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Eurobond issuing procedure and benefits over bank loans.

Master thesis
30 credits

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International Finance Law

Spring 2011

Contents

Summary

All companies, governments, states and organisations need to raise additional finance for different purposes. There are several different methods, such as bank loans, bonds, notes, structured products or new equity, available to obtain the required amount of money.

The set of financial sources used by a corporate entity is called the company´s capital structure. Commonly, a company uses a number of different sources to safeguard access to sufficient amount of capital. Two of the most important sources are loan financing and bond financing. These two sources will be compared in the second part of this essay. In the first, the issuing process, the distribution and marketing process and subsequent service of Eurobonds will be discussed.

As observed above, bond financing is an important source of long-term funding for corporate entities. Simply, it is a way of borrowing money that later needs to be repaid, often with interest. In many respects, the issuance of bonds has a lot in common with borrowing from a bank. At the same time, it has its own characteristics.

The bond instrument is of bearer character, which gives the holder of the instrument the right of repayment at maturity. The bearer could also realise the value of the bonds prior maturity by selling them on the secondary market. The funds received could then be used for other investment purposes.

As observed above, bonds are issued to secure access to a sufficient amount of capital. There are many different types of bonds. Domestic bonds are bond issued in the home currency of the issuer while Eurobonds are international bonds issued in another currency than the local currency of the issuer and not native to the country of issuance.
Eurobonds are often marketed, distributed and sold by a syndicate of underwriters or managers. These are responsible to place the bonds among investors and they are also obliged to pay for unsold bonds at the closing day. By paying a fee, the issuer can protect himself against unsold bonds.

According to the pecking order theory, corporate managers prefer to use internal financing first, secondly they issue debt, and as last resort they issue new equity. The biggest benefit of bonds is that it, when it is used in combination with bank loans, allows the company to create a well diversified funding structure. This diversification benefit is important since the company becomes less dependent on one source and more resistant to temporary disruptions in the markets. Using both loan and bond financing also allow the company to create a capital and funding structure that matches the individual requirements of the company. This is the most important conclusion of this essay!

Sammanfattning

Alla företag, stater, myndigheter och organisationer är i behov av att kunna locka till sig extra kapital till att användas för att finansiera olika verksamheter. Det finns ett flertal olika metoder för detta ändamål såsom banklån, obligationslån, strukturerade produkter, eller utgivning av nya aktier.

Uppsättningen av finansieringsmetoder som används av ett företag kallas företagets kapitalstruktur. Vanligtvis använder sig företaget av en mängd olika metoder för att säkerställa ett tillräckligt flöde av nytt kapital. Två av de viktigaste är banklån och obligationslån. Dessa två metoder kommer att jämföras och fördelar och nackdelar med de båda kommer att identifieras och diskuteras. Detta kommer ske i uppsatsens andra del. I den första delen kommer utgivningsprocess, distributionsprocessen samt den efterföljande servicen och administrationen av Eurobonds att diskuteras.

Som tidigare har noterats är obligationslån en viktig finansieringskälla för företag. Kort och gott är obligationslån ett sätt för företag att låna pengar som vi ett senare tillfälle skall återbetalas på ett eller annat sätt. Obligationslån har i flera avseenden stora likheter med banklån. Samtidigt har obligationslån sina egna karaktärsdrag.

Obligationsinstrumentet är av utgiven i innehavarform, vilket innebär att det är innehavaren eller bäraren som är berättigad till att åtnjuta sig instrumentets förmåner, det vill säga återbetalning samt ränteutbetalningar. Samtidigt kan innehavaren välja att sälja instrumentet på sekundärmarknaden för att realisera obligationens värde innan förfallodatumet. De medel som mottages vid avyttringen kan då användas för andra investeringar.

Såsom tidigare påpekats, utgives obligationer av företag för att säkerställa företagets tillgång till kapital. Det finns många olika typer av obligationer, både inhemska och internationella. Inhemska obligationer ges ut i en valuta som motsvarar den lokala valutan i utgivarens hemvistland. Eurobonds är internationella obligationer som ges ut i en annan valuta än den lokala i företagets hemvistland och annan än den lokala i utgivningslandet. Eurobonds marknadsförs, distribueras och säljes till investerare av ett syndikat av finansiella institutioner som garanterar utgåvans totala belopp. Dessa finansiella institutioner är ansvariga för att hitta köpare till samtliga obligationer i utgåvan samt att betala för osålda obligationer vid ett visst datum. Genom att betala en avgift till dessa institutioner kan således det utgivande företaget köpa en försäkring mot osålda obligationer.

Enligt pecking order teorin, så söker företag i första hand intern finansiering genom kvarhållna vinster, därefter extern finansiering genom skuldsättning och som tredje alternativ. finansiering genom nyemission av aktier. Därför

har ansats varit att jämföra banklån och obligationslån och identifiera fördelar med de olika alternative. Min viktigaste har varit att det är just kombinationen av dessa båda som innebär den största vinsten för företaget. Genom att ha goda kanaler för kapitalanskaffning genom både banklån och obligationslån blir företaget mindre känsligt för tillfälliga störningar i en av finansieringskällorna. Dessutom kan företaget genom att utnyttja både banklånets och obligationslånets fördelar skapa sig en individuellt anpassad kapitalstruktur som passar just det företagets behov och krav. Detta är min viktigaste slutsats!

Preface

This essay marks an important milestone in my life as I finish my juridical studies at the University of Lund. For sure, it has been some of the best years of my life. I have met a lot of good friends which I will keep in contact with and experienced a many joyful moments.
Now, I am looking forward to start working and to the many challenges ahead of me.

I would like to thank Lars Gorton, who has supported me with many good advices and ideas, and my family, Stefan, Annika, Ulf and Björn, who have supported me my whole life.

During the autumn of 2010, I attended the Center of Commercial Studies at Queen Mary, University of London. I became very interested in international financial law and we learned a lot about syndicated loan transactions. However, we did not learn as much about its main alternative to big corporations, i.e. bond issues. That is why I choose to write about this subject and it has been a great pleasure.

Happy reading!

Anders Lindgren
2011-05-27

Abbreviations

AUS	Australian Dollar.
CAD	Canadian Dollar.
CP	Commercial Paper.
ECP	Euro Commercial Papers.
EMTN	Euro Medium-Term Notes.
EUR	EURO.
IPMA	International Primary Market Association.
MTN	Medium Term Notes.
OTC	Over-The-Counter.
SEK	Svenska kronor - the currency of Sweden.
US	United States.
USD	United States Dollar.

1 Introduction

The ability to raise finance is crucial to most companies, municipals, institutions, and states. The money could be needed for many purposes, from long-term funding of a specific project or investment to short-term day-to-day needs.

Depending on the purpose, the prerequisite of the actors, and the markets´ ability and interest to provide the money, there are several different methods, such as loan facilities, bonds, notes, structured products or equity, that could be used to obtain the required amount of money. The sources mentioned above all have in common that they involve external parties, which provide the company with the required sum. Such external parties are exposed to the risk of suffering a loss if the borrower or issuer defaults. To be willing to accept this risk, they want some kind of compensation in return. This compensation could be in form of interest, potential capital gain or other benefits. The external parties commonly tries to mitigate the effect of a default by the borrower or issuer and protect themselves against undesired consequences if an default occurs. This could be done in different ways such as taking security or including certain covenants and terms and conditions in the agreement, etc.

External financing could be divided into equity and debt financing. The equity financing simply means that the company issues new equity which is subsequently bought by existing or new shareholders. In debt financing, the company borrows money from an external party that later needs to be repaid together with interest. It includes both traditional bank loans and issuance of debt securities such as bonds, notes and commercial papers (CP) and is the major source of external financing for large corporations. In 2007, it made up 94% of all public funds raised in the European Capital markets.[1] Already at this point, one needs to be aware of the important difference between equity and debt financing. Debt financing requires the borrower to repay the debt at maturity along with interest. Equity financing does not require the borrower to make such repayments. Instead the company can pay to the stockholders dividends. However, dividend payments are not obligatory. The company can decide at its own discretion if dividends should be paid and the size of these dividends.[2]

Apart from external financing, internal financing could be used to fund activities of the company. In internal financing, the firm´s own saved profits from earlier years are used to fund future needs.[3]

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[1] Yener & Kara & Marques-Ibanez; *Large debt financing: syndicated loans versus corporate bonds*, p. 437.
[2] Byström, Hans; Capital Structure and Dividend Policy – The Two Modigliani & Miller Theorems, July, 2007, p. 2
[3] Byström, Hans; Capital Structure and Dividend Policy – The Two Modigliani & Miller Theorems, July, 2007, p. 2.

There are several different financial markets in which the required capital could be raised. The main financial markets are money, banking, capital, financial derivatives, and the insurance markets.[4] Here, some short comments on the banking, capital and money markets will be made.
In the banking markets, banks provide their services to corporate entities and to individuals. These main services include deposit taking, corporate loans, and consumer credits. Thus, the banking markets provide individuals, corporate entities and governments with long- and short-term borrowing opportunities.
Capital markets allow companies to raise funds by issuing equity, bonds, notes, CPs, warrants, convertibles, or hybrid instruments which are subsequently bought by investors. The primary capital market consists of the initial issuance of those instruments and the secondary market of the subsequent trading of capital market instruments. This secondary market trading could be conducted on an official exchange or on an over-the-counter (OTC) basis.
The money markets refers to primary and secondary markets for short-term money market instruments such as government treasury bills, corporate bills, promissory bills issued by banks, certificates of deposits and CPs. These are debt instruments with a lifetime of one year or less. The primary money markets are used by central banks to adjust the amount of money in the economy and the secondary money markets provide investors in short-term money market instruments with trading opportunities.

Bond financing is an important source of longer term funding for corporate entities. It is one of the main alternatives to issuing equity or taking a traditional bank loan. Simply, it is a way of borrowing money that later needs to be repaid, often with interest. The bond instrument is of bearer character, which gives the holder of the instrument the right of repayment at maturity. If the bearer for some reason do not want to hold the instrument until maturity, it could be traded and sold on the secondary market.

Depending on the nature of the issuer, bonds could be divided into government and corporate bonds. Government bonds are issued by sovereign states and corporate bonds by corporate entities. Additionally, government and corporate bonds could be issued as international or domestic bonds. International bonds are to investors in multiple countries and in another currency than the home currency of the issuer and include Eurobonds, foreign bonds and global bonds. Domestic bonds are issued in the home currency of the issuer. Eurobonds will be the subject of this essay and will be discussed in detail in later chapters.

Bonds could be issued as stand-alone issues or within the framework of debt programmes. Within the programme, the issuer can issue bonds in various quantities and currencies and with different maturities and interest rates without the complicated and costly documentation and issuing procedure

[4] Walker; *Introduction to financial markets*, p. 4.

associated with issuing a stand-alone bond.[5] This gives the issuer access to a quick and flexible source of funding, and the terms and conditions could easily be adjusted to meet specific needs at time of issuance and to meet the requests of investors. Accordingly, debt programmes allow issuers to issue attractive instruments at a lower cost than associated with issuing a stand-alone bond.[6] Medium-term note (MTN) programmes are examples of such debt programmes. The majority of the MTNs are bonds with a fixed interest rate and a date of maturity. However, the structure, and terms and conditions can vary between different issues within the programme. In many respects, issues within an MTN programme are similar to stand-alone corporate bonds or Eurobonds. The main difference is the way in which MTNs are set on the primary market. Accordingly, these programmes are framework agreements which give high volume issuers access to a reliable source of income.

Debt securities with a maturity of less than one year could be issued within a CP programme. Apart from the maturity time, the main difference between MTN programmes and CP programmes is that the CP market is issuer driven while the MTN market is more investor driven. This means that issuers offer MTNs to the market when demand appears and when market conditions are favourable while CPs are offered more on a continuous basis to meet day-to-day capital requirements of the issuer.[7]

Commonly, a company uses a number of different sources to safeguard access to sufficient amount of capital. The set of sources used by a corporate entity is called the firm´s capital structure.[8] Accordingly, a company could use bond financing, loan financing and equity financing at the same time.

As we will see, large international companies prefer to use a mix of bank loans and bonds. In many respects, the issuance of bonds has a lot in common with borrowing from an bank by taking a loan. At the same time, it has its own characteristics.

[5] Wood; *Law and Practice of International Finance*, p. 177.
[6] Valdez & Molyneux; *An Introduction to Global Financial Markets*, p. 178.
[7] Choudhry; *Corporate Bonds & Structured Financial Products*, p. 247.
[8] Brooks; *Financial Management – Core Concepts*, p. 481.

1.1 Method and Material

Annually, Forbes ranks the biggest companies in the world in The Global 2000.[9] The ranking is based on a composite of parameters such as sales, profits, assets, and market value and aims to give an accurate impression about the size of the companies.[10]

According to The Global 2000, the twenty biggest Swedish public companies are, in stated order, Nordea Bank Group, Volvo Group, LM Ericsson, Telia Sonera Group, SEB-Skand Enskilda bank, Swedbank, Svenska Handelsbanken, Scania, SCA - Svensk Cellulosa, Sandvik, H&M Hennes & Mauritz, Atlas Copco, Skanska, SSAB Svenskt Stål, SKF Group, Elektrolux Group, Investor, Kinnevik, Assa Abloy and Tele 2.[11]
These companies are all big Swedish firms acting on global markets and several different industries, such as Banking, Capital Goods, Technology Hardware & Equipment, Telecommunications Services, Household & Personal Products, Retailing, Construction, Materials, Consumer Durables, Diversified Financials, and Business Services & Supplies, are represented.
Among the Swedish companies, the largest industry is Capital Goods including five companies and that the second largest is Banking represented by four companies. Thereafter follows two industries, i.e. Telecommunications Services and Diversified Financials, including two companies each and then seven industries, i.e. Technology Hardware & Equipment, Household & Personal Products, Retailing, Construction, Materials, Consumer Durables, and Business Services & Supplies, including one company each.

