is nondeductible to the extent the repurchase price exceeds a "normal call premium." If an issuer can show that repurchase premium is attributable to the cost of borrowing and not the conversion feature, then deductions for the premium should not be limited under this provision.

Convertible Call Spread Transactions

Issuers that want to issue convertible bonds on favorable terms but guard against the dilution that comes from lower conversion prices may want to consider a "convertible call spread" transaction. In a typical transaction, the issuer issues convertible bonds, purchases bond hedges, and issues warrants. The bond hedges entitle the issuer to purchase the same amount of common stock that is issued on the convertible bonds at a strike price equal to the conversion price. The warrants obligate the issuer to sell shares at a significantly higher strike price than the conversion price on the bonds. The economic effect of the convertible bonds, the bond hedge, and the warrants is equivalent to a convertible bond with a higher strike price (equal to the strike price on the warrants). However, the issuer may be able to take advantage of pricing convertible bonds with a lower strike price. See further details under "Dilution Mitigation Options – Call Spread Overlays" later in this guide.

The IRS has issued a favorable advice memorandum describing such a transaction where a convertible bond issuer filed an "integration election" that integrated the convertible bonds and the bond hedge for tax purposes. The result of the integration election is that the cost of the bond hedge reduces the issue price of the convertible bonds, which generate original issue discount deductions for the holders. As a result, the cost of the bond hedge becomes tax deductible. Meanwhile, the warrant premium received by the issuer is not subject to tax.

UK Tax Considerations

Considerations for Holders

The UK tax treatment of holders of convertible bonds will depend upon various factors, including whether the holder is a company, or otherwise within the charge to UK corporation tax, or an individual.

If a holder is a UK corporation tax payer, the convertible bond will usually be treated as a creditor loan relationship for it under the UK's loan relationship rules, in which case, the holder will generally be required to bring interest, profit, and losses into account in respect of the convertible bond in accordance with its accounting treatment of the bond (assuming that accounting treatment is "GAAP-compliant", i.e., it conforms with either UK GAAP or IFRS).

Consequently, as holders of convertible bonds of this nature will often account for those bonds on a fair value basis, recognizing fair value profits and losses under the bonds in their profit and loss account or income statement on an annual basis, such holders would also generally bring those annual profits and losses into account for tax purposes. Similarly, they would also generally be taxed on interest under the convertible bond which they accrued or otherwise recognized in their accounts.

Importantly, it is understood that under accounting standards such as FRS 101, 102, and IFRS 9, holders of convertible bonds that are within the charge to UK corporation tax are no longer required, ordinarily, to bifurcate their convertible bonds in circumstances where this might have been required under previously relevant accounting standards such as FRS 26 and IAS 39. In turn, this bifurcation, which, in respect of the issuer of convertible bonds, is explained in more detail below, should no longer be relevant to the UK corporation tax treatment of such holders under those bonds.

Assuming that a holder of a convertible bond within the charge to UK corporation tax accounts for the bond on a fair value basis in the manner anticipated above, it should only be subject to UK corporation tax on a conversion of the bond to the extent that the market value of the shares it acquires on conversion exceeds the fair value at which it carries the bond in its accounts. The holder would also usually obtain a UK tax-related base cost in those shares broadly equal to the market value of the bond at the time of conversion.

Holders of convertible bonds who are UK tax resident individuals will generally be subject to income tax on interest they receive under the bonds. In contrast, they will generally be subject to UK capital gains tax on profits they derive from a sale of the bonds, although they may also suffer income tax on such a sale under the UK's accrued income scheme rules. However, a conversion of a bond into shares of the issuing company would usually fall within section 132 of the Taxation of Chargeable Gains Act 1992, in which case, the holder would not be subject to capital gains tax as a result of the conversion and, instead, would be treated as acquiring the shares for the same amount and at the same time as the holder originally acquired the convertible bond.

