

FSC PREPARES ADDITIONAL MEASURES TO IMPROVE CONVERTIBLE BOND MARKET

The FSC announced additional measures for improving rules on the convertible bond market on September 7. As in the case with the convertible bonds (CBs) and bonds with warrants (BWs) issued by listed firms, the regulation on refixing and call option will also apply to (redeemable) convertible preference shares issued by listed companies.

BACKGROUND

In October 2021, the FSC introduced a revision¹ to the regulation on the issuance of securities and disclosure to help prevent CBs from being used in unfair transactions in such cases where CBs are used expediently to increase the shareholding of largest shareholders.

※ Key Details of Revised Regulation (for CBs and BWs issued by listed companies)

(A) (REFIXING) Privately offered CBs with a downward conversion price adjustment (refixing) clause are required to also have upward adjustment of conversion prices when share prices rise.

⇒ Aims to prevent excessive dilution of shareholding value of general shareholders if CBs are converted into stocks at a lower adjusted conversion price following a downward conversion price adjustment even when the price of share is rising.

(B) (CALL OPTION RESTRICTION) When issuing CBs with a call option to largest shareholders or specially affiliated persons, exercising call option is restricted to their initial shareholding proportion at the time of CB issuance, and the call option related disclosure duties are strengthened.

⇒ Aims to prevent CBs from being used inappropriately for expanding shareholding proportion of largest shareholders through call option.

Moreover, the FSC introduced a supervisory guideline on the accounting practices of CB call options to help improve the transparency in CB market from an accounting perspective.²

However, in the process of pursuing regulatory improvements, a concern has been raised about the possibility of stronger regulation (on refixing, etc.) posing excessive restriction on companies' fundraising activities.³ Therefore, the authorities have prepared additional measures for regulatory improvement after examining the trend of CB issuance since the revised regulation went into effect from December 1, 2021.

¹ Effective from December 2021

² Companies issuing CBs with a third party call option attached should treat their call options as separate derivatives assets in their accounting practices and report conditions of issuance through footnote disclosure.

³ A refixing option increases the appeal of CB investment, thereby helping companies raise funds more easily.

CONVERTIBLE BOND MARKET TREND⁴

(ISSUANCE AMOUNT) The monthly average CB issuance amount in the first quarter of this year was KRW579.0 billion, a drop of 36 percent compared to the same period last year (KRW904.6 billion)⁵ This is on a par with the declining trend of corporate bonds over the same period (*down 29.2 percent y-o-y*). However, when including the amount of CB issuance prior to the implementation of the revised regulation (KRW2.2 trillion, November 2021), the monthly average CB issuance amount appears to be on course for recovery after a temporary fluctuation.⁶

(ISSUANCE RATE) With the expansion in liquidity amid COVID-19 response measures, the CB issuance rate went down slightly in 2020 but edged back up narrowly due to the effects of base rate hike, etc.⁷

(REFIXING PROPORTION) Since the implementation of the revised regulation, the proportion of CBs being issued with a refixing option attached has declined from 88.5 percent in 2021 to 65.2 percent in the first half of 2022 based on the number of times it has been issued.

(CALL OPTION PROPORTION) Since the implementation of the revised regulation, the proportion of CBs being issued with a call option attached has declined from 72.4 percent in 2021 to 61.0 percent in the first half of 2022 based on the number of times it has been issued.

< Convertible Bonds Issued with Refixing or Call Option Attached >

(%)		Q1 2021	Q2 2021	Q3 2021	Q4 2021	2021	Q1 2022	Q2 2022	H1 2022
Refixing option	# of Times	89.7	92.1	88.6	83.5	88.5	68.0	62.9	65.2
	Issuance amount	68.1	82.8	96.0	69.4	78.7	42.7	39.9	41.0
Call option	# of Times	61.1	72.9	77.9	75.6	72.4	57.3	64.0	61.0
	Issuance amount	71.9	78.3	91.8	75.2	79.1	57.6	85.3	74.4

ASSESSMENT ON IMPACT OF REVISED REGULATION AND NEED FOR IMPROVEMENT

(EFFECTS ON MARKET) The elements of revised regulation appear to have settled in the market without placing heavy restriction on companies' fundraising capabilities. The amount of CB issuance has declined somewhat from the previous year but it is difficult to see this as a major shock resulting from the revised regulation.⁸ However,

⁴ Based on the date of resolution by boards of listed firms

⁵ Monthly average issuance amount (in billion KRW): 677.3 (H1 2020), 626.3 (H2 2020), 904.6 (H1 2021), 987.3 (H2 2021), 579.0 (H1 2022)

⁶ Monthly average issuance amount (in billion KRW): 651.8 (2020), 876.7 (Jan-Oct 2021), 757.3 (Nov 2021-Jun 2022)

⁷ However, the rate of return for CBs are determined not only by the issuance rate but also by considering their conversion margins, thus it is difficult to compare CB rates to ordinary corporate bond rates.