This essay will focus on the capital structure and the choice between loan and bond financing of companies included in the industry of Capital Goods. According to Forbes' Global 2000, the biggest Swedish Capital Goods companies are Volvo Group, Scania, Sandvik, Atlas Copco, and SKF group (these are in the following referred to as "the reference group" or "the reference companies").

The industry of Capital Goods is quite homogenous and the reference companies have during a long period of time played an important role in the Swedish economy. They are all capital-intensive businesses who use a large portion of capital to buy required equipments. Consequently, they are dependent upon a continuous flow of funding from the capital markets and the loan markets.
According to the pecking order theory, managers prefer to use internal financing first, i.e. retained earnings, secondly they issue debt i.e. bank

[9] http://www.forbes.com/lists/2009/18/global-09_The-Global-2000-Sweden_10Rank.html, accessed 2011-04-25.
[10] http://www.forbes.com/2008/04/02/worlds-largest-companies-biz-2000global08-cx_sd_0402global_land.html, accessed 2011-04-25.
[11] http://www.forbes.com/lists/2009/18/global-09_The-Global-2000-Sweden_10Rank.html, accessed 2011-04-25.

loans and bonds, and as last resort they issue new equity.[12] Consequently, new equity is used when additional capital could not be raised through debt financing. All of the reference companies are well established and mature companies who have good access to the debt markets. In these circumstances, it is most natural to compare the advantages and disadvantages between different sources of debt financing, i.e. loan and bond financing, and not to compare debt with equity financing.

The purpose of the investigation which will be made in this section is two folded. Firstly, I will try to observe in what extent companies within the industry of Capital Goods use loan and bond financing. Do they tend to use one of them and in that case which, or do they use them both at the same time? Accordingly, which set of funding sources do Swedish Capital Goods companies use and could any similarities between the companies be identified?
Secondly, how does a typical bond issued by a Capital Goods company look like? Is it a domestically issued corporate bond or an internationally issued Eurobond? Which law is selected to govern the issue? This typical bond will then be described and discussed in following chapters.

Volvo Treasury is responsible for all funding operations within the Volvo Group. Volvo Treasury has access to capital market funding under several debt programmes such as two MTN programmes, including one EMTN programme and one SEK MTN programme, and five CP programmes, including ECP, SEK CP, US CP, CAD CP, and AUD CP programmes. The EMTN programme has a limit of USD 15 billion and the SEK MTN programme of SEK 10 billion. The CP programmes are limited to USD 1 billion (ECP), SEK 20 billion (SEK CP), USD 1,350 million (US CP), CAD 750 million (CAD CP) and AUD 350 million (AUD CP). Within the EMTN programme, several individual issues have been made in different currencies, and with changing maturity time and nominal value during the recent years. The SEK MTN programme has not been used for new funding since May 2005.[13] Volvo Treasury also has two long-term committed facilities of EUR 2 billion and USD 1.4 billion.[14]
When looking into the prospectuses of the recent EMTN issues, one could see that they all are governed by English law.[15] No such information

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[12] Berk & DeMarzo; *Corporate Finance*, p. 539.
[13] http://www.volvogroup.com/group/global/en-gb/investors/debt_investors/debt_programmes/Pages/debt_programmes.aspx, accessed 2011-04-25.
[14] http://www.volvogroup.com/group/global/en-gb/investors/debt_investors/Pages/longterm_committed_facilities.aspx, accessed 2011-04-25.
[15] http://www.volvogroup.com/SiteCollectionDocuments/VGHQ/Volvo%20Group/Investors/Documents,%20misc/EMTN%20prospectus%20dated%209%20november%202010/Volvo%20EMTN%20prospectus%209%20Nov%202010.PDF, p. 14, accessed 2011-04-25.
http://www.volvogroup.com/SiteCollectionDocuments/VGHQ/Volvo%20Group/Investors/Documents,%20misc/EMTN%20prospectus%2011%20November%202009/EMTN%20Prospectus%20dated%2011%20November%202009.pdf, p. 13, accessed 2011-04-25.

regarding the SEK MTN has been found. The reason for this could be that the SEK MTN programme has not been used for new funding activity for such a long period of time.

Scania also relies on a mix of bond and loan financing. The company has two short-term CP programmes and two longer-term MTN programmes. The CP programmes consist of one ECP programme of EUR 0,4 billion and one SEK CP of SEK 10 billion. The long-term funding MTN programmes include one EUR 3,5 billion EMTN programme and one SEK MTN programme of SEK 13,0 billion. However, only about 3% of the borrowing space under the SEK MTN programme has been used while 45% of the borrowing space under the EMTN programme has been utilised.[16] This might indicate that Scania finds it easier to attract additional capital from international investors than from domestic.
Apart from bond financing, Scania also has syndicated multi-currency revolving facilities of EUR 1.0 billion, EUR 1.0 billion, SEK 5.0 billion, and SEK 4.0 billion.
The EMTN programme is governed by English law[17] while the SEK MTN programme is governed by Swedish law.[18]

Sandvik´s capital structure consists of two long-term MTN programmes, two short-term CP programmes, two syndicated loan facilities and one revolving credit facility. The MTN programmes include one SEK MTN programme of SEK 15 billion and one EMTN programme of EUR 3 billion and the short term CP programmes include one SEK CP of SEK 10 billion and one ECP programme of EUR 750 million. It needs to be observed that Sandvik has utilised around SEK 9 billion of the 15 billion SEK MTN programme and only about EUR 590 billion of the EUR 3 billion EMTN programme. [19] However, the possible lending space is bigger in the EMTN programme than in the SEK MTN programme.
The loan facilities include one loan of SEK 0.424 billion and one of SEK 3.178 billion.

The fourth company to be dealt with is Atlas Copco which has one SEK CP programme of SEK 6 billion, one ECP of EUR 4 billion and one US CP programme of USD 1 billion. Furthermore, Atlas Copco has an USD 3 billion EMTN programme and four outstanding bonds denoted in USD, EUR and SEK of whom two is part of the EMTN programme.[20]
Atlas Copco also has two syndicated multi-currency loan facilities of USD 1 billion and SEK 6.390 billion.

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http://www.volvogroup.com/SiteCollectionDocuments/VGHQ/Volvo%20Group/Investors/Documents,%20misc/EMTN%20prospectus%2019%20November%202008/EMTN%20Prospectus%20dated%2019%20November%202008.pdf, p. 12, accessed 2011-04-25.
[16] http://www.scania.com/investor-relations/bondholders/funding-programmes/
[17]http://se.scania.com/Images/ICM-%2310314376-v1-Scania_2010_Final_Clean_Base_Prospectus_145823.pdf, p. 22.
[18] http://se.scania.com/Images/MTN%20programme_46851.pdf, p. 5.
[19]http://www.sandvik.com/sandvik/0010/Internet/Global/se03350.nsf/Adm/42E6A7E6BA3379BFC1256B5100384994.
[20] http://www.atlascopco.com/us/Investorrelations/debtinvestors/.

The last company is SKF Group, which also has turned to the capital markets to finance its activities. According to the Annual Report of 2010, SKF has issued one note of EUR 0.396 billion on the European Bond market and two notes of SEK 0.556 billion and EUR 0.100 billion on the Swedish bond market.
Furthermore, SKF group has three loan facilities and two term loans.[21]

In terms of investigation, one obstacle or problem that has been identified is the difficulty to find accurate and reliable information regarding the terms and conditions of the issues. Only in two cases, prospectuses have been found. Consequently, it is difficult to draw any certain conclusions. However, some similarities have been identified which will be presented in the following paragraphs.

The five companies all seem to rely on a mix of loan and bond financing. They all utilise short-term funding and CP programmes as well as longer-term financing and MTN programmes. They all use a combination of different types of MTN and CP programmes such as EMTN and ECP, USD MTN and USD CP, SEK MTN and SEK CP programmes. It is clear that Eurobonds issued within the framework of EMTN programmes constitute an important source of funding. In terms of available lending space, all companies have relied more on international investors than on domestic. This is not strange since the base of investors is larger internationally than domestically. In Scania, the portion of the used lending space of the EMTN programme by far exceeds the used lending space of the SEK MTN programme.
Apart from capital market financing they also turn to the syndicated loan market in order to attract sufficient amount of capital.

Also, both Volvo and Scania seem to prefer using trustee and paying agents to administer and service the issue during its lifetime.[22] Later in the essay, I will try to identify the advantages and disadvantages with appointing a trustee or a fiscal agent. Another similarity for Eurobond issues is that they are governed by English law.

This essay will deal with internationally issued Eurobonds. Although most bonds are issued within the scope of a debt programme, I will focus on stand-alone issues of Eurobonds. The reason for this is that there are a lot of similarities between stand-alone issues and issues made within the framework of debt programmes. However, the most important reason is that if stand-alone Eurobonds are properly understood, the concept of debt

[21] SKF Annual Report 2010, p. 23.
[22] http://www.volvogroup.com/SiteCollectionDocuments/VGHQ/Volvo%20Group/Investors/Documents,%20misc/EMTN%20prospectus%20dated%209%20november%202010/Volvo%20EMTN%20prospectus%209%20Nov%202010.PDF, p. 21.
http://se.scania.com/Images/ICM-%2310314376-v1-Scania_2010_Final_Clean_Base_Prospectus_145823.pdf, p. 91.

programmes will also be more easily mastered. Debt programmes are nothing but a modification of stand-alone bonds. Consequently, stand-alone bonds constitute the fundament upon which also debt programmes are constructed.

In the writing of this essay a legal dogmatic method has been applied using legal doctrine, legal and economic articles, annual reports of the five reference companies and case law. It is not a traditional juridical essay in that I will not discuss all laws and paragraphs applicable to Eurobond issues, but will try to put the issuing procedure and the comparison between bonds and loans into an economical-juridical perspective.

1.2 Purpose

The purpose of this essay is to examine and discuss

- the issuing, marketing and distribution process of Eurobonds,
- subsequent service and administration of Eurobonds, and
- the advantages and disadvantages with bond financing compared to loan financing.

1.3 Delimitations

This essay will not deal with other types of bonds such as sovereign and municipal bonds and domestic corporate bonds but will focus on internationally issued Eurobonds. The reason for choosing Eurobonds instead of domestic bonds is that the investigation done in the method section clearly showed that Eurobonds are more frequently used by large Swedish Capital Goods corporations than domestic bonds. The most obvious explanation is the Swedish bond market is not big enough to service these companies with sufficient amount of additional capital.

The purpose of this essay is to explain and discuss the issuing, market and distribution, and subsequent service of Eurobond issues. Accordingly, topics such as common terms and clauses in bond contracts, liability for misstatements, systems of dealing in securities, how conflicts are solved and similar topics falls outside the scope of this essay. These are extensive questions that have to be discussed separately. A topic that would have been interesting to investigate further is who is to be regarded as the holder of a bond which is in fact held by a custodian.

This essay will not deal with question arising from taxation.

As observed above, most Eurobonds are governed by English law. Consequently, this essay will describe the issuing process according to English law and not discuss the regulations of other jurisdictions. Accordingly, in this essay, the issuing process, marketing and distribution

and subsequent service and administration of Eurobonds will be discussed according to English law.

2 Bonds issued by corporate entities

This section will deal with and discuss some general aspects concerning all bonds issued by corporate entities, i.e. both domestic and international bonds. The following chapter will focus on and in detail discuss the issuing procedure and subsequent service of Eurobonds.

2.1 What are bonds?

Bonds issued by corporate entities are simply a promise by the issuer to repay a specified sum at a fixed date in the future.[23] Also, it is a commitment by the bondholder to agree to lend a certain amount of money to the issuer for a fixed period of time. Meanwhile, the issuer is obliged to pay the bondholder interest in accordance with the agreement between the parties. The size of interest and how it is calculated can vary between different types of corporate bonds.

For investors, lending funds to a corporate entity is riskier than lending to a government because of the increased credit risk, i.e. the risk of default.[24] The interest rate of a bond instrument should reflect this risk and reward the investor for accepting the additional risk. Consequently, the interest rate of corporate bonds is often higher than for otherwise similar government bonds.

It is also important to observe that the term "bond" applies to instruments that are medium to longer term. Whether the bonds are shorts or longs is determined by their remaining maturity. Consequently, the classification of the bond can change over its lifetime.[25] Most bonds have a maturity ranging from 5 to 25 year, but there are also bonds with much longer life time. British Gas issued a bond with 50 years maturity in 1994.[26] CPs are debt instruments with a maturity time of one year or less.

2.2 Bond markets

Bonds can be issued either in domestic or in international markets. Corporate bonds refer to bonds issued domestically and in the local currency of the issuer.[27] Bonds issued internationally and in another currency than the local currency of the issuer and not native to the country of issuance are

[23] Wood; *Law and Practice of International Finance*, p. 159.
[24] Byström, Hans; *Finance*, p. 61.
[25] Valdez & Molyneux; *An Introduction to Global Financial Markets* p. 150.
[26] Arnold; *Corporate Financial Management*, p. 360.
[27] Valdez & Molyneux; *An Introduction to Global Financial Markets*, p. 140.

called Eurobonds.[28] Apart from domestic bonds and Eurobonds, there are also foreign bonds. These are bonds issued in a domestic market by a foreign entity, i.e. a corporation not incorporated in the country in which the bonds are issued, in the domestic market´s currency.[29]
This essay will deal with Eurobonds and these are often denominated in large and global currencies such as the US dollar, the euro, or Japanese yen.