Considerations for Issuers

Accounting treatment

A UK corporate issuer of convertible bonds may be required to bifurcate those bonds into a host debt instrument and either an equity or derivative financial instrument for accounting purposes. Alternatively, the issuer may account for the composite bond on a fair value basis, recognizing fair value profits and losses under the bond in its profit and loss account or income statement as a result.

In each such case, but subject to the commentary below, the issuer will generally be required to follow its accounting treatment of the bond for UK corporation tax purposes. For example, if, for accounting purposes, an issuer validly bifurcates a convertible bond into the host debt instrument and an equity instrument represented by the call option over shares that is contained within the bond, it will be taxed in respect of the host debt instrument under the UK's loan relationship rules. In contrast, the equity instrument would usually constitute a tax nothing for it; albeit that the issuer may be eligible to obtain an allowable loss if it cash settles the convertible debt instrument at a loss, for example, by redeeming the bond for more than the issue proceeds it received under the bond.

Similarly, if, for accounting purposes, the issuer bifurcates a convertible bond and the call option over shares embedded within it into a host debt instrument and separate derivative contract, it will be taxed in respect of the host debt instrument under the loan relationship rules but under the UK's derivative contract rules in respect of the derivative. In this regard, the question of whether a call option over shares of this nature qualifies as an equity or derivative when accounted for separately can be a complicated one and will usually require specialist accounting input. Broadly, however, if the issuer can be required to deliver cash rather than its shares to holders on a conversion of the bond or under the terms of the bond a holder's entitlement to shares is a variable one such that a fixed amount of cash is not required to be exchanged for a fixed amount of those shares, it is understood that the call option is likely to be treated as a derivative for relevant accounting purposes (see also IAS 32.16 in this regard).

If the above type of call option falls within the UK's derivative contract rules, the issuer may be subject to either income or capital taxation in respect of it under those rules. The issuer's eligibility for capital taxation will depend upon whether the call option satisfies conditions in sections 652 and 656 Corporation Tax Act 2009, which are beyond the scope of the current discussion. By way of illustration, however, if the call option falls within section 652, the issuer will disregard for tax purposes any fair value profits and losses that it recognizes in its accounts during the life of the option but may realize a chargeable gain or allowable loss under the Taxation of Chargeable Gains Act 1992 when the option is settled or if it expires unexercised.

Tax relief for interest

A UK corporate issuer of a convertible bond would generally expect to obtain tax relief for interest it paid under the bond, broadly, in accordance with its GAAP-compliant accounting treatment of the bond.

However, tax relief for interest and other finance costs can be restricted in numerous cases under UK tax law and should not be assumed. For example, under the UK's corporate interest restriction rules, tax relief for interest may be denied to an issuer of a convertible bond if, broadly, the net tax-interest expense of the UK group of which the issuer forms part exceeds both an annual de minimis of £2 million and a percentage (usually, 30%) of the group's tax-EBITDA in the UK. The issuer may also be denied tax relief for that interest if the interest exceeds a reasonable commercial return on the amount lent under the bond or if the bond is not listed on a recognized stock exchange and does not contain terms and conditions that are reasonably comparable with those of convertible bonds that are so listed.

One point to note, however, is that if, for accounting purposes, an issuer separates a convertible bond into a host debt instrument and call option over shares, it may be entitled (subject to the type of restriction noted above) to tax relief for both the interest it pays under the bond and any accreting discount that it recognizes in its accounts in respect of the host debt instrument. In this regard, it is understood that an issuer which accounts for a convertible bond in this way would usually amortise over the life of the bond the difference between its initial carrying value in respect of the host debt instrument and the amount repayable under the bond, recognizing generally tax-relievable debits in respect of that difference as a result.

Withholding and stamp taxes

The UK issuer of a convertible bond will not be required to withhold UK tax from interest it pays under the bond if it constitutes a "quoted Eurobond", which will generally be the case if the bond is listed on a recognized stock exchange or admitted to trading on a multilateral trading facility which is operated by certain recognized stock exchanges. An exemption from this withholding tax may also be available under an applicable double tax treaty or if the holder beneficially entitled to the interest is within the charge to UK corporation tax in respect of it.

