



Questions and answers on the bond market and on bondholder representatives

Bond market background

What are bonds?

Bonds are publicly issued securities with long-term maturity (over one year), where the total amount is divided into a number of small parts as promissory notes or bond units. In Finland, issuers of bonds have traditionally been the central government and other public bodies, large companies and financial institutions, but nowadays also, to an increasing extent, small and medium-sized enterprises (SMEs). Bonds may pay a floating, fixed or zero rate of interest or may be index-linked. Bonds typically have a maturity ranging from several to ten years. Bonds may be, and nowadays generally are, in book-entry form, in which case they are in an electronic register of securities, where trades are implemented as transfers between owners' book-entry accounts.

How big is the bond market in Finland?

The total nominal value of long-term bonds issued by domestic operators has more than doubled since 2002. At that time, their total value was just under EUR 80 billion, while their nominal value in 2015 was more than EUR 200 billion. At the beginning of 2015, the total nominal value of bonds issued by domestic institutions was approximately half of the market value of the stock market.

According to statistics of the Bank of Finland, the total value of bonds issued by Finnish companies has fluctuated in recent years, from just over EUR 400 million in 2008 to approximately EUR 10 billion in 2012. At the same time, the number of issuances annually has ranged from less than 10 to nearly 50. In total, the corporate sector funded its operations in 2015 by issuing bonds valued at approximately EUR 3.1 billion, which was more than half a billion euros less than the previous year.

Why is the bond market growing in significance as a corporate financing channel?

Bonds have become increasingly common as a form of corporate financing in recent years, because the increasing cost of business loans and stricter lending terms have compelled an increasing number of Finnish companies, particularly large companies, to seek external financing from elsewhere than loans from deposit banks. According to the spring 2016 SME Barometer and the Bank of Finland's 2015 Survey of Business Finances, collateral requirements appear to have tightened further. In addition, the special conditions, i.e. covenants, of business loans have tightened for some companies. According to the SME Barometer, growth companies have a greater need for financing than other SMEs. Just over a quarter of growth companies and 17% of SMEs consider that the poor availability of financing adversely affects the implementation of investment projects.

What are the special characteristics of the Finnish bond market?

When assessing bond markets, it is necessary to make a distinction between domestic or regional and Europe-wide or global markets, especially in relation to the secondary market. A number of special characteristics can

be distinguished for the Finnish bond market. Only a few banks engaged in professional market-making activity for bonds issued by Finnish companies are operating in the Finnish market. Correspondingly, the market has a very small number of professional investors, and the size of issuances is normally small but the transaction size large. For this reason, trading in the local bond market is sporadic and the market as a whole can be considered to be illiquid. In Norway, Sweden and Denmark, the special characteristics also include the own national currencies of these particular countries. The number, investment capacity and diversity of professional investors operating in the Europe-wide and global markets are, in contrast, extensive, both in the primary and secondary markets.

How does the market function elsewhere?

Due to local special characteristics (such as the low number of market participants), the Finnish and other Nordic countries' bond markets differ from the more extensive European markets. When a bond is offered to a more extensive international market, the issuance is often done by choosing an English market participant and using documentation familiar to international investors under English law. *Euro Medium Term Note* (EMTN) documentation will often apply. Bonds offered to the international market may have several dozens of active market makers (underwriters), in which case the liquidity of a bond's secondary market is substantially better than when a bond is offered solely to domestic investors.

What has been done in Finland to develop the bond market?

In Finland, assessment of regulations relating to bondholder representatives is part of measures to develop the domestic bond market that began with the Stadigh working group's report *Pääomamarkkinat ja kasvu* (*Capital markets and growth*), which was completed in the Ministry of Finance on 13 March 2012. The Government decided in its structural policy programme in November 2013 to support the introduction of standardised terms of agreement related to bond issue. The so-called EK model terms, prepared by the Confederation of Finnish Industries (EK) in cooperation with the Advisory Board of Finnish Listed Companies, were introduced in January 2014. At the same time, Nasdaq Helsinki opened on the Helsinki Stock Exchange an alternative marketplace for bonds, *First North Bond Helsinki*. Issuances made in the marketplace are more lightly regulated (including lighter administrative requirements and obligations). In the decision on the implementation of the structural policy programme announced by the Government on 25 March 2014, the Government decided to enhance the functioning of the bond market by launching a project to prepare legislation on a bondholder representative model.