The bond market could be divided into the primary and the secondary bond market. The primary market includes actors such as investment banks with the required knowledge to put the issue on the market. Commonly, a bond issue is underwritten by one or several financial institutions which means that the underwriters guarantee that the issue will be fully subscribed. In larger issues, it is common that a syndicate of investment banks underwrite the issue.[30]
Even though bonds commonly are listed on an official exchange, the secondary market trading is generally executed on an OTC basis, i.e. directly between the buyer and seller. The reason for listing bonds is that in several jurisdictions institutional investors have limitations concerning holding non-listed instruments.[31] The most frequently used stock exchanges for listing Eurobonds are London Stock Exchange and Luxembourg Stock Exchange in Europe and Hong Kong Stock Exchange and Singapore Stock Exchange in Asia. [32]

As observed above, many European companies choose to issue Eurobonds rather than domestic bond. The market for domestic issued corporate bonds is much stronger in the US than in Europe.[33] In the US, there are more corporate bond issues listed on the New York Stock Exchange than there are equities.[34]

2.3 Different types of bonds

During the recent decades, corporate bonds have undergone many alternations and the instrument has become increasingly complex. Nowadays, there are many different types of corporate bonds. In some cases, the interest rate changes weekly, the maturity date is not always fixed, and principal payments or the sum due at maturity may fluctuate. Despite these variations, bonds are still just a debt instrument denoting the issuer to pay the holder a certain amount at maturity.

The purpose of this section is not to describe in detail all different types of bonds but to deliver a brief oversight over the most common types.

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[28] Valdez & Molyneux; *An Introduction to Global Financial Markets*, p. 166.
[29] Tennekoon; *The Law and Regulation of International Finance*, p. 147.
[30] Choudhry; *The Bond & Money Markets - Strategy, Trading, Analysis*, p.322.
[31] Choudhry; *The Bond & Money Markets - Strategy, Trading, Analysis*, p.323.
[32] Wood, *Law and Practice of International Finance*, p. 169.
[33] Valdez & Molyneux; *An Introduction to Global Financial Markets*, p. 159.
[34] Choudhry; *The Bond & Money Markets- Strategy, Trading, Analysis*, p.323.

Bonds could be categorised into five main groups which are straight bonds, floating rate notes, convertible bonds, bonds with warrants and synthetic bonds.[35] Bonds from all of these five groups could be issued either domestically as corporate bonds or internationally as Eurobonds. Of course, there are also variations within each of these five groups. However, such variations will not be discussed within the scope of this essay since the purpose is to give a broad oversight and not a deep understanding of different variations.

Straight bonds are bonds that offer investors periodically payments of fixed and equal amounts, i.e. interest, at agreed intervals. Usually, the interest is paid annually. The maturity of such bonds could range from a couple of weeks to over 40 years in some cases. Some bonds pay no interest at all, so-called zero coupon bonds. Instead of interest, these bonds are bought by investors at a discount. For example, British Gas offered a 30 year zero coupon bond which was sold at 8.77 dollar for each 100 dollar nominal value.[36] Consequently, in zero coupon bonds the investors benefit from the capital gain and not the interest.

Bonds could also be backed by security consisting of land, buildings, shares or other assets. If the issuer defaults, the security is sold to meet claims of the bondholders. Security backed bonds are usually considered to be safer investments than unsecured bonds and in consequence they pay lower rate of interest.[37] Accordingly, secured bonds give the issuer access to cheaper finance compared to more unsecure debt instruments. However, since legal procedures in the event of a dispute must be dissolved before the security could be sold, rearranged or replaced by other assets, it could be problematic to tie up assets for such a long period.[38] As far as I know, Eurobonds are always unsecured.

Bonds issued with floating interest rates are commonly referred to as floating rate notes. Instead of fixed interest rate, the interest is calculated by using a reference rate, often an interbank rate.[39]

Convertible bonds are bonds that can be converted into equity of the issuer on agreed conditions at the option of the investor. The instrument is attractive to investors since it offers the fixed income associated with a straight bond and the possibility of capital gain associated with equity. However, the rate of interest is lower than for straight bonds. The most common types of convertibles give the holders the right to convert into equity at a premium than varies between 10% and 25% over the market price of the equity at the point of issuance.[40] Fluctuations in market price of the underlying equity affect the convertible´s price on the secondary market.

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[35] Gallant; *The Eurobond Market*, p. 54.
[36] Valdez & Molyneuz; *An Introduction to Global Financial Markets*, p. 175.
[37] Valdez & Molyneux; *An Introduction to Global Financial Markets*, p. 159.
[38] Valdez & Molyneux; *An Introduction to Global Financial Markets*, p. 160.
[39] Gallant; *The Eurobond Market*, p. 62.
[40] Gallant; *The Eurobond Market*, p. 65.

If the stock price of the underlying equity increases, the value of the convertible will also increase.

Bonds issued with warrants give the holder the right on agreed terms to buy some other asset in the future, such as equity of the issuer, bonds, currency, or gold. The warrant could be detached from the bond and sold separately on the secondary market.[41] Warrants could be attached to straight bonds, zero coupon bonds and floating rate notes.[42] Since the holder of the convertible is guaranteed the secure cash flow of a bond and the potential capital gain from an increase in value of the underlying asset, the issuer can receive the borrowing on better terms than for a straight bond.

Debt instruments could also categorised based on their duration. The term bond often refers to longer term debt instruments while CPs are debt instruments with a duration of one year or less. While bonds are issued to fund long-term capital needs such as investments, CPs are issued to meet shorter term capital requirements.[43]

CPs are money market instruments which allow the issuer to borrow money for short-term needs. For a corporate entity in need of short-term funding, the main alternative to a CP is a traditional bank loan. A CP is simply a promise by the issuer to repay the holder of the CP a specified amount at a certain time. Normally, CPs are issued as zero coupon bonds which are offered to investors at a discount. The majority of the CPs have a very short maturity ranging from 30 to 90 days but can last as long as 270 days.[44]

To summarise, debt instruments are just a promise by the issuer to repay the holder a specified amount at a certain time. Terms such as interest, maturity and other conditions could differ between different types of debt instruments. A bond is a longer-term debt instrument while a CP is a debt instrument with shorter duration.

2.4 Parties

The one who issues the instrument is called the issuer. In corporate bonds, the issuer is a corporate entity. The issue is then bought by investors. The base of investors generally consists of large corporate pension and investment funds, insurance companies, banks and other sophisticated investors seeking investments with a stable and reliable cash flow.[45]

A managing group led by a lead manager is often engaged to assist the issuer with the issuance. The responsibility of the managing group is to put the issue on the market and to sell the bonds to investors.[46] Commonly,

[41] Gallant; *The Eurobond Market*, p. 68.
[42] Gallant; *The Eurobond Market*, p. 69.
[43] Choudhry; *Corporate Bonds & Structured Financial Products*, p. 247.
[44] Choudhry; *The Bond & Money Markets - Strategy, Trading, Analysis*, p.414.
[45] Wood, *Law and practice of international Finance*, p. 159.
[46] Walker; *Bond Finance*, p. 6.

large bond issues are underwritten either by managing groups or by separate underwriting groups. Selling groups could also be used to sell the bonds to investors.

To service and administrate the bonds during their lifetime, a bondholder´s trustee or a fiscal agent must be appointed.[47] The role of the bondholder´s trustee is to represent bondholders and to safeguard their interest. The role of a fiscal agent is to act as the issuer´s agent and to protect the interests of the issuer. If a bondholder´s trustee is appointed, principal paying agents will also be selected in different countries to service the issue, to advance payments from the issuer to investors and facilitate communication between the parties.[48]

Obviously, there are many similarities between the parties of syndicated loans and the parties of corporate bonds. Large bond issues are often syndicated and the syndication process is often managed by a lead manager. In both cases, an agent or trustee is appointed to carry out administrative functions that are required under the bond or syndicated loan contract.[49]

The role and the responsibilities of different parties in the issuing procedure will be discussed more deeply in later chapters. At this moment, it is sufficient with a basic comprehension of their functions and responsibilities.

2.5 Rating of bonds

Rating of bonds is important since it ranks the issuer´s credit-worthiness and capability to meet its obligations under the issue, i.e. to pay interest during the bond´s lifetime and to repay the loan at maturity.[50] Commonly, the rating is performed by independent credit rating agencies such as Moody´s or Standard and Poor. Furthermore, the rating is given for a specified amount. A high credit rating is almost necessary in order to attract the interest of investors and convince them to purchase the issue.[51] Bonds with lower ranking often pay higher interest to compensate investors for the additional risk.

2.6 Negotiablility of bonds

The secondary bond market enables bondholders to sell their bonds prior maturity. An investor could wish to do so for several reason such as that the funds are needed for other investment purposes, the risk connected to the bonds has increased or to realise a gain in value. In contrast to bank loans,

[47] Wood; *Law and Practice of International Finance*, p. 189.
[48] McKnight; *The Law of International Finance*, p. 539.
[49] Wesalo; *The fundamentals of municipal bonds*, p. 15.
[50] Wood; *The Law and Practice of International Finance*, p. 171.
[51] Choudhry; *The Bond & Money Markets - Strategy, Trading, Analysis*, p.407.

where the deposited funds could be withdrawn at any time, bonds have to be sold on a liquid market in order to realise the value of the bonds prior maturity.[52]

In order to create a well functioning and liquid secondary market for bonds, the bond instruments and the rights connected to them must be safely transferred from seller to buyer. The buyer will wish to obtain perfect title in the purchased bonds which means that the assets are free from any prior defects and that the buyer becomes the unencumbered owner.[53]

International bonds are issued in bearer form, which means that the holder of the instrument has direct legal rights to the issuer. The holder is considered to be the legal owner of the instrument and consequently has the right to receive repayment at maturity and interest during its lifetime in accordance with the bond agreement.[54]

The next question that needs to be answered is whether or not bonds are negotiable instruments? For negotiable bearer instruments, the rights and benefits of the instrument passes on to a bona fide buyer when the instrument is physically delivered to the buyer. If bonds are negotiable instruments, buyers will obtain perfect title in the assets free of any prior defects. Accordingly, if the buyer of a negotiable instrument takes the instrument in good faith without knowledge of any defects in title or any notice of dishonour, he receives a strong position and is not affected by circumstances such as that the seller has obtained the bond by fraud, stolen the bond or acted with an illegal intent.[55]
According to English law, an instrument can get the characteristics of negotiability in three ways; it falls within the definition of bills of exchange or promissory notes in the Bills of Exchange Act of 1882, it is considered to be negotiable by mercantile custom, or it is considered to be negotiable by judicial precedent.[56] It seems to be fairly clear that debt instruments such as bonds, notes or CPs do not qualify as bills of exchange or promissory notes under the Bills of Exchange Act since they do not contain an unconditional order to pay the holder at maturity but just a promise of repayment.[57] However, an instrument can also qualify as negotiable if it is treated as negotiable by mercantile usage recognized by courts and regarded as negotiable in the trading markets. The negotiability of bonds was concluded in 1902 in the case *Edelstein v. Schuler & Co*[58]. In this case, the judge declared that *"this class of security in my view creates no difficulty in the way of holding that they were negotiable by virtue of the law of merchant; they were dealt in as negotiable instruments in every minute of a working day... Thus it has been found convenient to treat securities like those in*

[52] McKnight; *The Law of International Finance*, p. 496.
[53] McKnight; *The Law of International Finance*, p. 496.
[54] Tennekoon; *The Law and Regulation of International Finance*, p. 161.
[55] McKendrick; *Goode on Commercial Law*, p. 533.
[56] Tennekoon; *The Law and Regulation of International Finance*, p. 163.
[57] McKendrick; *Goode on Commercial Law*, p. 613.
[58] *Edelstein v. Schuler & Co.* (1902) 2 KB 144.

question as negotiable". Furthermore, the judge adds that it *"would have been a great misfortune if it were otherwise for it is well known that such bonds are treated in all foreign markets as deliverable from hand to hand; the attribute not only enhances their value by making them easy of transfer but qualifies them to serve as a kind of international currency; and it would be very odd and a great injury to our trade if these advantages were not accorded to them"*[59]. Consequently, traditional bonds where the instrument is physically transferred from the seller to the buyer qualifies as negotiable and acquires the characteristics of negotiability according to mercantile custom.[60]

Nowadays, physical delivery of bonds is commonly not used. Instead the rights are transferred from the seller to the buyer through centralised systems and clearing houses. This give rise to additional problems. Who are the bearer of a bond which is in fact held by a clearing house in favour of investor? Is the clearing house the bearer or is the actual owner the bearer? As long as the issuer does not default, this does not cause any serious problems. However if the issuer defaults, only the holder can sue the issuer and accelerate the bond. However, in such a case definitive bonds will be issued and transferred to those investors who are registered as owners of the bonds. As holder of definitive bonds, the investors can sue the issuer due to the default.[61]

[59] *Edelstein v. Schuler & Co.* (1902) 2 KB 144, p. 154-155.
[60] McKendrick; *Goode on Commercial Law,* p. 614, McKnight; *The Law of International Finance,* p. 498.
[61] Tennekoon; *The Law and Regulation of International Finance,* p. 447.

3 International bonds - the issue procedure

This chapter will deal with international bonds, i.e. Eurobonds, and outline the issuing procedure, the documentation, the marketing and distribution, and subsequent service and administration.

3.1 Considerations before the issue

Bonds and CPs are issued to meet long- and short-term funding requirements. To get the issue fully subscribed and attract the interest of investors, a lot of decisions have to be made before the issue is announced. Even though adjustments theoretically could be made after the date of announcement, the main terms and conditions have to be determined already at an early stage. According to market practice, later adjustments are rarely done except in extraordinary circumstances.[62]
Hence, it is crucial to be familiar with the market in order to structure the issue in a way that will meet the expectations of the investors and attract their interest. Before the mandate to the lead manager is granted, the potential lead manager normally makes presentations on the current and future market conditions and how the issue could be structured.