As a result of provisions recently enacted in Finance Act 2024, the issue of convertible bonds should no longer be subject to UK stamp duty or stamp duty reserve tax any circumstance. In contrast, transfers of convertible bonds may be subject to those taxes unless, broadly, they are made through a clearing system and the clearing system has not elected for stamp duty reserve tax to be payable in such circumstances under section 97A Finance Act 1986 or another exemption applies.

US Accounting Considerations

Convertible accounting getting simpler in the US under ASU 2020-06

In August 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity* (*Subtopic 815-40*)*: Accounting for Convertible Instruments and Contracts in an Entity's Own Equity* ("ASU 2020-06"), which simplified the accounting treatment for convertible debt under US GAAP.

Prior to ASU 2020-06, there were five accounting models for convertible debt instruments under GAAP: a "traditional" convertible model that recognized convertible debt as a single debt instrument, and four other models which required that the convertible debt instrument be separated or bifurcated into a debt component and an equity or derivative component, using varying measurement guidance. ASU 2020-06 reduced the number of accounting models from five to three and, removed in particular, the cash conversion model and the beneficial conversion feature model. Hence, a convertible debt instrument with a conversion feature that does not require derivative accounting and does not result in a substantial premium, would no longer be accounted for separately from the debt instrument; such convertible debt instrument will be treated as a single unit and accounted for as debt on the balance sheet. Interest expense on such convertible debt would simply reflect the cash coupon payable on the convertible bond.

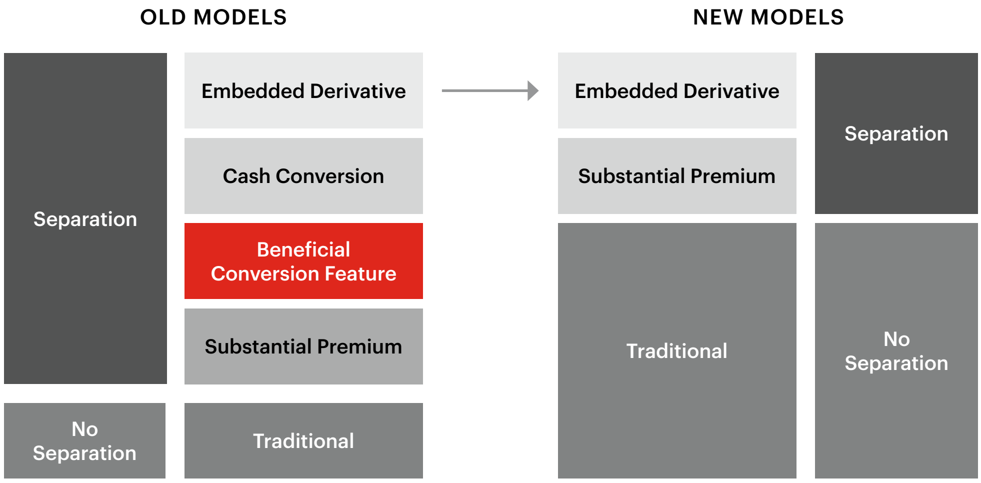
ASU 2020-06 also amended the manner of calculating diluted earnings per share (EPS) for certain convertible debt instruments, which generally result in more dilutive EPS calculations for issuers. Under GAAP, there are two methods of calculating diluted EPS: the "if converted method" and the "treasury stock" method. The "if converted" methods assumes that the convertible debt will be converted into shares at the beginning of the reporting period (or, if later, when the bonds are issued). Such method assumes that the entire convertible debt instrument would be settled physically in shares, which would in turn, lead to a higher number of shares to be used in the the denominator of diluted EPS, hence resulting into more dilution and a lower diluted EPS. In contrast, the treasury stock method assumes that the option or warrant was exercised at the beginning of the reporting period and that the proceeds from exercising options and warrants would be used by an issuer to repurchase outstanding shares, hence the net number of shares added to the diluted EPS denominator would be less than the shares underlying the options or warrants. In effect, here, only "in the money" shares would be counted in the calculation. This treasury stock method would generally result to less shares in the denominator, leading to less dilution and to a higher reported diluted EPS, as compared to the "if converted" method amount.