Bondholder representative

What is a bondholder representative?

A bondholder representative is a company that represents investors in their relationship with issuers, i.e. companies seeking financing. The representative may be, for example, an investment service provider or a company set up for this particular purpose.

Legally, a bondholder representative means a business that has undertaken to act for the benefit of bondholders in the manner stated in the terms and conditions of the bond or in a representation agreement related to the bond.

What does a bondholder representative do?

A bondholder representative's role generally includes verifying and interpreting the effectiveness of documentation and the terms and conditions of a loan (bond) or security during the preparation phase of an issuance. Representatives are also obliged to monitor the implementation of the terms and conditions of the

loan during the term of the loan, even though this is largely a passive obligation, i.e. representatives are not obliged other than in exceptional cases to take an active role in obtaining information about the issuer's activities. During the life cycle of a bond, representatives may also sometimes confirm a possible interest rate criterion, monitor compliance with any commitments, such as special terms, i.e. covenants. Representatives also often have the right to institute proceedings on behalf of bondholders against issuers or third parties, the right to exercise in legal proceedings the bondholders' right to be heard without separately obtaining an authorisation from them, the right to file for an issuer's bankruptcy, the right to represent the bondholders and exercise on their behalf their right to be heard in an issuer's bankruptcy proceedings, as well as the right to manage collateral and guarantees given for bonds for the benefit of bondholders.

What are the advantages of using a bondholder representative?

In principle, the use of a representative model is expected to reduce transaction costs, improve bondholders' access to information about issuers and the status of their investments, improve communication between issuers and bondholders, and accelerate the making of decisions in any problems that issuers may have.

The benefits of a bondholder representative model derive from the fact that issuers can communicate with only one party in matters concerning the bonds that they issue. Rather than issuers having to try and reach a large number of anonymous and possibly nominee-registered bondholders separately in order to arrange a meeting of bondholders, issuers can simply turn to a representative working on behalf of the bondholders. Moreover, bondholders' access to information, monitoring of payment of interest, and contacts with issuers are facilitated when they can simply turn to their representative instead of to the issuers. The management of collateral for the joint benefit of bondholders is also facilitated, because the use of a representative in secured bonds is a practical necessity.

What's the aim of the act on bondholder representatives?

The aim of the proposal is to create a better functioning bond market, improve companies' access to financing, diversify the financial markets and increase investor protection by prescribing for representatives' activities a light, clear and mainly voluntary legislative framework.

This will presumably also increase foreign investors' interest in the Finnish bond market. An effective bondholder representative model is expected to improve the functioning of the Finnish bond market and help expand SMEs' access to sources of external financing.

Why is an act on bondholder representatives required?

In the Finnish bond market, representatives' powers, rights and obligations have to date largely been based on the terms and conditions of each bond issuance or on a representation agreement related to a bond. A certain degree of legal uncertainty has been associated with the interpretation of these.

To enhance legal certainty and improve the functioning of the bond market, the working group proposes a limited and largely voluntary framework act on bondholder representatives.

The aim of the proposed act is to:

- enhance the functioning of the bond market and thereby economic growth and companies' access to financing
- diversify the existing financial markets
- clarify the ground rules for representative activity
- improve investor protection when bondholder representatives represent non-professional (retail) investors in bond issuances

- promote issuers', bondholders', investors', other parties' and bondholder representatives' understanding of their rights and obligations.

What will the act contain?

The provisions of the act would be mainly voluntary, although certain separately specified provisions would be expressly mandatory. These would include, for example, a bondholder representative's obligation to treat bondholders equally, a bondholder representative's disclosure obligation, and the separation of assets belonging to some other party from a bondholder representative's own assets. In addition, based on their content and purpose, provisions relating to good securities market practice, supervision and penalties would also be mandatory.

The act would, however, also impose on bondholder representatives certain obligations such as a disclosure obligation as well as an obligation to keep separate, to secure and to handle in a reliable way collateral given for bonds and the client's assets. In addition, the act would lay down provisions on the permanence of representatives' right of representation as well as on the procedure for changing a representative.

Who will be able to act as a bondholder representative?

A business will be able, as a rule, to act as a representative in a bond only if it is registered as a representative in a public register of bondholder representatives maintained by the Financial Supervisory Authority.

The legal structure of representatives will not be restricted; a representative may be, in addition to a limited company, a cooperative, a limited partnership, a general partnership, a European company, a European cooperative or association or an equivalent foreign corporation.