⁸ Compared to 2021, the amount of issuance has somewhat declined (down KRW120 billion a month on average), but it needs to be noted that CB issuance soared in 2021 due to abundant liquidity in the market.

※ Monthly average issuance amount (in billion KRW): 651.8 (2020), 876.7 (Jan-Oct 2021), 757.3 (Nov 2021-

as the overall corporate financing environment has deteriorated recently due to increases in prices, interest rates and FX rates as well as raw materials supply disruption, there are also possibilities of worsening conditions in the CB market.⁹

(KEY OUTCOME) Since the implementation of the revised regulation, there has been a decline in the proportion of CBs being issued with a refixing or call option attached. Considering that the main purpose of the last year's regulatory change was to prevent CBs from being used inappropriately for expanding shareholding proportion of largest shareholders and to resolve the problem of dilution of shareholding value of general shareholders, it is a positive outcome that the proportion of CBs being issued with a refixing or call option has gone down without creating conditions where corporate fundraising is restricted significantly.

(ROOM FOR IMPROVEMENT) However, there exist issues of regulatory disparity with other types of mezzanine securities that can be issued with a refixing or call option such as (redeemable) convertible preference shares and there are concerns about the potential balloon effect. With regard to (redeemable) convertible preference shares that have a refixing or call option attached, there are potential problems—as in the case with CBs and BWs—of being used as a means for expanding shareholding proportion of largest shareholders and resulting in dilution of shareholding value of general shareholders. But these types of securities were excluded from the last year's regulatory overhaul¹⁰ considering that they are mostly issued by non-listed companies. However, as listed firms are also continuing to issue (redeemable) convertible preference shares with a refixing or call option attached, it was deemed necessary to draw up appropriate measures. An analysis into the call option attachment on (redeemable) convertible preference shares revealed that between November 2021 and June 2022, the proportions of call option assigned were 18.4 percent for issuing companies, 77.4 percent for the issuing company and third party designated by the former and 4.1 percent for largest shareholders. Considering that it is possible that third parties designated by the issuing company can also be largest shareholders, the maximum chances of largest shareholders exercising call option was about 81.5 percent (77.4 +4.1) at the greatest.

IMPROVEMENT MEASURES

(MONITORING) With rising base rates and continuation in supply chain disruption for raw materials, there are concerns about deterioration in financial difficulties of SMEs, and the financial authorities will continue to maintain close monitoring of CB market conditions.

(REGULATORY IMPROVEMENTS) The refixing and call option rules that are currently in place for CBs and BWs will be equally applied to (redeemable) convertible preference shares issued by listed companies.

Jun 2022)

⁹ Some argue that CB issuing companies may experience financing difficulties as CB investors give up their option of stock conversion due to recent fall in stock prices and exercise put option early instead.

¹⁰ Only CBs and BWs issued by listed companies were subject to the regulatory overhaul.

- **(REFIXING RULE)** When a listed company issues (redeemable) convertible preference shares through private offering,¹¹ upward adjustment of the convertible price becomes mandatory when share price increases.
 - ▶ **(ADJUSTMENT DUTY)** If share price rises after an adjustment in convertible price following a drop in share price, an upward adjustment of convertible price will be required.
 - ▶ **(LEVEL OF ADJUSTMENT)** The level of upward price adjustment will be restricted within the initial convertible price.

- **(CALL OPTION RULE)** There will be restrictions to exercising call options and imposition of disclosure duties.
 - ▶ **(CALL OPTION LIMIT)** Exercising call options by largest shareholders and specially affiliated persons will be limited to their initial shareholding proportion at the time the (redeemable) convertible preference shares were issued.
 - ▶ **(DISCLOSURE DUTY)** When a call option is exercised by a third party or when sales of listed firm's own (redeemable) convertible preference shares takes place to a third party, the issuing company will be subject to disclosure duties.

FURTHER PLAN

The financial authorities plan to revise the regulation on the issuance of securities, disclosure, etc. within this year (advance notice of regulatory change expected in September). Moreover, the authorities will seek additional measures for improvement while continuing to closely monitor market situations on convertible bonds, etc.

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For press inquiry, please contact Foreign Media Relations at fsc_media@korea.kr.

¹¹ Aims to improve regulatory consistency with current rules on CBs and BWs and considers the fact that there currently exist tighter regulations on public offering such as a duty to file security registrations, etc.