ASU 2020-06 has had a significant on the diluted EPS of convertible debt that allow for combination settlement. Share settlement is presumed for these convertible debt instruments that can be settled in cash or shares, hence the "if converted" method would apply. Prior to ASU 2020-06 however, this presumption of share settlement can be rebutted if the issuer has a stated policy or history of cash settlement, which would then permit the use of the treasury stock method instead of the "if converted" method. This is no longer the case under ASU 2020-06. The following illustrations provide additional details of the impact of ASU 2020-06.

US Accounting Considerations

Simpler accounting treatment under ASU 2020-06

FASB issued ASU 2020-06 in August 2020 simplifying the accounting treatment for convertible debt under US GAAP. ASU 2020-06 reduced the convertible accounting models from five to three and eliminated the cash conversion model and beneficial conversion models.



Other accounting treatment changes under ASU 2020-06

SETTLEMENT METHOD	OLD ACCOUNTING	NEW ACCOUNTING
Net Share Settlement – Issuer to settle principal amount in cash; conversion premium over par can be settled in cash or shares at Issuer's option ("Instrument C")		
Balance Sheet	Bifurcated into debt and equity	Not bifurcated; Single debt unit
EPS	Treasury stock method	Treasury stock method
Flexible Settlement – Conversions can be settled in cash, shares or any combination, at issuer's option ("Instrument X")		
Balance Sheet	Bifurcated into debt and equity	Not bifurcated; Single debt unit
EPS	If-converted method	If-converted method
Flexible Settlement with Net Share Settlement Intent – Flexible settlement per indenture, but issuer has stated "intent" or stated policy to do net share settlement		
Balance Sheet	Bifurcated into debt and equity	Not bifurcated; Single debt unit
EPS	Treasury stock method	Treasury stock method
Physical Settlement – Conversion settled entirely in shares		
Balance Sheet	Not bifurcated; Single debt unit	Not bifurcated; Single debt unit
EPS	If-converted method	If-converted method

Induced conversion accounting updates under ASU 2024-04

On November 26, 2024, FASB issued ASU 2024-04, *Debt—Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments (“ASU 2024-04”)*, which aims to improve the application and relevance of accounting guidance related to induced conversions of convertible debt instruments.

When the terms of a convertible debt instrument are changed to induce conversion of the instrument, current US GAAP provides guidance to determine whether the transaction should be accounted for as an induced conversion (induced conversion accounting) as opposed to a debt extinguishment (extinguishment accounting). According to FASB, after ASU 2020-06 was enacted, it has received a number of questions from stakeholders whether to apply induced conversion accounting or extinguishment accounting, to the settlement of convertible debt (particularly, convertible instruments that can be settled in cash) at terms that differ from the original conversion terms.

Under ASU 2024-04, the FASB clarified that in order to qualify for induced conversion accounting, an inducement offer is required to provide the debt holder with, at a minimum, the consideration (in form and amount) issuable under the original terms of the instrument (i.e., the form and amount of the consideration issued is at least equal to the consideration issuable under the existing terms). The new accounting guidance will require the inducement offer to preserve the conversion consideration issuable, in form and amount, with this assessment to be performed at the time the inducement offer is accepted by the holder. In addition, ASU 2024-04 provides that the incorporation, elimination, or modification of a VWAP formula does not automatically cause a settlement to be accounted for as an extinguishment; instead, one must assess whether the form and amount of conversion consideration are preserved (i.e., provided for in the inducement offer) using the fair value of the issuer’s shares as of the offer acceptance date. Finally, for any convertible debt instruments that have been modified or exchanged within the one-year period leading up to the inducement offer acceptance date, the issuer should compare the terms of the inducement offer with the terms that existed one year before the offer acceptance date.