The structure of the issue must reflect the requirements of the issuer concerning amount, maturity and currency. Factors important in the choice of currency are those relating to risk management and those relating to borrowing costs. When it comes to risk management, it is often the wish of the issuer to match the currency of its interest and principal payments to that of the cash flow of its business activities. An example of this is the positive correlation between having a subsidiary in a currency area and issuing bonds denoted in that currency. However, mismatches between asset and liability flows can be eliminated by using derivates such as currency SWAPs.[63] Investors, on the other hand, commonly want to match returns to current and future expenses.[64]
When it comes to borrowing costs, these are often determined by institutional factors such as taxes, regulatory burdens, and the size and liquidity of the market. This is also why many Eurobonds are denoted in big currencies such as the Euro, GBP, USD or Japanese yen. The issuer can select to issue bonds in the market with lowest costs and then change into the preferred currency by using SWAPs.[65]

It is necessary to consider and take advantage of current and future market conditions What are the estimations on the future rate of interest and will it

[62] Tennekoon; *The Law and Regulation of International Finance,* p. 151.
[63] Cohen; *Currency choice in international bond issuance,* 54.
[64] Cohen; *Currency choice in international bond issuance,* 54.
[65] Cohen; *Currency choice in international bond issuance,* 55.

rise or fall? Fluctuations in interest rates affect the value and attractiveness of bonds in the eyes of potential investors. If the risk free interest rate falls, the attractiveness of bonds as investments will in most cases increase.[66]
The influence of changes in interest rate on the value of bonds is determined by the remaining maturity of the bond, the size of the coupons, and other terms and conditions of the issue. Consequently, short-term zero coupon bonds are less sensitive to changes in interest rates than longer term bonds or floating rate notes. Furthermore, bonds with higher coupons are less sensitive than bonds that pay lower coupons.[67] Unless the bond is a floating rate note, changes in interest rates only affect investors who plan to sell the instrument on the secondary market.

Borrowing from individuals and institutions through issuing bonds is different from borrowing from a bank. Commonly, the bank has a well-established relationship to its clients and can therefore make well-founded assessments of the risks associated with the loan. Lending from the public is different in that respect. Of course, some investors have a good relationship with a specific issuer and continuously invest in new issues from that issuer, especially if the issuer is a well-known corporation with a good reputation in the market. However, if the issuer cannot rely on such a relationship the issuer must educate potential investors and provide them with the information necessary to make proper assessments of the risks associated with the bonds. In stand-alone issues, public relation campaigns, corporate advertising or road shows to meet institutional investors might be necessary to market the issuer and the issue towards the target group of investors.[68]

3.2 Open priced, pre-priced and bought deals

Commonly, the bond issuing process starts with the issuer inviting a number of investments banks to compete for the role of lead manager. The competing actors discuss the issue with the issuer and propose a fee and indicate at which price they can sell the issue to investors. Often, the issuer´s choice of lead manager will be a candidate with whom the issuer already has a good relationship. If there are many candidates competing for the role as lead manager, the choice will be based on factors such as the fee that the lead manager will charge, the willingness of the lead manager to support the issue in the secondary market, the history of the bank in similar issues and how big the bank´s base of potential investors is.[69] Of course, also the bank´s reputation in the market for placing similar issues is an important factor to take into account.[70]

[66] Berk & DeMarzo; *Corporate Finance*, p. 226.
[67] Berk & DeMarzo; *Corporate Finance*, p. 227.
[68] Gallant; *The Eurobond Market*, p. 139.
[69] Choudhry; *Corporate Bonds and Structured Financial Products*, p. 201.
[70] Gallant; *The Eurobond Market*, p. 131.

In addition, it is the responsibility of the lead manager to contact prospective investment banks to form underwriting or managing groups, which are responsible for subscribing the issue. If the issue is fully subscribed, the underwriters are committed to take the issue for their own account if they are unable to sell it to investors. For providing this service, they charge a fee.[71] If the issue is supposed to be sold to retail investors, selling groups will be formed. The responsibility of those selling groups is to place the issue with wealthy individuals.[72] The members of the underwriting and managing groups are selected on their reputation, distribution capabilities and their relationship with the borrower and the lead manager.[73] Co-lead managers in other geographical markets could be appointed to enlarge the base of potential investors. The size of the syndicate depends on the size and aggregate amount of the issue.[74]

In the 1970s it was common with open priced deals, which means that the lead manager retains the right to determine the price of the issue. Accordingly, the issuer will not exactly know the interest, coupon or price at which the issue will be sold to investors until after the mandate has been granted.[75] In these deals a preliminary prospectus is sent out to a group of financial institutions which are given the right to respond to the proposed pricing terms. This enables the issuer and the lead manager to test the market before the final terms are fixed.[76] The main advantage with open-priced deals is that it provides a protection against adverse market movements. If such movements would occur, the issuer could terminate the issue or adjust the pricing terms to meet the changed conditions. The size of the syndicate is also larger in open-priced deals than in pre-priced and bought deals. Even though most Eurobond issues today are pre-priced or bought deals, open priced deals are still used in more restricted areas such as in Switzerland.[77]

Nowadays, most Eurobond issues are pre-priced. In pre-priced deals all the pricing terms, include the amount, currency, maturity, offering price, rate of or means of calculating interest, and the redemption price are agreed before the mandate is granted.[78] Usually these terms are subject to contract and can therefore be changed until the day of signing. This gives both the issuer and the lead manager the flexibility to adjust the pricing terms to meet the demand and request of potential investors. However, even though the issuer and the lead manager have the right to change the terms, this is rarely done as a matter of market practice except in unusual circumstances.[79] Since the pricing details in pre-priced deals are pre-determined and the time to form a syndicate is usually shorter, the number of members of the syndicate tends

[71] Gallant; *The Eurobond Market*, p. 131.
[72] Tennekoon; *The Law and Regulation of International Finance*, p. 152.
[73] Gallant; *The Eurobond Market*, p. 131.
[74] Choudhry; *Corporate Bonds & Structured Financial Products*, p. 204.
[75] Tennekoon; *The Law and Regulation of International Finance*, p. 150.
[76] Wood; *The Law and Practice of International Finance*, p. 166.
[77] Gallant; *The Eurobond Market*, p. 137.
[78] Tennekoon; *The Law and Regulation of International Finance*, p. 150.
[79] Tennekoon; *The Law and Regulation of International Finance*, p. 151.

to be smaller than in open priced deals. Consequently, each member has to subscribe for a larger portion of the aggregate amount.[80]

An alternative to a pre-priced deal is a bought deal, which means that the lead manager buys the entire issue and all the bonds himself on the pricing terms agreed between the issuer and the lead manager and then sells them to investors.[81] It is a matter of market practice that a lead bank who enters into a bought deal is legally committed to purchase the aggregate issue himself on the agreed terms. However, if the lead manager´s offer is made subject to contract he would not be legally committed until the necessary legal documents have been signed unless a contrary intention can be shown to exist.[82] The main difference between a pre-priced deal and a bought deal is that in a pre-priced deal the lead manager only commits to place the bonds in the market on certain pre-determined conditions while the lead manager in a bought deal is obliged to purchase the whole issue himself. In both cases, the lead manager will use a syndicate of underwriters to place the bonds in the primary market.[83]

Bond could be issued either publicly or as private placements. While bonds issued publicly could be bought by anyone, private placements are placed by the managers among a limited group of private clients or a single investor. In addition, these issues are commonly not listed on an official exchange.[84]

3.3 The mandate

After the lead manager has been selected, the issuer awards the lead manager a mandate to initiate the issuance process. The mandate is expressed in a mandate letter. In many respects, the mandate letter of international bond issues is similar to the mandate letter given to the lead bank of a syndicated loan.[85] The mandate letter is a commercial understanding which enables the parties to proceed with the issuing process before the formal and necessary documentation is in place.

Commonly the mandate letter summarises the financial terms, states that that the managers´ undertakings are subject to a material adverse change in market conditions and includes a commitment by the issuer not to participate in competing issues.[86] As observed above, most Eurobond issues are pre-priced. Consequently, the financial and pricing terms in the mandate letter could be detailed.

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[80] Gallant; *The Eurobond Market*, p. 137.
[81] Wood; *Law and Practice of International Finance*, p. 167.
[82] Tennekoon; *The Law and Regulation of International Finance*, p. 151.
[83] Tennekoon; *The Law and Regulation of International Finance*, p. 151.
[84] Wood; *Law and Practice of International Finance*, p. 167.
[85] Walker; *Bond Finance*, p. 8.
[86] Wood; *Law and Practice of International Finance*, p. 167.

The mandate is given subject to contract as a non-binding commercial undertaking to avoid creating legal obligations at a pre-contract stage. However, although the agreement is subject to contract, legal obligations can arise because of the mandate letter. Normal principles of contract law presume that commercial agreements or undertakings in a commercial context are intended to be legally binding, if it is not shown that this was not the intention of the parties.[87] [88]

It is the responsibility of the lead manager to arrange for the necessary documents involved in the issue to be prepared. These draft documents include the prospectus, the subscription agreement, underwriting agreements, selling group agreements, managers´ agreements, listing agreements, and the trust deed or fiscal agency agreement. The lead manager is also responsible for arranging the stock exchange listing.[89] Furthermore, lead manager should agree terms of the issuance with the issuer, select members of the syndicate of underwriters, agree the terms and conditions of their engagement and subsequently put the issue on the primary market.[90]
It is important to understand that the lead manager is also part of the underwriting group. It is the responsibility of the lead manager to negotiate the subscription and underwriting agreement with the issuer for the syndicate´s account. Of course, the lead manager must protect the interest of the syndicate during these negotiations. Since the lead manager is often part of the syndicate, it has its own interest to negotiate in good faith. However, since the lead manager commonly has a long and good relationship with the issuer, it cannot offer too good of a deal to the syndicate.

The responsibilities of lead managers in international bond issues commonly have a lot in common with the functions of lead banks in syndicated loan deals. The lead bank in a syndicated loan deal should prepare the documentation and information memorandum, administer expression of interest to participate in the syndicate and negotiate the loan documentation.[91] These responsibilities correspond to those of the lead manager in a bond issue. In both cases, the lead manager is appointed as an independent contractor to advice the borrower and to form a syndicate.

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[87] Wood; *Law and Practice of International Finance,* p. 95 and McKendrick; *Goode on Commercial Law,* p. 882.
[88] This was shown in the case *Edwards v. Skyways Ltd*. In the cases, *Perry v. Suffields Ltd.* and *Pagnan SpA v. Feed Products Ltd.* the court concluded that a complete contract could be deemed to have arisen even where key commercial terms are still to be agreed. In *Okura & Co Ltd. v. Navarra Shipping Corporation SA* the court ruled that pre-contract documentation including incorporation of key terms and conditions could be considered to constitute a complete and legally enforceable agreement.
[89] Gallant; *The Eurobond Market,* p. 132.
[90] Gallant; *The Eurobond Market,* p. 131.
[91] Wood; *Law and Practice of International Finance,* p. 96.

3.4 The launch

The issue is launched through an announcement where the lead manager contacts prospective buyers to present the issue.[92] An initial and informal inquiry is followed up by a formal invitation to participate in the syndicate. The formal invitation includes all necessary details about the bonds such as subscription price, interest, currency, maturity, redemption price, ratings, guarantees, security, negative pledges, early redemption, sales restrictions, cross default and force majeure but is still subject to contract. Furthermore, the invitation includes information about the issuer, a timetable of the proceedings and tax restrictions applicable to the issue. The invitation must also contain a specification of the lead manager´s expenses such as legal costs and costs of printing necessary documentation.[93]

The invitation is not regarded to be legally binding, but is drafted carefully and is closely examined by the lead manager´s lawyers. It is a matter of market practice that the formal legal documents will be drafted strictly in accordance with the terms of the invitation.[94] According to market practice, the lead manager and prospective members of the syndicate are "committed" to participate in the issue as soon as the invitation has been sent out unless there are any subsequent material adverse changes in or additions to the invitation.[95]

3.5 The prospectus

Commonly, the issue of a transferable security is preceded by the publication of a prospectus. After the launch, the prospective members of the syndicate are sent a prospectus by the lead manager giving information about the issuer and the issue. Commonly, the prospectus is prepared jointly by the issuer and the lead manager.[96]
Because of the character of financial assets, they can only be sold by describing them and not by showing them to potential buyers. The investors base their evaluation and investment decision on this description and the information included in it. Consequently, the rules[97] concerning the form and content of public prospectuses are often detailed and require the description to be accurate and not misleading. Public prospectuses must include certain information and disclose everything that is materially relevant to the investors.[98]

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[92] Wood, *Law and Practice of International Finance*, p. 169.
[93] Tennekoon; *The Law and Regulation of International Finance*, p. 154.
[94] Tennekoon; *The law and Regulation of International Finance*, p. 153.
[95] Tennekoon; *The Law and Regulation of International Finance*, p. 153.
[96] Tennekoon; *The Law and Regulation of International Finance*, p. 154.
[97] The Prospectus Directive EC 2003/71 OJ L345 31/12/2003 on prospectuses to be published when securities are offered to the public which has been implemented in the UK legislation by the Prospectus Regulation 2005 SI 2005/1433 and amendments to Part IV of FSMA and to the Financial Service and Markets Act 2000 (Official Listing of Securities) Regulations 2001 SI 2001/2956.
[98] Wood; *Law and Practice of International Finance*, p. 372.

A prospectus should contain information about the issuer such as history, ownership, line of business, sales, turnover, employees, pension liabilities, directors, senior executives, audited past five years' financial performance and the most recent financial statements. Additionally, a prospectus includes details about the issue, list the members of the syndicate, legal counsel, paying or fiscal agents and trustee if any, and outline all commissions or expenses. It should also detail any selling restrictions, taxation provisions and conformity with stock exchange provisions or other regulations.[99] Other legal documents such as contracts, the underwriting agreement, legal opinions and other documents could also be enclosed to the prospectus. Sometimes, these documents are not circulated to potential investors but held available at named place for inspection.[100]
Usually, the prospectus also constitutes the listing particulars, which are needed when the issue should be listed on an official exchange. Consequently, the form and content of the prospectus must meet the requirements of listing particulars on the stock exchange which the issue should be listed on. The aim of these requirements is to facilitate for investors to make informed investment decision on whether to buy the bonds or not.[101]

An important and difficult question arises if the bonds are issued and the information in the prospectus later proves to be incorrect. The result of misstatements in prospectuses could be investors buying bonds which they would not have bought if they had not relied on the false information. As a result, they could suffer a loss. There is no doubt that the issuer is responsible for the accuracy of information given in a prospectus since the prospectus is the issuer´s document.[102] But what happens if the issuer is insolvent at the time of discovery? Can the lead manager or any other party be held liable in such a case? Since this question falls outside the scope of this essay, I will be content with observing that except from the issuer, persons such as directors, auditors, other experts, or underwriters could be held liable if they have acted negligently or fraudulently.[103] This liability is often joint and several.[104] As a rule, this enhanced liability is impossible to contract out. However, most securities laws provide for exemptions that loosen up these rules in order to facilitate the issue of securities. The main exemptions are those for private offerings, offerings to sophisticated investors and offerings by governments and certain international organisations.[105] Consequently, prospectuses often include disclaimers that exclude liability if the issue is a private placement or the bonds are offered to sophisticated investors.

