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Exchanges Alter View on 20% Rule for Convertible Bonds

BY ROBERT EVANS III

Bankers who originate convertible bonds issued and companies interested in issuing convertible bonds received a rare regulatory win a couple of months ago. Nasdaq and the New York Stock Exchange altered their views about how their rules apply to convertible bonds. The new views remove a potential obstacle to U.S. public companies seeking convertible bond financing. The changes specifically affect companies doing Rule 144A offerings where the number of shares underlying the convertible bonds exceeds 20% of the outstanding shares.

The convertible bond market for public companies is on pace for its best year since 2007 (though if it keeps that pace it will still raise only half as much as it did in '07). From the beginning of 2014 to May 8, 2015, there have been 128 deals (excluding mandatories and convertible preferreds); three-quarters of them are private placements under Rule 144A rather than registered public offerings. Also, most of those deals give the issuer of the bonds the right to settle all or part of the conversion obligation with cash instead of shares of stock.

The Nasdaq and NYSE rule changes apply to Rule 144A offerings of convertible bonds that allow for settlement in cash or a combination of cash and shares. Previously, shareholder approval was required if a listed company offered convertible bonds like that under Rule 144A and the number of shares of common stock underlying the convertible bond exceeded 20% of the outstanding shares or voting power. Now, Nasdaq and the NYSE will treat alike convertible bonds with flexible settlement and convertible bonds that only convert into shares of common stock. If the conversion price is at least equal to the greater of the book value and market value per share of common stock, no shareholder approval will be required.

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Background

Nasdaq and the NYSE have rules that require shareholder approval before a listed company can enter into some types of dilutive transactions. For a convertible bond offering, the 20% rule is usually the one to remember. The Nasdaq rule differs somewhat from the NYSE rule, but the bottom line is that unless an exemption applies, shareholder approval will be required if the maximum number of shares underlying the convertible bonds represents 20% or more of the voting power or the number of shares outstanding before the issuance of the convertible bonds.

Registered public offerings are generally exempt, assuming a broad marketing effort. That leaves private placements, including Rule 144A offerings. The exemption that remains for Rule 144A offerings applies if the sale price of the common stock is at least equal to the

greater of the book and market value of the common stock.

Convertible bonds issued by public companies are typically optionally convertible by the investor and have an embedded conversion premium. The conversion premium is the amount by which the conversion price exceeds the market price of the common stock at the time of pricing of the convertible bond deal. A typical conversion premium would be 25% percent – so if the stock is trading at $40 per share, the conversion price in that case would be $50 per share.

The conversion premium is a pricing term and varies depending on the situation. Because for most companies the book value is less than the market price, a typical convertible bond would almost always satisfy the terms of the exception. That is, the conversion price would be higher than the greater of the book value and the market value of a share of common stock. The calculation is complicated under Nasdaq's interpretation by the typical ''make whole'' feature in convertible bonds. Note that this analysis generally would not apply to private equity-style converts or mandatorily convertible securities.

In the early 2000s, net share settled convertible bonds gained favor as a result of investment bankers and issuers trying to solve for the accounting impact of issuing public company convertible bonds. Ordinary, physically settled convertible bonds, where the investor surrenders a bond for conversion and receives only shares of common stock, have an unfortunate side effect on the issuer's earnings per share. The shares underlying the convertible bond can end up added to the denominator in calculating fully diluted earnings per share. If the company's common stock trades in the market based on EPS, a dampening effect on the stock price may result. To help with that concern, net share settled convertible bonds allow the company to pay a portion of the conversion value, up to the principal amount of the bonds, in cash and the remainder in shares. The accounting treatment for these types of securities can be different – the Treasury method is used and the underlying shares do not count in the denominator until the bonds are in the money.