The amendments in ASU 2024-04 are effective for all entities for annual reporting periods beginning after December 15, 2025, as well as interim reporting periods within those annual reporting periods. Early adoption is permitted for companies that have adopted ASU 2020-06 for that period.

Dilution Mitigation Options

Mitigating dilution of existing shareholders stakes in the company

There are a number of ways in which a company might, as part of its structuring of a convertible bond, seek to reduce dilution for existing shareholders. Each such approach will, however, result in a very different tax and accounting outcome for the company. Dilution might be mitigated in one of the following manners:

- **Call Spread Overlays:** Dilution might be mitigated through a classic convertible bond call spread overlay. A call spread overlay comprises of the following three elements:

  1. **The issue of a convertible bond** at a fixed conversion price.
  2. **The execution of a "Convertible Bond Hedge Transaction."** The company buys a hedge from an affiliate of one of the underwriting banks of the convertible bonds (the "Underwriter") on their issue date. The hedge entitles the company to purchase from the Underwriter existing ordinary shares of the company at a strike price *equal to* the conversion price of the bonds (and thereby receive delivery of a number of ordinary shares equal to the conversion shares). The hedge is automatically exercisable at one or more times as the corresponding convertible bonds are converted, is settled in the same manner as the bonds and expires on their maturity date. The company pays the affiliate of the relevant underwriting bank a premium for entering into the Convertible Bond Hedge Transaction, based on the fair market value of the hedge – the Convertible Bond Hedge Transaction is a perfect hedge to the embedded equity call option in the convertible bonds, as it offsets the embedded equity call option 1:1, resulting in no equity dilution for the company's shareholders at the conversion price of the bonds.
  3. **The execution of "Separate Warrant Transaction."** The company sells a warrant/call option to the affiliate of the relevant Underwriter, giving the affiliate the right to purchase a number of ordinary shares of the company equal to the conversion shares at a strike price *significantly higher* than the conversion price of the bonds and, consequently, the strike price of the Convertible Bond Hedge Transaction (the "Warrant Strike Price").

  Elements 1–3 above allow the company to (a) eliminate all equity dilution resulting from the conversion of the convertible bonds at the conversion price (this means that the company can decide to fix, at pricing, a conversion price which is lower than it might have otherwise been able to do so, thus attracting demand for the bonds and reducing the required coupon), and (b) in the case that the Warrant Strike Price is reached, protect against equity dilution following the exercise of the Separate Warrant Transaction to a degree, as the proceeds paid to the company by the affiliate of the Underwriter, as part of the Separate Warrant Transaction, can be used by the company to repurchase ordinary shares in the market (as described in further detail below).

- **Cash Settlement:** The company may include, in the terms of its convertible bonds, a right to elect to deliver (in whole or in part) cash to bondholders instead of shares on the exercise of conversion rights, at a price equal to the average of the market price (customarily, VWAP) of the ordinary shares underlying the relevant bonds during a prescribed calculation period, thereby avoiding, in whole or in part, dilution of existing shareholders.
- **Net Share Settlement:** A net share settlement feature provides that the principal amount of the relevant bonds to be converted is paid by the company in cash upon conversion, with only the excess value of the ordinary shares underlying the bonds over the principal amount of the bonds, if any, being "paid" in ordinary shares, thereby reducing dilution of existing shareholders. There are obviously many variables that can be adjusted in this type of feature (i.e., level of cash settlements, cash, the number of common shares, shares or a combination thereof).
- **Parity Value Call Protection:** A Parity Value Call Protection has been discussed earlier in this Guide and is a regular feature of convertible bonds. To reiterate, the upside potential of bond holders is capped by reference to a threshold. Once Parity exceeds this threshold, the company has a right to redeem the bonds at par. This call right effectively "forces" holders to convert their bonds at the prescribed threshold, thereby limiting dilution of existing shareholders to this level.
- **Concurrent Share Repurchases:** A company may, in addition to the above methods to mitigate dilution, use some of the proceeds of the issue of the convertible bonds to enter into simultaneous share repurchases (or a repurchase of another series of outstanding convertible bonds or other equity-linked instruments). By reducing the total number of ordinary shares (or convertible bonds or other equity-linked instruments) outstanding on a fully diluted basis, the company would be able to reduce the net potential dilution to existing shareholders from the conversion of the new bonds.