Through registration, the aim is to create a sufficient threshold for entry into the market, which in turn is of great significance from the perspective of the credibility of investor protection and representative activity.

Will it be mandatory in all circumstances to use a registered bondholder representative?

No. Exceptions to the registration obligation will apply to a situation where a prospectus as referred to in the Securities Market Act (746/2012) is not published for a bond or where an application is not made to trade a bond in a regulated market. The registration obligation, moreover, will not apply to a credit institution, payment institution, fund management company, investment service provider, alternative fund manager or some other financial services company that has obtained a operating licence granted by the Finnish Financial Supervisory Authority or the competent supervisory authority of a country belonging to the European Economic Area countries (*EEA country*) or a country belonging to the Organisation for Economic Cooperation and Development (*OECD country*), nor to some other party providing financial services that is subject to the corresponding supervision of such a supervisory authority when operating as a representative in Finland. The registration obligation will also not apply to a business established in another EEA country or OECD country that is only operating temporarily as a representative in Finland or which has been appointed as a representative for a bond issued by a Finnish company in another EEA country or in a third country. The registration obligation will also not apply to loan-based crowdfunding where the capital collected is less than EUR 5 million. Otherwise, a business wishing to operate as a bondholder representative will have to fulfil the precisely specified conditions for registration. At the same time, for existing market operators or businesses considering entering the market, a viable option will be created to practise representation business activity in the bond market in accordance with the principle of proportionality.

Using a registered representative may be considered, however, to be the main rule, and the default position will be that light framework regulations prepared in accordance with the principle of proportionality will

result, in practice, in all businesses engaged in representation business activity in Finland being registered with the Financial Supervisory Authority.

Will it be mandatory to use a bondholder representative?

No. The use of a representative will not, neither on the basis of current market practice nor the legislative proposal, be mandatory in the future. In certain circumstances in the future, a registered representative will, however, have to be used, although in the proposal there will be certain exceptions to this, as mentioned above. The decision to use a representative will also remain in the future with the parties to a bond or other arrangement.

How will the act improve investor protection?

The working group has not identified any significant deficiencies in investor protection in the current regulations. Many of the changes put forward in the proposal will, however, improve investor protection and enhance legal certainty. Representatives will have to, as a rule, register with the Financial Supervisory Authority, which will also supervise that representatives' activities comply with the law. In addition, representatives will in the future have to have capital of at least EUR 50,000 or professional liability insurance, a bank guarantee or other corresponding security which the Financial Supervisory Authority deems to be sufficient. The proposal would also impose on representatives certain obligations such as a disclosure obligation as well as an obligation to keep separate, to secure and to handle in a reliable way collateral given for bonds and the client's assets. In addition, the act would lay down provisions on the permanence of representatives' right of representation as well as on the procedure for changing a representative.

The working group has given special attention to opportunities for increasing the participation of small (retail) investors in the bond market. Using a representative may, as a rule, reduce the legal risks and costs of bond management and therefore also improve investor protection and the fulfilment of investors' management rights.

The objective, moreover, is to succeed in approving business practised by representatives as a regulated form of activity and business in the financial markets. To ensure adequate investor protection provisions and compliance with them, the working group has endeavoured in its work to make market activities transparent and predictable, taking investors' justified expectations into account, through use of prescribed penalty provisions.

What is the scope of the proposal?

The act would be applied to bondholder representatives. The act will be applied to representatives in connection with the issuance of bonds as well as during the period of validity of a representation agreement and issued bond. The act will also be applied in situations in which a representative enters into bankruptcy, restructuring proceedings, a private individual's debt adjustment or other applicable domestic or foreign insolvency proceedings or acts contrary to good securities market practice. For the effectiveness of the representative model, it is essential that representatives are able to attend, on the bondholders' behalf, to the collection of receivables, the realisation of collateral, and judicial proceedings in relation to issuers and debtors' insolvency proceedings, including issuers' bankruptcies and restructuring proceedings.

In addition, a small part of the act will apply to security agents used in collective financing arrangements other than bonds, unless otherwise agreed. The appointment of a security agent and its tasks as well as the use of a security agent in collective financing arrangements other than bonds are prescribed on in more detail in Chapter 5 of the legislative proposal. The act will also apply to security agents acting as representatives, if the appointment of a security agent has been agreed and, instead of a representative, the management of bond collateral for the benefit of all bondholders is given as a task expressly to a separate security agent. The

provision is not intended to be exhaustive; it seeks only to clarify that the provisions relating to representatives may be applied to security agents or to representatives acting as a security agent which manage collateral for the benefit of all bondholders.