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[99] Gallant; *The Eurobond Market*, p. 133.
[100] Wood; *The Law and Practice of International Finance*, p. 375.
[101] Tennekoon; *The Law and Regulation of International Finance*, p. 154.
[102] Wood; Law and Practice of International Finance, p. 380.
[103] Wood; *Law and Practice of international Finance*, p. 379.
[104] Wood; *Law and Practice of International Finance*, p. 379.
[105] Wood; *Law and Practice of International Finance*, p. 172.

3.6 Listing

After the announcement, a formal application for listing on an official exchange will be submitted.[106] In this process, the lead manager plays an important role. There is no legal requirement under English law that bonds must be listed on an official exchange.[107] However, there are a lot of advantages connected to a listing. The main advantage is that it widens the base of potential investors since many big institutional investors such as pension funds, insurance companies and banks[108] only are allowed to hold listed securities.[109] Consequently, if the bonds are not listed they cannot be bought by such large investors. Another advantage is that the stock exchange quotes the current market price of the bonds.[110] This facilitates for investors to make business decisions on whether to buy or sell a particular bond at the best available price.
The main disadvantage of listing is that the issuer must comply with the stock exchange disclosure requirements. To do this, the issuer must provide continuing information and notify the markets of events which could affect the issuer´s ability to meet its obligations.[111] The most common stock exchanges for Eurobond issues are the London and Luxembourg stock exchange.[112]

The formal application must include listing particulars, containing necessary information "which according to the nature of the issuer and of the securities for the admission of which the application is being made, is necessary to enable investors and their investment advisors to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospect of the issuer and the rights attached to the securities"[113]. However, how much information that is necessary to satisfy this requirement depends on whether or not the issuer have shares or other debt securities already listed on the exchange and the nature of the particular issue.[114]

3.7 Stabilisation

Thereafter, the preliminary trading in the "grey market" begins. At this point, before the bonds have even been issued, traders in the market will start buying and selling bonds that later on will be issued.[115] Trading on the grey market allows the lead manager to form an opinion on the attractiveness of the issue. Basically, the bonds are sold short with the

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[106] Tennekoon; *The Law and Regulation of International Finance*, p. 155.
[107] Tennekoon; *The Law and Regulation of International Finance*, p. 317.
[108] Wood; *Law and Practice of International Finance*, p. 169.
[109] McKnight; *The Law of International Finance*, p. 511.
[110] Wood; *The Law and Practice of International Finance*, p. 170.
[111] Wood; *The Law and Practice of International Finance*, p. 170.
[112] Wood; *The Law and Practice of International Finance*, p. 169.
[113] Carmichael; *Changes in the London listing of Eurobonds*, p. 33.
[114] Tennekoon; *The Law and Regulation of International Finance*, p. 155.
[115] Tennekoon; *The Law and Regulation of International Finance*, p. 155.

intention from the dealers to make a profit from a price fall. If the price falls, the dealers can buy the bonds at a lower price than the price of sale and make a profit. Short selling of bonds in the grey market can cause problems for the lead manager since the price fall can make it difficult for the lead manager to place the bonds at the pre-determined price.[116]

The bonds can also be sold in the grey market at a discount to the nominal value of the bond. The sellers will make a profit as long as the selling price exceeds the purchase price for the underwriters. Already at the offering stage, potential members of the syndicate have indicated the number of bonds they would be interested in underwriting. Now, when the time of issuance is approaching, the managers could feel that they may not be able to place the bonds at the issue price and therefore begin to sell the bonds at a discount.[117] Since they have agreed to underwrite the issue, they would otherwise be bound to pay for the entire allotment themselves. For the lead manager, such dumping activities by members of the syndicate could obstruct the placement of bonds at the pre-determined price.

To prevent the negative effects of shorting and dumping activities, the lead manager could support the price by placing bids for the bonds or offering to purchase the bonds at a higher price than the price of the market place.[118] The lead manager can use the "bear squeeze" tactics which means that the lead manager purchases the entire issue, including the short sale, himself. Later, when the short sellers are obliged to buy the bonds, the lead manager can sell them to the short seller on very unfavourable terms. The short seller has no other choice than to purchase the bonds on these unfavourable terms since the bonds have to be delivered at a certain date according to the short selling agreement.[119]

A positive effect of the trading on the grey market could be that it allows the lead manager and the issuer to make adjustments to terms and conditions of the issue such as coupon, maturity, or offering price, if such adjustments are necessary to attract the interest of the investors. A well-functioning grey market enables the lead manager to assess the investor´s interest for the issue.[120] However, as observed in earlier sections, market practice prevents the lead bank from adjusting the pricing terms after the date of announcement, except in extraordinary circumstances.

A way to handle problems arising when the bonds are traded on the grey market is the use of the "fixed price re-offer" mechanism. Under this mechanism, the lead manager settles the price at which the members of the syndicate may on-sell the bonds which are allotted them.[121]

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[116] Tennekoon; *The Law and Regulation of International Finance*, p. 155.
[117] Tennekoon; *The Law and Regulation of International Finance*, p. 156.
[118] Tennekoon; *The Law and Regulation of International Finance*, p. 156.
[119] Benzie; *The development of the International Bond Market*, p. 36.
[120] Choudhry; *Corporate Bonds & Structured Financial Products*, p. 207.
[121] Tennekoon; *The Law and Regulation of International Finance*, p. 156.

3.8 Signing

A few weeks after the mandate was granted and seven to fourteen days after the date of announcement, the formal signing of the legal documents will take place. This is the point where legal obligations arise for the underwriters. In previous sections, it has been observed that terms set out in the formal invitation and the prospectus were subject to contract. The contracts agreed and signed under the signing, make the terms and conditions of the issue definite and legally binding.[122]

At this point, at least two but sometimes as much as three documents are signed. The Subscription Agreement, the Agreement between the Managers and in some cases the Underwriting Agreement and the Selling Group Agreement determine and state how the bonds should be marketed and placed among investors. However, nowadays the Underwriting Agreement and the Selling Group Agreement are rarely used.[123]
In this section, the Subscription Agreement, the Agreement between Managers and the Selling Group Agreement will be discussed in more detail.

Before the Subscription Agreement, the Agreement between Managers and the Selling Group Agreement are further discussed, some words need to be said about the structure of the syndicate and the distribution and marketing channels of Eurobonds. Eurobonds are commonly market, distributed and sold to investors through a syndicate of managers. As mentioned earlier, these are selected on their reputation, distribution capabilities and their relationship with the issuer and the lead manager.[124]

Additionally, the managing group may appoint sub-underwriters or selling groups to facilitate the distribution of the bonds to investors. Such sub-underwriters could be either local to the currency of the issue or non-local. Local underwriters can benefit from greater expertise and placement capabilities among local investors and are more frequently used in big issues than in small. Furthermore, local underwriters are more frequently used in public issues than in private placements.[125]

To promote and facilitate the distribution of bonds, a selling group could be appointed.[126] Members of the selling group are engaged in the selling and marketing of bonds but do not necessarily have underwriting obligations. However, commonly they are also underwriters.[127] If not, their only assignment is to sell their portion of the issue to investors on behalf of the managers. For this service, they earn the difference between their selling price and the price they have paid for the bonds.

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[122] McKnight; *The Law of International Finance*, p. 511.
[123] Tennekoon; *The Law and Regulation of International Finance*, p. 178.
[124] Gallant; *The Eurobond Market*, p. 131.
[125] Kollo; *Underwriter competition and gross spreads in the Eurobond market*, p. 40.
[126] Gallant; *The Eurobond Market*, p. 131.
[127] Gallant; *The Eurobond Market*, p. 136.

When describing the following agreements, also the terms and conditions of the agreements will be discussed. The reason for this is that these provisions affect the marketing and distribution process and the interplay between the issuer and the members of the syndicate.

3.8.1 The Subscription Agreement

The Subscription Agreement is the main agreement between the issuer on the one hand and the syndicate including the lead manager on the other hand.[128] Also, the guarantor, if any, is part of the agreement.[129] By signing the Subscription Agreement, the members of the syndicate commit themselves to offer bonds to investors on agreed terms and to subscribe and pay for unsold bonds on the closing day. If the bonds are to be sold through a selling group, the managers are obliged to offer allotted bonds to the members of the selling group on pre-determined conditions.[130] If managers are unable to sell all bonds to investors, they are obliged to pay for the unsold bonds themselves. The underwriters accept this risk in exchange for a premium or commission of around 3-4% of the nominal value of the bonds.[131] Also, the underwriters profit from the price difference between the price they pay for the bonds and what they can get from investors.

From the issuer´s perspective, the underwriters act as an insurance. For a fee, the issuer can be sure of getting the issue fully subscribed and receive the total amount of the issue leaving no bonds unsold. The payment for the entire issue, including unsold bonds, should be transferred to the issuer on the closing day.[132]

The agreement is commonly a joint and several undertaking by the managers to purchase the whole issue.[133] Accordingly, each manager undertakes to underwrite the total amount of the issue. If some managers default in paying for their portion of the issue, the issuer can turn to any one of the managers and require this manager to pay for all unsold bonds. This risk is handled by the managers in the Agreement between Managers by including a pro rata sharing clause. The joint and several obligation of the members in the bond syndicate to pay for unsold bonds differ from the obligation of the syndication participants in a syndicated loan deal. In a syndicated loan, each member of the syndicate is only responsible for lending its own portion of the total amount and is not obliged to cover up if any other member fails in honouring his share of the agreement. The responsibility is said to be several.[134]

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[128] Tennekoon, *The Law and Regulation of International Finance,* p. 178.
[129] McKnight; *The Law of International Finance*; p. 534.
[130] Tennekoon; *The law and Regulation of International Finance*, p. 178.
[131] Tennekoon; *The law and Regulation of International Finance*, p. 178.
[132] Tennekoon; *The law and Regulation of International Finance*, p. 179.
[133] Tennekoon; *The law and Regulation of International Finance*, p. 179.
[134] McKnight; *The Law of International Finance*, p. 534.

It is under the Subscription Agreement that legally binding commitments concerning the pricing terms and other terms and conditions of the issue arise. These could be included in the agreement either expressly or by reference to another document. The fees and the commissions to managers will also be included in the agreement together with other provisions that must be satisfied by the issuer before the managers are obliged to pay for the bonds on the closing day.[135] If these conditions are not staisfied, the managers have the right to terminate the entire agreement.[136] Since these conditions are of vital importance to the execution of the agreement, the most common conditions need to be mentioned. Most agreements state that the issuer´s latest financial statements should be available to the managers, that there should not have been any material adverse changes in the financial position of the borrower since the date of the account, that the prospectus must contain all necessary information regarding the issuer and that this information must be accurate and not misleading, that listing particular has been published in accordance with the rules of the particular stock exchange on which the bonds should be listed and that the information in the listing particular is true and accurate, and that the issue receives a satisfactory rating by an rating agency.[137] Furthermore, the issuer must guarantee that the execution of the agreement constitutes a legally binding commitment by the issuer and that the performance of the subscription does not break or contravene any regulatory laws, that the issuer is not involved in any litigation or arbitration where the amounts are material to the aggregate amount of the issue, and, finally, that the issuer has received all necessary consents, authorisations, and permissions from regulatory bodies. Of course, the issuer must also notify the managers if any material adverse changes have occurred after the signing of the agreement.[138] Regarding the demand for conformity with applicable laws, it needs to be observed that it is the issuer that needs to comply with such laws. Of course, also managers have to comply with applicable laws but it is not required for the execution of the Subscription Agreement.[139]

If the agreement is terminated due to failure by the issuer to satisfy any of the conditions above, the managers could recover any loss or damage suffered as a result of the issuer´s failure. However, the agreement could not be terminated after the date of closing.[140]

In addition to the conditions mentioned above, the Subscription Agreement will also include a provision giving the managers the right to terminate the agreement before the closing date in an event of force majeure.[141] The purpose of this clause is to protect the managers from major market disruptions which could obstruct or impede the distribution of the bonds. As all force majeure clauses, it is drafted as widely as possible and allows termination of the agreement if "changes in national and international

[135] McKnight; *The law of International Finance,* p. 535.
[136] Tennekoon; *The law and Regulation of International Finance,* p. 180.
[137] Tennekoon; *The law and Regulation of International Finance,* p. 180.
[138] Tennekoon; *The law and Regulation of International Finance,* p. 180.
[139] Tennekoon; *The law and Regulation of International Finance,* p. 180.
[140] Tennekoon; *The law and Regulation of International Finance,* p. 180.
[141] McKnight; *The Law of International Finance,* p. 535.

financial, political or economic conditions or currency exchange rates or exchange controls, as would in their view be likely to prejudice materially the success of the offering and distribution of the bonds or dealings in the bonds in the secondary market"[142] occur. The force majeure clause commonly includes a long list of events and then specifies the consequences if they occur. The list may include events such as labour strikes or other industrial actions, external blockades, war, terrorist attacks, civil commotion, and acts of God.[143] The consequences could include temporary suspension of a party´s obligations, adjustments in the contract price, extension of time to perform, restitutions of money paid, and compensation for work or services that have already been performed.[144]
However, there are some problems associated with broadly defined force majeure clauses. Firstly, it is up to the lead manager to determine whether or not an event of force majeure has occurred. Secondly, the force majeure clause covers also events which affect subsequent trading of the bonds.
Thirdly, the lead manager has the right to cancel the agreement on behalf of the members of the syndicate if an event of force majeure occurs. In this situation, the lead manager acts as agent on behalf of the syndicate and owes a duty of due care and must act in the interest of the syndicate as a whole and not only his own interest.[145]