Stock Borrow

What is "stock borrow" and why might it be critical to the success of a convertible bond offering?

In economic terms, a stock borrow arrangement is simply a loan of securities in return for a fee paid to the lender (though, as a legal matter, it usually involves the outright transfer of legal and beneficial ownership of securities from lender to borrower with an agreement by the borrower to redeliver "equivalent securities" at the end of the loan). It is important, however, that the lender remains the economic owner of the securities, as it enables the lender to keep the loan securities on its balance sheet for accounting purposes – to preserve this economic ownership, a stock loan will usually provide for the borrower to compensate the lender for any dividends or interest payments that arise on the loaned securities during the loan term.

Stock borrowing is an essential part of the securities markets and one of its primary purposes is to enable market participants to fulfil their delivery obligations under short sales. This is a critical aspect of the investment strategy of "convert arbitrage" hedge funds, which simultaneously purchase convertible bonds and "short" the company's ordinary shares (thus creating delivery obligations which, given the potential lack of liquidity in the ordinary shares of the relevant company, they may find difficult to meet without stock borrow being available to them).

By going "long" the convertible bonds and "short" the ordinary shares, these hedge funds seek to put themselves in an economic position that, if the company's ordinary share price falls, they benefit from the short position in the company's ordinary shares and, in addition, benefit from their long position in the convertible bonds (the price of which is likely to decline less than the ordinary shares, given their Bond Floor). On the other hand, if the company's ordinary share price rises, these hedge funds will be in a position to convert their bonds and sell the conversion shares at market value, thereby benefitting from their "long position" in the convertible bonds and, ideally, compensating for any losses on their short position in the ordinary shares.

Annex A – Examples of Core Terms and Conditions of Convertible Bonds

Summary examples of Eurobond negative pledge and events of default

Summary Example of a Eurobond Negative Pledge:

"So long as any of the Bonds remain outstanding (as defined in the Trust Deed), the Issuer will not create or permit to subsist, and will ensure that none of its subsidiaries will create or permit to subsist, any mortgage, charge, lien, pledge, or other form of encumbrance or security interest upon or with respect to the whole or any part of its present or future business, undertaking, property, assets, or revenues (including any uncalled capital) to secure any Relevant Indebtedness or to secure any guarantee of or indemnity in respect of any Relevant Indebtedness unless, in the case of the creation of a security interest, before or at the same time and, in any other case, promptly, any and all action necessary shall have been taken to the satisfaction of the Trustee to ensure that:

(i) all amounts payable by the Issuer under the Bonds and the Trust Deed are secured by the relevant security interest equally and ratably with the Relevant Indebtedness or guarantee or indemnity, as the case may be, to the satisfaction of the Trustee; or

(ii) such other security interest or guarantee or indemnity or other arrangement (whether or not including the giving of a security interest) is provided in respect of all amounts payable by the Issuer under the Bonds and the Trust Deed either (i) as the Trustee shall in its absolute discretion deem not materially less beneficial to the interests of the Bondholders or (ii) as shall be approved by an extraordinary resolution of the Bondholders.

"Relevant Indebtedness" means any present or future indebtedness (whether being principal, interest, or other amounts), in the form of or evidenced by notes, bonds, debentures, loan stock, or other similar debt instruments, whether issued for cash or in whole or in part for a consideration other than cash, and which are, or are capable of being, quoted, listed, or ordinarily dealt in or traded on any stock exchange, over the counter or other securities market."