The provisions in the proposal relating to bonds and parts thereof will also be applied as such to other predominantly debt-based securities or other corresponding securities, unless otherwise agreed in the representation agreement, and also to loan-based crowdfunding. In practice, the provisions will also facilitate extending the scope of the act to predominantly debt-based securities other than bonds. This prepares for the utilisation of the representative structure in innovative financing arrangements based on financial technology (fintech), such as crowdfunding, which in the future will probably become increasingly commonplace and arise more often than currently.

Is the proposal also significant for non-professional investors?

Yes it is. The proposal has taken into account the status of investors, particularly from the perspective that the representative model will in the future be significant not only for professional investors, but also for retail investor, i.e. non-professional investors. The proposal endeavours to support this by, among other things, bringing representatives under the supervision of the Financial Supervisory Authority and by prescribing that they become operators with an obligation to register with the Financial Supervisory Authority. Based on the proposal, the rights of non-professional investors will be fulfilled better than at present, in addition to which investor protection will, as a result of the proposal, be better in the case of bonds where a representative is used.

Preparation of the project

How has the Ministry of Finance prepared the project?

The Ministry of Finance has prepared the project in cooperation with market operators and other authorities. The Financial Market Department of the Ministry of Finance published an assessment memorandum, prepared as part of its official duties, on legislation concerning bondholder representatives on 24 June 2014 and circulated it for consultation. The summary of opinions and the press release of the then Minister of Finance Antti Rinne on the status and progress of the project were published on the Ministry of Finance's website and in the Government's project register (VM056:00/2014) on 24 November 2014.

After consulting with the Ministry of Justice, the Ministry of Finance established on 25 February 2015 a working group (i) to prepare a Government proposal for legislation concerning bondholder representatives and (ii) to assess possible other measures required to comprehensively improve the functioning of the bond market. The working group's term of office began on 1 March 2015 and the working group completed its work by 30 June 2016. The working group's unanimous proposal for legislation concerning bondholder representatives was published on 1 July 2016 and a summary of opinions on the proposal was published on 24 October 2016. On 9 May 2016, the working group was granted six months' additional time, until 2 January 2017, to complete the work.

The working group has held 18 meetings and its two sub-working groups have held a total of 17 meetings. The working group arranged for stakeholders three extensive hearings on its draft proposals, on 10 March 2016, 25 November 2016 and 16 December 2016. Lawyers, issuers, arranger banks, investors, interest groups and public authorities were invited to the hearings.

Working group's development proposals in the second stage of its work

How has the completion of the bondholder representative model progressed?

Based on the consultation feedback received, the working group has completed a legislative proposal on bondholder representatives. A corrected draft has been attached to the working group's now published second memorandum.

What other proposals does the working group have?

The working group has assessed the development of the bond market and legislation detrimental to it as part of developing the financial markets, improving competitiveness and facilitating growth financing.

The development proposals are divided into three groups: civil and insolvency law, financial market regulation, and strengthening the legal status of bondholder representatives.

What kinds of changes does the working group propose for corporate restructuring?

The working group proposes that in corporate restructurings it should be possible to convert bonds into shares without the consent of shareholders. At present, a company's shareholders must give their consent to this so-called debt-to-equity swap. This is considered to be the main obstacle to the development of bond markets, particularly from the perspective of institutional investors.

If the consent of shareholders were not needed, corporate restructuring would become a more attractive option for creditors. This would reduce creditors' desire to institute bankruptcy proceedings against companies.

In debt-to-equity swaps, creditors would receive a separately determined holding in the company, and the holdings of the existing shareholders would be correspondingly reduced. The proposal is based on, among others things, experiences gained from the Talvivaara corporate restructuring.

What else does the working group propose?

It is proposed that the Investment Services Act be amended to expand the investor base of the bond market and by taking the status of foundations as investors into account. The working group also proposes that prerequisites for offering investment services on an incidental basis be clarified. An additional proposal is that companies' international acquisition of funds be eased by clarifying the right to offer investment services without establishing a branch. It is proposed that a provision on good securities market practice be added to the Investment Services Act and to the Act on Trading with Financial Instruments. A revision of the Crowdfunding Act and the Insurance Companies Act will enable insurance companies to act as crowdfunding intermediaries.