3.8.2 The Agreement between Managers

The Agreement between Managers is frequently used in modern Eurobond issues. The main purposes are to allocate the underwriting obligation under the Subscription Agreement to each member of the syndicate, to strengthen the lead manager´s control over the marketing and distribution process, and to make sure that this process comply with all applicable securities laws.[146]

The Agreement between Managers is an agreement between the members of the syndicate, i.e. the lead manager and other participating managers. Accordingly, the issuer is not part of the agreement.[147] As noted in an earlier section, the liability to pay for unsold bonds on the closing date is joint and several according to the Subscription Agreement. Since the responsibility is joint and several, the issuer can demand any of the managers to take up all unsold bonds.[148] Because of this, there is a need for a pro rata sharing clause in the Agreement between Managers.[149] This pro rata sharing clause states that if one manager is requested to pay for all unsold bonds, that manager could demand the rest of the managers to pay for their pro rata share of the issue. Accordingly, the managers are liable only up to a sum reflecting their

[142] Tennekoon; *The Law and Regulation of International Finance*, p. 181.
[143] McKnight; *The Law of International Finance*, p. 38.
[144] McKnight; *The Law of International Finance*, p. 38.
[145] Tennekoon; *The Law and Regulation of International Finance*, p. 182.
[146] Tennekoon; *The Law and Regulation of International Finance*, p. 184.
[147] McKnight; *The Law of International Finance*, p. 535.
[148] Tennekoon; *The Law and Regulation of International Finance*, p. 184.
[149] Tennekoon; *The Law and Regulation of International Finance*, p. 179.

proportion of the original underwriting commitment. Consequently, if a manager is responsible for underwriting 10% of the aggregate amount of the issue, that manager could not be obliged to take up more than 10% of all unsold bonds. Sometimes, an pro rata sharing clause is not found in the agreement. In such cases, the lead manager should act fairly and sharing on pro rata basis should be applied as a matter of market practice.[150]

It is quite common that investment banks form separate sub-underwriting groups which are then assigned a portion of the aggregate underwriting commitment.[151] This Sub-underwriting agreement is entered into between the lead manager and the group of sub-underwriters. The sub-underwriters affect the redistribution of unsold bonds in that they are obliged to pay for unsold bonds up to their maximum underwriting commitment before the lead manager can turn to the managers and activate their pro rata share underwriting obligation.[152] Commonly, unsold bonds are divided between sub-underwriting groups on a pro rata sharing basis.
It is also worth mentioning that sub-underwriters are not protected by the conditions precedent or the force majeure clause in the Subscription Agreement. If an event of force majeure occurs, the sub-underwriters must rely on the managers to terminate their obligations since the sub-underwriters do not have an independent right to do so.[153]

The second purpose of the Agreement between Managers is to strengthen the lead manager´s power over the issue and the distribution process.[154] This is done by including certain provisions in the agreement that are transmitting all powers entrusted by the issuer to the group of managers to the lead manager. Such powers include the right to terminate the Subscription Agreement due to an event of force majeure or because conditions precedent are not satisfied. The lead manager is also entrusted the right give up conditions in the Subscription Agreement on behalf of the syndicate.[155]

An important function of the Agreement between Managers is to determine how marketing and distribution costs should be divided between the managers. In an earlier section, the role of the lead manager as stabilisation manager was discussed. In the Agreement between Managers, the lead manager is appointed as stabilisation manager and, hence, given the right to support and stabilise the price of the bonds during the stabilisation period. Such price stabilising transactions could include quoting a price floor if the bonds are selling poorly or other similar transactions.[156] Consequently, other members of the syndicate are not allowed to take price stabilising measures. In pre-priced issues, costs arising from price stabilising transactions should

[150] Tennekoon; *The Law and Regulation of International Finance*, p. 186.
[151] Tennekoon; *The Law and Regulation of International Finance*, p. 185.
[152] Tennekoon; *The Law and Regulation of International Finance*, p. 186.
[153] Tennekoon; *The Law and Regulation of International Finance*, p. 185.
[154] Tennekoon; *The Law and Regulation of International Finance*, p. 186.
[155] Tennekoon; *The Law and Regulation of International Finance*, p. 187.
[156] Gallant; *The Eurobond Market*, p. 164.

be borne by the lead manager as a matter of market practice unless the lead manager in the initial invitation sent to potential syndicate members has informed that such costs should be recoverable from the managers. However, the recoverable costs must not in any case exceed the underwriting commission that the managers are entitled to.[157] Sometimes, the managers are required to agree to set up a stabilisation fund to cover the costs of price stabilising transactions.[158]
As a rule, all expenses except those associated with price stabilising transactions are recoverable from the issuer.[159] If not, the Agreement between Managers generally includes a provision stating that such costs should be divided between the managers on a pro rata basis[160].

Commonly, the Agreement between Managers also gives the lead manager the right to reduce or increase the total amount of the issue, or, if necessary, to adjust the terms and conditions of the issue. The lead manager is also entitled to adjust the underwriting commitment of the managers. Of course, such changes require the consent of the issuer and on part of the concerned underwriters.[161]

Another important provision included in the Agreement between Managers concerns the authority of the lead manager to terminate the issue in an event of force majeure. Under the Subscription Agreement, the power to terminate the issue is given the group of managers, but in the Agreement between the Managers this power is entrusted the lead manager. Accordingly, the lead manager is acting as a representative of the syndicate. In practice, the lead manager could terminate the issue although the majority of the managers are in a different opinion. However, it is important to notice that the lead manager owes a duty of due care as an agent and must act in the interest of the syndicate as a whole and not only in his own interest.[162]

Finally, it needs to be observed that it is the responsibility of the lead manager to receive notification of interest from banks and financial institutions willing participate in selling groups and sub-underwriting groups. Furthermore, the lead manager is entrusted to agree the terms of their participation and allot them bonds.[163]

3.8.3 The Selling Group Agreement

As observed above, Selling Group members are responsible for selling bonds to investors and do not necessarily have underwriting obligations. However, selling agents are often underwriters as well.[164] The Selling

[157] Tennekoon; *The Law and Regulation of International Finance*, p. 187.
[158] Gallant; *The Eurobond Market*, p. 164.
[159] McKnight; *The Law of International Finance*, p. 536.
[160] Tennekoon; *The Law and Regulation of International Finance*, p. 189.
[161] Tennekoon; *The Law and Regulation of International Finance*, p. 188.
[162] Tennekoon; *The Law and Regulation of International Finance*, p. 188.
[163] Tennekoon; *The Law and Regulation of International Finance*, p. 187.
[164] Gallant; *The Eurobond Market*, p. 135.

Group Agreement is entered into between the members of the Selling Group and the managers[165]. The lead manager enters into the agreement on behalf of the syndicate of managers.[166]
The agreement determines the conditions on which the members of the Selling Groups are allowed to sell the bonds to investors on the primary market. The share of bonds allotted to the Selling Group is commonly not included in the Selling Group Agreement, but is set out in the offering message sent out by the lead manager to the members of the Selling Group. By confirming the message, each member confirms the share of bonds allotted to him and the price of those bonds.

The main obligation of a Selling Group member is to sell his share of bonds to investors. However, the Selling Group Agreement is not a purchase agreement since it does not include any pricing terms. The price and the number of bonds are agreed by accepting the offering message sent out by the lead manager to the members of the Selling Groups. The Selling Group Agreement sets out the standard terms and conditions of sale of bonds in the primary market.[167] It also imposes selling restrictions determining in which geographical markets the members of the Selling Group are allowed to market, sell and distribute the bonds.[168] These restrictions are important to avoid conflicts between securities regulations in different jurisdictions as bonds are offered to international investors in different countries. Another purpose of the Selling Group Agreement is to secure compliance with applicable securities laws.

Furthermore, the Selling Group Agreement should prevent the circulation of information other than the information given in the final prospectus. Accordingly, the members of selling groups are not allowed to give any information other than the information given in the prospectus. This is to prevent the circulation of false or misleading information about the issuer and the issue.[169]

[165] Tennekoon; *The Law and Regulation of International Finance*, p. 189.
[166] Tennekoon; *The Law and Regulation of International Finance*, p. 187.
[167] Tennekoon; *The Law and Regulation of International Finance*, p. 189.
[168] Tennekoon; *The Law and Regulation of International Finance*, p. 190.
[169] Tennekoon; *The Law and Regulation of International Finance*, p. 192.

3.9 Allotment

The allotment takes place after the signing of the legal documents. During the allotment, a message is sent to all managers who have expressed an interest to subscribe for a certain number of bonds. The message is considered to be a legally binding offer by the issuer to the managers to sell bonds on behalf of the issuer.[170] However, often managers´ shares of bonds have already been proposed in the initial invitation to participate in the syndicate. Commonly, in pre-priced issues the allotment is made the business day after the launch or at least as soon as practicable after the syndicate has been organised. According to English contract law, the offer is legally accepted by each manager when the payment for the manager´s portion of the issue is transferred to the lead manager on the closing day.[171]

It could also be interesting to observe that the time difference between the point when the informal allotment is made and the point when the formal message of allotment is sent to the managers, allows the lead manager to punish managers who have been engaged in short selling or dumping activities. These punitive measures could include that a lower number of bonds are allotted to managers responsible for short selling. This reduced share of the total issue makes it hard for the manager to satisfy his obligations under the short selling contract.
However, the possibility to take such punitive measures is restricted in pre-priced issues since the final allotment should be made within the business day after the launch date. Another protection for the members of the syndicate is that in pre-priced issue, the lead manager is required to grant pre-allotments of not less than 50% of the finalised or expected minimum underwriting commitment if this is requested by the group of managers.[172] This request by the group of managers should be made at the time they accept to participate in the syndicate. This means that the managers are guaranteed at least 50% of the desired underwriting commitment and could engage in short selling and other grey market transactions[173] in at least this portion of the intended commitment.[174]
However, one must be aware that these protections are recommendations made by the IPMA[175]. Such recommendations are as a matter of market practice followed but are not regulated in any laws. However, they serve the purpose of setting uniform standards for the issuance of new securities.[176]

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[170] Tennekoon; *The Law and Regulation of International Finance*, p. 157.
[171] Tennekoon; *The Law and Regulation of International Finance*, p. 157.
[172] Tennekoon; *The Law and Regulation of International Finance*, p. 158.
[173] Gallant; *The Eurobond Market*, p. 162.
[174] Tennekoon; *The Law and Regulation of International Finance*, p. 158.
[175] IPMA means International Primary Market Association and was established to promote the interest of and to maintain high ethical standards among lead managers in securities issues. The IPMA has given recommendations which are widely accepted among the members of IPMA.
[176] Gallant; *The Eurobond Market*, p. 164.

Accordingly, the message containing the allotment should be considered as a legally binding offer by the lead manager to the members of the syndicate to subscribe for a certain number of bonds. The offer is accepted by the managers, when funds are advanced to the lead manager at the closing day.

3.10 The closing

At the closing, the allotment is accepted by the managers when funds are advanced to the lead manager. This is the point where the issue comes into effect. Commonly, the closing takes place about a week after the signing of the legal documents.[177]

It is also at the closing the remaining documents, such as the trust deed and the principal paying agency agreements or the fiscal agency agreement, are signed. These documents will determine the service and administration of the bonds during its lifetime.[178] Below, these documents will be discussed in more detail.

In many cases, managers or selling group members have already at this point sold all or most of the bonds allotted to them. The agreed purchase price is be transferred to the lead manager who will then advance the funds, minus commission and compensation for expenses, to the issuer. At the same time, the issuer will transfer to the lead manager a temporary global bond which is later replaced by a permanent global bond or by definitive bonds. The temporary global bond is transferred by the lead manager to the two clearing houses Euroclear and Cedel.[179] In practice however, a custodian will hold the bond instrument on behalf of the two clearing houses.[180]

3.10.1 Trust deed and principal paying agency agreement or fiscal agency agreement

At the closing, the documents concerning the administration and service of the issue during its lifetime are finally determined and signed. There are two main alternatives, either a trustee is appointed or a fiscal agent. The trustee is simply an agent who acts on behalf of the bondholders and protects their interests. The fiscal agent is a paying agent of the issuer and performs administrative duties on behalf of the issuer.[181] If an trustee is appointed, a large number of paying agents will also be appointed to handle principal and interest payments. Even though the relevant documents are signed at the closing day, a decision on whether to appoint a trustee or a fiscal agent is commonly made at an earlier stage and the choice is reflected in the

[177] McKnight; *The Law of International Finance*, p. 512.
[178] McKnight; *The Law of International Finance*, p. 512.
[179] Gallant; *The Eurobond Market*, p. 177.
[180] Tennekoon; *The Law and Regulation of International Finance*, p. 159.
[181] Tennekoon; *The Law and Regulation of International Finance*, p. 159.

mandate.[182] However, the choice of trustee or fiscal agent is often not indicated in the initial invitation sent out to potential members of the syndicate even though the choice has great significance to them.[183]
In this section, the trustee and the fiscal agent will be discussed and some advantages and disadvantages associated with the alternatives will be presented. One of the purposes of this essay is to discuss the service and administration of the issue during its lifetime. The choice between trustee and fiscal agent is important since it determines how this service and administration will be carried out.

3.10.1.1 Trustee and principal paying agent

As observed above, a trustee is appointed to safeguard the interests of the bondholders and to act on their behalf. As an agent, the trustee owes fiduciary duties to the bondholders.[184]

Information about the trustee and the issue could be found in the Trust Deed. It contains provisions about the forms of the bonds, the terms and conditions of the issue, the procedure for the calling of bondholders´ meetings and how resolutions are passed.[185] More about the Trust Deed and the contents of the agreement will follow later in this section.