Summary Example of Events of Default in European Transactions:

"The Trustee at its discretion may, and if so requested in writing by the holders of at least [•]% in principal amount of the Bonds then outstanding or if so directed by an Extraordinary Resolution of the Bondholders shall (subject in each case to being indemnified and/or secured and/or prefunded to its satisfaction and provided that in the case of paragraphs (b), (d), (h), (k), and (l) – and, in the case of a subsidiary only, paragraphs (f) and (g) – the Trustee shall have certified that in its opinion such event is materially prejudicial to the interests of Bondholders), give notice in writing to the Issuer that the Bonds are, and they shall accordingly thereby immediately become, due and repayable at their principal amount, together with accrued interest as at such date, if any of the following events (each an "Event of Default") shall have occurred:

(a) the Issuer fails to pay the principal of or any interest on any of the Bonds when due and such failure continues for a period of seven days in the case of principal and 14 days in the case of interest; or

(b) the Issuer does not perform or comply with any one or more of its other obligations in respect of the Bonds or the Trust Deed and such default is incapable of remedy or, if (in the opinion of the Trustee) capable of remedy, is not (in the opinion of the Trustee) remedied within 30 days (or, in the case of failure to deliver ordinary shares due upon conversion of the Bonds, 10 days) after the Issuer shall have received from the Trustee written notice of such default; or

(c) if (i) any Indebtedness of the Issuer or any subsidiary becomes due and repayable prematurely by reason of an event of default (however described); (ii) the Issuer or any subsidiary fails to make any payment in respect of any Indebtedness on the due date for payment as extended by any originally applicable grace period; (iii) any security given by the Issuer or any subsidiary for any Indebtedness becomes enforceable; or (iv) default is made by the Issuer or any subsidiary in making any payment due under any guarantee and/or indemnity given by it in relation to any Indebtedness of any other person;

(d) if (i) a distress, attachment, execution, or other legal process is levied, enforced, or sued out on or against all or any substantial part of the property, assets, or revenues of the Issuer or any subsidiary and is not discharged or stayed within 30 days or such longer period as may be permitted by the Trustee in its sole discretion; or (ii) any step is taken by any person with a view to the seizure, compulsory acquisition, expropriation, or nationalisation of all or a material part of the assets of the Issuer or any subsidiary; or

(e) any step is taken to enforce any mortgage, charge, pledge, lien, or other encumbrance, present or future, created or assumed by the Issuer or any subsidiary (including the taking of possession or the appointment of a receiver, administrative receiver, administrator manager, judicial manager, or other similar person); or

(f) the Issuer or any subsidiary is insolvent or bankrupt or unable to pay its debts, or stops, suspends, or publicly announces an intention to stop or suspend payment of all or a substantial part of (or of a particular type of) its debts, or proposes or makes any agreement for the deferral, rescheduling or other readjustment of all of (or all of a particular type of) its debts (or of any substantial part) which it will otherwise be unable to pay when due, or proposes or makes a general assignment or an arrangement or composition or compromise with or for the benefit of the relevant creditors in respect of any of such debts or a moratorium is agreed or declared or comes into effect in respect of or affecting all or any substantial part of (or of a particular type of) the debts of the Issuer or any subsidiary; or

(g) an order is made or a resolution is passed for the winding-up or dissolution of the Issuer or any subsidiary, or the Issuer or any subsidiary has passed a special resolution to have itself wound up or has made an announcement or issued a notice to that effect, or the Issuer or any subsidiary ceases or publicly announces an intention to cease to carry on all or substantially all of its business or operations, except in any such case (i) for the purpose of and followed by a reconstruction, amalgamation, reorganisation, merger, or consolidation on terms approved by the Trustee or by an extraordinary resolution of the Bondholders or (ii) in the case of a subsidiary, whereby the undertaking and assets of the subsidiary are transferred to or otherwise vested in the Issuer or another subsidiary; or

(h) any action, condition, or thing (including the obtaining or effecting of any necessary consent, approval, authorisation, exemption, filing, licence, order, recording, or registration) at any time required to be taken, fulfilled, or done in order (i) to enable the Issuer lawfully to enter into, exercise its rights and perform and comply with its obligations under the Bonds or the Trust Deed, as the case may be, (ii) to ensure that those obligations are legally binding and enforceable and (iii) to make the Bonds and the Trust Deed admissible in evidence is, in the case of (i), (ii) or (iii) above, not taken, fulfilled or done; or