It is proposed that the operating rights of bondholder representatives be strengthened

- in the Act on Trading with Financial Instruments, in situations where trading is discontinued and a security is removed from a stock market list or a multilateral trading facility
- in the Act on the Book-Entry System and Clearing Operations, when a matter relates to an issuance account and access to information on nominee-registration
- in the Act on Book-Entry Accounts, when payment protection given to an issuer and representative is involved.

On what did the working group disagree and why?

An amendment proposed to the Gift Promises Act will facilitate the gifting of fund units and clarify the legal situation. The Ministry of Justice, in its dissenting opinion, considered that the proposal will be unsuccessful. The matters falls within the remit of the Ministry of Justice.

It is proposed that preconditions for debt-to-equity swaps in corporate restructurings be clarified. The proposal is based on, above all, experiences gained from the corporate restructuring of Talvivaara Mining Company Plc. The proposal is not unanimous; there are three dissenting opinions (Ministry of Justice, Finnish Family Business Association / Federation of Finnish Enterprises and Finnish Foundation for Share Promotion / Finnish Shareholders Association). The Ministry of Justice, within whose remit corporate restructuring legislation and corporate law falls, considers that the issue should be assessed separately, because it has fundamental significance and affects other areas besides the bond market. The other dissenting opinions considered that the debt-to-equity swaps will weaken the status of owner-entrepreneurs, and they opposed the proposal. The majority of the working group considered, however, that opening discussion on the issue to be timely and important. To rationalise the difference of opinion, the working group proposes two options, one of which is restricted to listed companies and listed bond issuers. A more extensive option in terms of area of application applies to all companies.

On other issues, the working group was unanimous.

Does the project have special political status?

Yes, because the project is part of the key Government projects action plan, in which the Government has outlined as follows: *“The Government considers it important that the Ministry of Finance prepare a Government proposal to improve the functioning of the bond market with the aid of a bondholder representative model.”*

Why a national act and not EU regulation?

No EU-level regulations exist on bondholder representatives; different EU states have resolved problems relating to the issue in different ways. Moreover, no EU regulations are expected on bondholder representatives in the near future. Regulations should therefore be implemented nationally in order to enhance and support the operation of Finnish bond market.

The subject is related to the objectives of the EU Capital Markets Union as well as national measures of Member States encouraged by the Commission.

Do other EU countries have similar legislation?

National regulations have been implemented in Germany, Denmark and, to a certain extent, France. In Norway, the rights of representatives to operate are based on prior decisions given by Norway’s Supreme Court. In Sweden, there is no separate legislation concerning representatives.

In the UK, bondholder representation takes place by utilising an institution called a *trust*. No detailed definition of a *trust* is found in legislation; its content and the powers of representatives have been determined from the joint effect of written legislation, case law and legal literature. In the UK, a trust has traditionally been considered to be a relationship in which a *trustee* manages property on behalf of and in the interests of a third party. Generally speaking, trustees have been considered to have a legal right of representation and possession (formal right of ownership, i.e. *legal ownership*) to the property they manage, whereas actual right of ownership (*beneficial ownership*), the right to the returns on the property and strong legal status are held by the beneficiaries of the trust.

What about the rest of the world?

In the *common law* legal system of the United States, the status of representatives is built on *trust* institutions. A feature differing from other legal systems is that in the United States *collective action clauses* are viewed more negatively. In those bonds to which the 1939 *Trust Indenture Act* applies, collective action clauses are not permitted if decision-making has an effect on a bond's capital or interest. In other words, changes affecting them require the agreement of all bondholders.

How will the work continue?

The organisation and scheduling of further preparation of the development proposals will be assessed on the basis of consultation feedback in March-April. The working group proposes that the Government would submit its supplemented proposal on the rights of bondholder representatives to Parliament in May and that the act would enter into force next autumn.

Inquiries:

Jarno Tepora, Professor Emeritus of Civil Law, Chair of the Working Group, tel. +358 40 554 22817,
jarno.tepora(at)helsinki.fi

Ilkka Harju, Legislative Counsellor, tel. +358 2955 30215, ilkka.harju(at)vm.fi

Urpo Hautala, Financial Counsellor, tel. +358 2955 30276, urpo.hautala(at)vm.fi