The choice and appointment of trustee is made by the lead manager, the issuer and their lawyers jointly. Even though bondholders do not have direct control over the appointment, in effect they play an important role and have considerable influence over the choice. The issuer and the lead manager are dependent on the confidence of the investor base. Since it is the assignment of the trustee to act on behalf of the bondholders, it is important to appoint a trustee that earns the confidence of the bondholders. The appointment of a trustee which is not totally accepted by the base investors makes the placement of the bonds more difficult. Therefore, a trustee with a high commercial reputation on the international market is usually appointed.[186]

To fulfil the assignment of acting on behalf of the bondholders and to protect their interests, the trustee is entrusted rights and powers. The responsibilities of the trustee are usually outlined in the Trust Deed. First of all, the trustee, and no one but the trustee, has the power to accelerate the bonds if the issuer defaults.[187] Usually, if holders of 20% of the aggregate amount of the issue require the trustee to accelerate the bonds due to an event of default, the trustee is commonly forced to do so. However, due to the anonymity of the bond instrument, it is hard to locate such a large share of bondholders and receive their consent. Another practical problem is that if the issuer has defaulted, the cross-default clauses of the issuer´s

[182] McKnight; *The Law of International Finance*, p. 536.
[183] Pergam; *Choosing between the trustee and fiscal agent for Eurobonds*, p. 8.
[184] McKnight; *The Law of International Finance*, p. 545.
[185] McKnight; *The Law of International Finance*, p. 539.
[186] Tennekoon; *The Law and Regulation of International Finance*, p. 224.
[187] Tennekoon; *The Law and Regulation of International Finance*, p. 228.

syndicated loan agreements would most likely already have been activated. Consequently, these loans are accelerated long before the bondholders manage to locate and mobilize holders of 20% of the aggregate amount.[188]
Another alternative to bondholders who desire to accelerate the issue, is the passing of an extraordinary resolution.[189] Yet again, it requires the consent of at least 10% of all bondholders which is not easily achieved.[190]
Consequently, it is hard for an individual bondholder to force the trustee to accelerate the issue if not the bondholder holds a substantial share of the issue. The trustee has a wide right of determination when it comes to acceleration of bonds.[191]

Furthermore, it is the responsibility of the trustee to bring enforcement proceedings against the issuer[192]. Such proceedings cannot be brought by individual bondholders, unless two conditions are met; the trustee has been bound to proceed against the issuer and the trustee has failed to do so within reasonable time.[193] This limitation in the bondholders right to bring enforcement proceedings is called the "no action" clause. The only situation where the trustee is bound to proceed is when the trustee has accelerated the bonds, demanded repayment from the issuer but the issuer fails to perform such repayment.[194]
It is important to bear in mind that all provisions, covenants and rights, except the obligation to pay interest and principal, are given to the trustee by the issuer and not to the bondholders.[195] For that reason, the trustee is entitled to give up claims based on the issuer´s breach against the trust deed, if the breach is not materially prejudicial to the bondholders.[196] Also, the trustee has the right and power to modify the terms and conditions of the trust deed without prior approval from the bondholders. However, in some cases the trustee needs consent from the issuer. However, there are two limitations concerning the trustee´s right to modify the provisions of the Trust Deed. Firstly, some stipulations in the agreement are protected from modifications and secondly, the right of modification does not include modifications which could be "materially prejudicial to the interest of the bondholders in the opinion of the trustee"[197]. Consequently, the trustee is not allowed to reduce the interest or principal, change the payment date of interest or principal or postpone the maturity date. [198] Additionally, the trustee may not change the bearer nature of the bonds, the governing law or clauses such as the parri passu clause or the negative pledge clause. [199] However, the trustee is allowed to change the debtor and put another

[188] Tennekoon; *The Law and Regulation of International Finance,* p. 208.
[189] Tennekoon; *The Law and Regulation of International Finance,* p. 207.
[190] Tennekoon; *The Law and Regulation of International Finance,* p. 208.
[191] Tennekoon; *The Law and Regulation of International Finance,* p. 228.
[192] Tennekoon; *The Law and Regulation of International Finance,* p. 228.
[193] Tennekoon; *The Law and Regulation of International Finance,* p. 210.
[194] Tennekoon; *The Law and Regulation of International Finance,* p. 210.
[195] Tennekoon; *The Law and Regulation of International Finance,* p. 229.
[196] Tennekoon; *The Law and Regulation of International Finance,* p. 231.
[197] Tennekoon; *The Law and Regulation of International Finance,* p. 231.
[198] Tennekoon; *The Law and Regulation of International Finance,* p. 231.
[199] Tennekoon; *The Law and Regulation of International Finance,* p. 233.

company in the issuer´s position as long as the new debtor will be able to fulfil its obligations to the bondholders.[200] In practice however, the trustee is commonly seeking the consent of the bondholders to any substantial change in the terms and conditions of the trust deed. It needs to be observed that the trustee is obliged to act fairly and to act in the interest of the syndicate and not only in the interest of himself.[201]

An important provision in the Trust Deed is the issuer´s obligation to provide the trustee with financial and other relevant information regarding the issue and the issuer´s ability to meet its obligations to the bondholders. Furthermore, the issuer has to keep proper books of account and grant the trustee access to those books if the trustee has reasonable grounds to believe that an event of default has occurred. Additionally, the issuer must give notice in writing to the trustee as soon as the issuer becomes aware that an event of default has occurred or is likely to occur in the future.[202]

Accordingly, the choice of trustee is important to the bondholders. To be able to attract the interest of investors, the issuer must appoint a trustee with unencumbered reputation in the market. Otherwise, the risk is that the issue will not be well accepted among investors. It is also of great significance to the managers and underwriters to be aware of the choice of trustee since it affects their prospects of placing the bonds among investors. Accordingly, the choice has to be made at an early stage and be reflected in the mandate.

In my opinion, the powers entrusted to the trustee is most necessary. The trustee is appointed to act on behalf of the bondholders and to safeguard their interests. If every modification requires the consent of each bondholder, it would be difficult to make necessary modifications. One must remember that adjustments also could benefit the bondholders, such as an increase in the interest rate due to changed and more favourable market conditions.
From the issuer´s point of view, it is easier to negotiate with just one party who is entrusted the power to act and make decisions on behalf of the whole group of investors. As observed above, the trustee has the duty to act with due skill and diligence as fiduciary in the performance of its functions. Because of this duty, the trustee is obliged to use the same care and skill in performing its duties as a trustee as an ordinarily prudent businessman will do in the managing of his own businesses.[203] Consequently, the trustee is not allowed to put his own interest in front of the interests of the bondholders. The appointment of a trustee also protects the issuer against bondholders who want to accelerate the bond in advance and force the issuer into formal insolvency proceedings even though the issuer is trying to achieve a private rescheduling with its main bank and bond creditors.[204] Such actions by single bondholders could damage the interest of the

[200] Tennekoon; *The Law and Regulation of International Finance*, p. 234.
[201] Tennekoon; *The Law and Regulation of International Finance*, p. 232.
[202] Tennekoon; *The Law and Regulation of International Finance*, p. 231.
[203] McKnight; *The Law of International Finance*, p. 545.
[204] Woods; *The Law and Practice of International Finance*, p. 181.

collective of bondholders since the value of the bonds could be negatively affected. "No-action clauses" in trust deeds prevent such early accelerations while a restructuring plan is negotiated. If the issuer defaults, the issuer would only have to deal with the trustee as a representative of the collective of bondholders and not with each bondholder individually.[205]
Of course, there are also disadvantages with the appointment of a trustee, such as increased costs and documentation, more extensive information covenants and the redistribution of powers from the bondholders to the trustee.[206]

In addition to a trustee, principal paying agents are appointed in different financial centres to facilitate principal and interest payments. The location of the principal paying agents depend on which countries the investors are located in and the currency of the issue. The parties to the Principal Paying Agency Agreements are the issuer, the paying agents, and the trustee. The assignments of the principal paying agents will be to advance payments and notifications between the issuer and the bondholders as well as authentication and replacements of bonds.[207]

[205] Woods; *The Law and Practice of International Finance*, p. 181
[206] Woods; *The Law and Practice of International Finance*, p. 182.
[207] McKnight; *The Law of International Finance*, p. 539.

3.10.1.2 Fiscal agent

Instead of appointing a trustee, the issuer may choose to appoint a fiscal agent. As observed above, the most important difference between a trustee and a fiscal agent is that the fiscal agent is acting on behalf of the issuer and not, as the trustee, on behalf of the bondholders. The assignment of the fiscal agent is similar to that of principal paying agents. Accordingly, the fiscal agent lacks many of the powers given to the trustee and has no control over the rights of bondholders.[208]

The main functions of the fiscal agent are to exchange the temporary global bond to a permanent global bond and deliver this global bond to the clearing houses, act as principal paying agent and advance funds between the issuer and the bondholders, redeem the bonds if they are to be redeemed prior to maturity, replace lost or destroyed bonds at the request of the bondholders, call for bondholders´ meetings,[209] and perform administrative duties such as publishing notices, and act as depository of information available for inspection.[210]

The advancement of principal and interest payments from the issuer to the bondholders is performed with the use of a number of paying agents appointed in different financial centres. In practice, the paying agents make payments from their own accounts and then they get repaid by the fiscal agent. After the funds have been repaid to the paying agents, the fiscal agent is exposed to the risk of suffering a loss if the issuer defaults. To avoid this, provisions in the fiscal agency agreement usually require the issuer to provide the fiscal agent with necessary funds two business days before the payments should be carried out. Some fiscal agency agreements even require the fiscal agent to hold a certain amount of money on trust on behalf of the bondholders.[211]

As noted above, the trustee has powers and rights to act on behalf of the bondholders in several matters. The fiscal agent is appointed to perform limited functions on behalf of the issuer. Accordingly, the bondholders must safeguard their own interests as creditors and may therefore accelerate the bonds if the issuer defaults and demand the issuer to compensate losses occurring from the default.[212] However, bondholders are also required to monitor the issuer´s compliance with the covenants of the agreement and to take suitable actions if a breach occurs.

The bondholders´ meeting is a forum in which decisions and voting could be made. Each bondholder has a separate agreement with the issuer and therefore every bondholder has to agree to a decision. Since this is almost impossible to accomplish, the bondholders´ meetings are given the authority

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[208] Tennekoon; *The Law and Regulation of International Finance*, p. 218.
[209] Tennekoon; *The Law and Regulation of International Finance*, p. 222.
[210] Pergam; *Choosing between the trust and fiscal agent for Eurobonds*, p. 8.
[211] Tennekoon; *The Law and Regulation of International Finance*, p. 219.
[212] Pergam; *Choosing between the trust and fiscal agent for Eurobonds*, p. 8.

to pass resolutions which are binding for all bondholders.[213] The main issues for bondholders´ meetings to decide upon are modification of the bondholders´ rights against the issuer, modifications of the terms of the bonds or fiscal agency agreement, changes in the the maturity date, altering the currency or reducing the principal amount or interest.[214] The bondholders´ meeting may also decide in questions such as release or creation of security for the bonds, conversion of the bonds into shares or other securities, and the appointment of a committee to represent the bondholders.[215] In market practice, the issuer or each bondholder holding at least 5-10% of the outstanding bonds can call for a bondholders´ meeting by giving notice, usually 21 days in advance.[216]

The appointment of a fiscal agent is easier and requires less documentation than the appointment of a trustee. The disadvantages are that each bondholder could put the issuer in default if the issuer breaches against the agreement and that the issuer do not have the possibility of renegotiating the terms and conditions with one counterparty but has to rely on the bondholders´ meetings.[217]

3.10.1.3 Trustee or fiscal agent?

In this section, some common arguments in favour of appointing a trustee and some arguments in favour of appointing a fiscal agent will be presented. As notes earlier, the choice is important to investors and could affect the attractiveness of the issue.

Factors such as the cost, the type of security being issued, and the requirements of the market all affect the choice of whether to appoint a trustee or a fiscal agent.[218] The cost associated with a fiscal agent is of course less than the cost of appointing a trustee. However, the trustee brings additional protection to the bondholders when it comes to monitoring the issuer´s compliance with the terms and conditions of the issue.

If the issue is secured, a trustee holding the security is commonly appointed. The security is in such a case given to the trustee and the trustee holds it on behalf of the bondholders. It would have been too complicated if each bondholder should hold the security individually.[219] However, as we have observed in earlier sections, Eurobonds are commonly not secured.

Another advantage from the issuer´s perspective with appointing a trustee is that it facilitates for the issuer to deal with only one entity acting on behalf of all bondholders instead of having to deal with them all individually. The trustee has the authority to make decisions, call for bondholders´ meetings

[213] Wood; *The Law and Practice of International Finance*, p. 185.
[214] Tennekoon; *The Law and Regulation of International Finance*, p. 222.
[215] Wood; *The Law and Practice of International Finance*, p. 187.
[216] Wood; *The Law and Practice of International Finance*, p. 187.
[217] Tennekoon; *The Law and Regulation of International Finance*, p. 220.
[218] Goodall; *Eurobonds issued with the benefits of trust deed*, p. 19.
[219] McKnight; *The Law of International Finance*, p. 536.

and act on behalf of the collective of bondholders. The trustee is a fiduciary who must treat all bondholders equally without favouring one bondholder over another. This equally treatment benefits small bondholders who may otherwise not have the ability to protect themselves as effectively as larger bondholders.[220]

The fiscal agent is an agent of the issuer and the advantages with appointing a fiscal agent are mainly on the issuer's side. The fiscal agency requires less documentation and is therefore easier and cheaper for the issuer. The issuer may also benefit from avoiding the unifying influence of a trustee, even though it is harder to pass modifications of the agreement in cases where a trustee is not appointed. However, commonly a committee of bondholders is appointed to coordinate the actions of all bondholders. Also, the issuer has to deal with the risk that all bondholders are entitled to bring legal enforcements against the issuer if something goes wrong.[221]

In jurisdictions where the trust institute is not recognised it could of course be better to appoint a fiscal agent. [222] This essay deals with Eurobonds and English law and in English law the trust institute is well recognised and frequently used. However, according to Swedish law the result could have been different.