(i) a final judgment or judgments for the payment of money are rendered against the Issuer or any subsidiary and which judgments are not, within 60 days after entry thereof, bonded, discharged, or stayed pending appeal, or are not discharged within 60 days after the expiration of such stay; or

(j) it is or will become unlawful for the Issuer to perform or comply with any of its obligations under or in respect of the Bonds or the Trust Deed, as the case may be; or

(k) any event occurs which under the laws of any relevant jurisdiction has an analogous effect to any of the events referred to in any of the foregoing paragraphs."

Summary Example of Events of Default in US Transactions:

"Each of the following events shall be an 'Event of Default' with respect to the Notes:

(a) default in any payment of interest on any Note when due and payable, and the default continues for a period of 30 days;

(b) default in the payment of principal of any Note when due and payable on the Maturity Date, upon any required repurchase, upon declaration of acceleration, or otherwise;

(c) failure by the Company to comply with its obligation to convert the Notes in accordance with this Indenture upon exercise of a Holder's conversion right and such failure continues for a period of five days or more;

(d) failure by the Company to issue a Fundamental Change Company Notice in accordance with Section 15.02(c), notice of a Make-Whole Fundamental Change in accordance with Section 14.03(b) or notice of a specified corporate event in accordance with Section 14.01(b)(ii) or 14.01(b)(iii), in each case when due and such failure continues for a period of five days or more;

(e) failure by the Company to comply with its obligations under Article 11 (Consolidation, Merger and Sale of Assets);

(f) failure by the Company for 90 days after its receipt of written notice from the Trustee or the Holders of at least 25% in principal amount of the Notes then outstanding to comply with any of its other agreements contained in the Notes or this Indenture;

(g) default by the Company or any Significant Subsidiary with respect to any mortgage, agreement, or other instrument under which there may be outstanding, or by which there may be secured or evidenced, any indebtedness for money borrowed in excess of $[ ] (or its foreign currency equivalent) in the aggregate of the Company and/or any such Significant Subsidiary, whether such indebtedness now exists or shall hereafter be created (i) resulting in such indebtedness becoming or being declared due and payable prior to its stated maturity or (ii) constituting a failure to pay the principal or interest of any such indebtedness when due and payable (after the expiration of all applicable grace periods) at its stated maturity, upon required repurchase, upon declaration of acceleration or otherwise;

(h) a final judgment or judgments for the payment of $[ ] (or its foreign currency equivalent) or more (excluding any amounts covered by insurance) in the aggregate rendered against the Company or any Significant Subsidiary, which judgment is not discharged, bonded, paid, waived or stayed within 60 days after (i) the date on which the right to appeal thereof has expired if no such appeal has commenced, or (ii) the date on which all rights to appeal have been extinguished;

(i) the Company or any Significant Subsidiary shall commence a voluntary case or other proceeding seeking liquidation, reorganization, or other relief with respect to the Company or any such Significant Subsidiary or its debts under any bankruptcy, insolvency, or other similar law now or hereafter in effect or seeking the appointment of a trustee, receiver, liquidator, custodian, or other similar official of the Company or any such Significant Subsidiary or any substantial part of its property, or shall consent to any such relief or to the appointment of or taking possession by any such official in an involuntary case or other proceeding commenced against it, or shall make a general assignment for the benefit of creditors, or shall fail generally to pay its debts as they become due; or

(j) an involuntary case or other proceeding shall be commenced against the Company or any Significant Subsidiary seeking liquidation, reorganization, or other relief with respect to the Company or such Significant Subsidiary or its debts under any bankruptcy, insolvency, or other similar law now or hereafter in effect or seeking the appointment of a trustee, receiver, liquidator, custodian, or other similar official of the Company or such Significant Subsidiary or any substantial part of its property, and such involuntary case or other proceeding shall remain undismissed and unstayed for a period of 30 consecutive days."

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