A net share settled convertible bond is like using cashless exercise for a warrant. Instead of surrendering the convertible bond for conversion and getting the full number of shares represented by the conversion ratio, the investor gets up to $1,000 per bond in cash and any remaining conversion value in shares of common stock. Because bankers (and issuers) like optionality, they often use a form of convertible bond, labeled ''Instrument X'' by accountants, that allows for settlement in cash, shares or any combination of cash and shares, with the usual settlement being net share.

Nasdaq, in response to net share settled convertible bonds, became concerned about how to apply its 20% shareholder vote requirement. Ultimately, it decided that any convertible bond where the issuer was required or had the option to pay cash upon conversion (other than cash for fractional shares) would not qualify for the exemption to the shareholder vote requirement. Nasdaq's theory seems to have been that net share settlement of the conversion is similar to the issuer repaying the bond in cash and giving out the shares of common stock representing the remaining conversion value for free. If the company did not receive anything for those shares, then they were not sold for at least the greater of the book and market value of the stock when the bonds were priced. For 10 years or so, that was Nasdaq's position. The NYSE eventually reached the same result in interpreting its shareholder approval rule.

As a result of those interpretive positions, shareholder approval was not usually required for Rule 144A offerings of traditional, physically settled convertible bonds where the number of underlying shares exceeded 20% of the outstanding shares. However, shareholder approval was required for convertible bonds with essentially the same economic terms that give the issuer the flexibility to settle part of the conversion value in cash.

New Guidance

Nasdaq posted new guidance on March 2, 2015. It shows up as Frequently Asked Questions on their website:

FAQ # 1136 – Does a flexible settlement provision in a convertible instrument change the way Nasdaq determines whether securities that are convertible into common stock are issued at a discount to market value?

No. A flexible settlement provision in a convertible instrument allows the issuer to settle conversions through payment or delivery of cash, shares of the company's common stock, or a combination of cash and shares. A convertible instrument with a flexible settlement provision that affects only the form of the settlement, without changing the conversion price of the instrument, will be treated under Rule 5635(d) the same as a convertible instrument with physical settlement only. See also FAQ # 276.

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FAQ # 276 – How does Nasdaq determine whether securities that are convertible into or exercisable for common stock are issued at a discount to market value?

To determine whether securities that are convertible into or exercisable for common stock are issued at a discount to market value, the conversion or exercise price is compared to the market value of the common stock. Market value is the consolidated closing bid price immediately before the company enters into a binding agreement with the investor. If the conversion or exercise price is less than the market value, then the issuance is at a discount.

A potential adjustment to the number of shares or conversion price due to a change to the company's capital structure, such as due to a stock split or extraordinary dividend, does not affect the determination of whether a transaction is at a discount to market value. However, if the company may reduce the conversion price, issue additional shares, or make a cash payment to the investors as a result of subsequent transactions or events, including ''make whole'' payments, the calculation of the conversion price will presume that the maximum amount of any such adjustments will be made. Similarly, potential cash payments to the security holders at the time of conversion, other than for accrued interest, are deducted from the value of the note and the resulting amount would be divided by the number of shares issuable when determining the effective conversion price. An example of such cash payments is

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payments for ''foregone interest'' that would have been earned by the investors after the time of conversion.

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FAQ # 276 includes reference to some features that are pretty typical in convertible bonds, so the analysis of whether the ''greater than book and market'' exemption is available will still require a case-by-case analysis. Also, and this is a potential trap for the unwary, Nasdaq's rules have a separate requirement for a shareholder vote if the use of proceeds of convertible bonds with 20% or more underlying common stock is to acquire the stock or assets of another company – and the greater than book and market exemption is not available under that requirement.

The NYSE has also changed its interpretation of the greater than book and market exemption in its rules. The new interpretation can be confirmed with NYSE staff members.

Conclusion

Bankers have long argued that flexible settlement convertible bonds should not be treated differently than physically settled bonds under Nasdaq and NYSE shareholder approval rules. Now, as a result of changes in the interpretation of the rules, they will be treated the same. That should make structuring new convertible bond offerings just a bit easier.