3.10.2 The bonds

As indicated above, it was more common in earlier years that definitive bonds were issued. Nowadays, the system is centralised and computerised and definitive bonds are often replaced by a global bond. The global bond represents the entire issue and is commonly deposited at a custodian. However, there are some situations where definitive bonds could be issued to replace the global bond. Examples of such situations are when the replacement is necessary for tax purposes, when the clearing and settlement system has stopped to function, and when the issuer has defaulted.[223]

3.10.2.1 The temporary global bond

The temporary global bond is commonly issued at the closing day. The temporary global bond is effective the first 40 days of the issue and is then replaced by an permanent global bond. This 40-day period is called the "lock-up" period.[224]

The temporary global bond includes the name of the issuer and it certifies that the bond is in bearer form. It also certifies the total amount of the issue, which will be paid to the holder of the instrument at a certain date, i.e. the maturity date. If there is a trust deed, the temporary global bond makes clear

[220] McKnight; *The Law of International Finance*, p. 537.
[221] McKnight; *The Law of International Finance*, p. 538.
[222] McKnight; *The Law of International Finance*, p. 538.
[223] McKnight; *The Law of International Finance*, p. 527.
[224] Tennekoon; *The Law and Regulation of International Finance*, p. 159.

that the issue is subject to the trust deed and to the terms and conditions of the trust deed. The temporary global bond is authenticated by the Fiscal Agent or the Principal Paying Agent.[225]

3.10.2.2 The permanent global bond

At a specified date, the temporary global bond is replaced by a permanent global bond. This permanent global bond will remain current for the remaining lifetime of the issue. The information included in the permanent bond instrument is very similar to that of the temporary bond. However, it also specifies the circumstances under which the permanent global bond could be replaced by definitive bonds. Additionally, it deals with the question of principal and interest payments.[226]

3.10.2.3 Definitive bond

Temporary and permanent global bonds are issued to represent the whole issue. Definitive bonds are issued for each individual bond, i.e. one definitive bond for each individual bond. Each one of these individual definitive bonds includes information about the name of the issuer, the principal amount of the bond, the interest rate, the date of maturity, and whether it is secured or subordinated or not.[227] Additionally, it contains an individual serial number showing that the individual bond is part of a series of bonds. It also certifies that the bond is of bearer character and that the nominal value of the bond will be paid to the holder at maturity. Furthermore, it declares that the definitive bonds are subject to the terms and conditions printed on the back of the bond instrument and on the trust deed. There is also coupons attached to the definitive bond, if it is not a zero-coupon bond. These coupons should be detached, one for each interest payment date, and presented to the paying agent. If the bond has a long lifetime, it will include a talon which could be exchanged for more coupons. The definitive bond is authenticated by the Fiscal Agent or one of the appointed Principal Paying Agents.[228]

[225] McKnight; *The Law of International Finance*, p. 528.
[226] McKnight; *The Law of International Finance*, p. 528.
[227] McKnight; *The Law of International Finance*, p. 529.
[228] McKnight; *The Law of International Finance*, p. 528.

3.11 The lock-up period

The lock-up period starts at the closing day and lasts until the definitive bonds or permanent global bonds have been issued which usually takes 40 days[229]. During this period the issue is represented by a temporary global bond deposited at a common depository while the definitive or permanent bonds are printed and delivered to the trustee or the fiscal agent.[230] Trading in bonds during the "lock-up" period are only allowed between buyers and sellers with an account in the clearing houses, but after the "lock-up" period the bonds could be sold to the public on the secondary market.[231]

[229] Gallant; *The Eurobond Market*, p. 141.
[230] Tennekoon; *The Law and Regulation of International Finance*, p. 159.
[231] Gallant; *The Eurobond Market*, p. 141.

4 Comparation between bonds and loans

As observed in the Introduction, companies in need of additional capital could use different sources of funding, such as bonds, bank loans or new equity. The set of sources used by a corporate entity is called the company's capital structure.[232] It is interesting to observe that in a perfect world the set of financial sources and the capital structure of a company do not affect the total value of the company as long as the choice does not change the firm´s cash flow.[233] Despite this, investors and the companies could prefer one capital structure over another.[234] As we observed in the Introduction, the reference companies rely heavily on debt financing and use a mix of loan finance and bond finance. Debt financing could be seen as the main alternative to equity financing. The latter includes the issuance of new shares and has the disadvantage of diluting the ownership of the company.[235] On the other hand, equity does not involve any payment obligations if the company does worse than expected since payment of dividend is not obligatory.[236]
However, the purpose of this chapter is to discuss debt financing and to identify advantages and disadvantages with loan financing compared to bond financing. It will not go deep into the loan structure or syndication process, but will focus on the benefits connected to the two sources of funding.

A company´s balance sheet gives important information about a firm´s financial status, condition and capital structure. Furthermore, the balance sheet provides an overview of what the firm owns, i.e. its assets, and what the firm owes to external parties, i.e. its liabilities, and to internal parties, i.e. its equity. The total of equity and liabilities must equal the sum of all assets.[237]

A common way to raise additional capital is by issuing new debt. This could be done in several ways. The two most common ways are by taking a bank loan or by issuing bonds, but there are also other ways open to the company such as borrowing from its employees or leasing necessary equipments.[238] All these methods have in common that the borrower initially borrows an amount of money that later needs to be repaid. From an economical perspective, renting equipment from a leasing firm instead of buying the

[232] Berk & DeMarzo; *Corporate Finance*, p. 539.
[233] Modigliani & Miller; *The cost of capital, corporation finance and the theory of investments*, p. 264.
[234] Berk & DeMarzo; *Corporate Finance*, p. 457.
[235] Arnold; *Corporate Financial Management*, p. 362.
[236] Arnold; *Corporate Financial Management*, p. 362.
[237] Fraser & Ormiston; *Understanding Financial Statements*, p. 36.
[238] Byström, Hans; *Capital Structure and Dividend Policy – The Two Modigliani & Miller Theorems*, p. 2

same equipment with borrowed money has a lot in common with debt financing.[239]

Taking a bank loan includes an obligation by the borrower to repay an equal amount of capital to the lender at maturity along with agreed interest. Commonly, the loan is repaid in regular instalments if not the loan is accelerated due to violation of the loan agreement.[240] Accordingly, either the company chooses to lend from a bank or issue bonds a debt will arise that later needs to be repaid.

For a large amount, a single bank may not be able or willing to lend the entire amount itself. To do so would expose the bank to an unacceptable risk of default on part of one of its borrowers. Consequently, it is common that several banks jointly lend money under common terms to a single borrower. This is called syndicated bank loan. The syndication of loans includes diversification benefits. Instead of giving one large loan to a single borrower, the bank can engage in many smaller loans to multiple borrowers.[241] It is important to know that each lender is responsible for their portion of the total loan amount and has no legal responsibility for other participants´ shares.[242] As observed earlier, the undertaking by the underwriters in a bond issue to subscribe for the issue is joint and several meaning that each manager undertakes to underwrite the entire amount of the issue himself. However, this risk is commonly handled in the Agreement between Managers by including a pro rata sharing clause.

Another important difference between bonds and bank loans is the transferability of the debt. A bank loan does not include the issuance of a transferable security while bond instruments could easily be transferred and sold by the bearer of the instrument on the secondary market.[243] However, even though bank loans in some cases could be traded on a secondary market, the process is far more complex. Bank loans are not strictly negotiable, and a transfer requires complex documentation and sometimes also the borrower´s consent.[244] The liquidity of the secondary market together with the transferability and negotiability of bonds increases the attractiveness of bonds as investments since the bonds could easily be sold if the money is needed for other investment purposes prior to maturity.[245] Since bonds are attractive among investors, the bond markets offer great lending opportunities to companies in need of additional capital.

Furthermore, the private nature of the loan compared to the public nature of the bond needs to be mentioned.[246] While a loan transaction usually involves a limited number of lenders a bond issue is normally a public

[239] Byström; *Finance - Markets, Instruments and Investments*, p. 2.
[240] Arnold; *Corporate Financial Management*, p. 427.
[241] Cranston; *Principles of Banking Law*, p. 55.
[242] McKnight; *The Law of International Finance*, p. 534.
[243] Wood; *Law and Practice of International Finance*, p. 161.
[244] Wood; *Law and Practice of International Finance*, p. 161.
[245] McKnight; *The Law of International Finance*, p. 496.
[246] McKnight; *The Law of International Finance*, p. 491.

transaction including a wide group of investors unless it is a private placement. Accordingly, information regarding the issuer and the issue will be spread to large groups of investors.[247] To be able to attract the interest of investors, the company must be well-known in the capital markets and have obtained a sufficient credit rating.[248] If not the issuer has a good relationship with specific investors which continually invest in the issuer´s issues, the issuer may be forced to market the issue towards the target group of investors.[249] This can of course be time consuming as well as expensive. Accordingly, funding through public bond issues are in practice only open to well-known corporations with a good reputation. Accordingly, small and medium size companies may find it easier to raise additional capital through loan transactions rather than bond issues. Loan transactions enable the borrower to benefit from a good relationship with a single or limited group of lenders. A public bond issue commonly requires the issuer to be well-known and to have a good reputation in the capital markets. The issuance procedure is also quite expensive and time consuming as it involves a lot of documentation.

The fact that bond issues are more public than bank loans, also includes benefits. In fact, bond issues enable the borrower to raise funds more cheaply than by borrowing from a bank.[250] Terms and conditions of the issue, such as maturity, time and interest rate, could be adjusted and tailored to appeal and match the investment strategy of target group investors.[251] Some investors are seeking high yielding bonds while other investors focus on the level of credit risk. While some investors are looking for long-term investments with a fixed interest rate, other investors are looking for short-term investments with a floating rate of interest or even no interest at all.[252] Some investors prefer the possibility of capital gain associated with convertible bonds while some investors are looking for the stable cash flow of a straight bond. While many banks are reluctant to make fixed rate loans for longer periods, there are multiple examples of bonds with a very long duration and fixed interest. The flexibility of bonds is an advantage and gives the borrower the opportunity to attract capital on suitable terms.[253] In a loan transaction, the terms are often more strict and not as flexible as in bond issues. The cost associated with borrowing directly from a bank is often higher because of the restrictive debt covenants of corporate loans. The purpose of such covenants is to reduce the credit risk associated with the loan and to make sure that the borrower will be able to repay the loan in the future.[254] The bank could require the borrower to leave security for the loan which means that the borrower pledges some assets as collateral for the loan. If the borrower defaults, the security is sold to cover the debt. This restricts the borrower´s possibility to dispose the assets during the loan

[247] McKnight; *The Law of International Finance*, p. 491.
[248] Gallant; *The Eurobond Market*, p. 139.
[249] Gallant; *The Eurobond Market*, p. 139.
[250] McKnight; *The Law of International Finance*, p. 492.
[251] McKnight; *The Law of International Finance*, p. 492.
[252] Gallant; *The Eurobond Market*, p. 185.
[253] Arnold; *Corporate Financial Management*, p. 428.
[254] McKnight; *The Law of International Finance*, p. 493.

period. As observed earlier, Eurobonds are almost always unsecured. In addition, also other covenants in loan agreements are more restrictive than the covenants of bond issues. A loan agreement commonly includes a negative pledge clause which prohibits the borrower from creating any security interests in favour of a third party over a certain property specified in the agreement.[255] The purpose of the clause is to prevent the borrower from disposal of the assets, but also from more limited forms of divestment of possession or title such as by way of lease or the grant of an equitable interest. Of course, such restrictive provisions are problematic for the issuer and implies a financial cost. The terms and conditions of bonds could also include a negative pledge clause, but it is often very limited.[256] While the loan agreement generally includes covenants such as detailed information requirements, a negative pledge, a parri passu clause, events of default, an anti-disposal clause, and controls on change of business the covenants of bond issues are commonly far more limited, less extensive and more favourable to the issuer. Simply put, banks place greater restrictions on what the company could do with the loan and are more concerned about the repayment of the loan than bondholders. These differences could be explained with the difficulties of obtaining consent and decisions from a large group of bondholders, while it is easier to do so from a smaller group of bank lenders.[257] Additionally, I believe that the competition among investors on the bond markets facilitate for issuers to issue and acquire the required amount of money on more favourable terms. The advantage of a liquid secondary market compensate for the less favourable covenants of the bond issue.

Private placements of bonds have a lot in common with the private nature of loan transactions. They both involve a limited number of lenders rather than a large group of investors. Accordingly, it is a private transaction between the borrower and a limited group of investors. The private nature and the confidentiality of bank loans make them more suitable for financing transactions of a confidential nature such as takeover bids. [258]

Of course, also factors outside the company such as the political and economical stability in a country, cultural aspects, and applicable regulations matters. I will not discuss such factors deeply, but will mention the debate concerning the impact of the new and stricter standards of Basel III on the possibility to raise additional capital through bank loans in the future. Basel III introduce new and stricter capital requirements on the level of minimum capital and the quality of such capital.[259] These stricter rules are a response to the recent financial crisis and the purpose is to make sure that banks build up reserves of high quality capital in good times that could be used to absorb losses in times of distress.[260] As banks are required to

[255] McKnight; *The Law of International Finance*, p. 152.
[256] Wood; *Law and Practice of International Finance*, p. 163.
[257] McKnight; *The Law of International Finance*, p. 494.
[258] McKnight; *The Law of International Finance*, p. 491.
[259] BIS; *"The Basel Committee´s response to the financial crisis: report to the G20"*, p. 4.
[260] Caruana; *"Basel III: towards a safer financial system"*, p. 3.

hold more capital on their balance sheets, critics fear that the rules will limit and decrease the banks´ lending capacity in the future. This could of course have great impact on the possibilities to raise additional capital by bank loans.[261]

Three common theories to explain the firm´s choice of whether to borrow from the capital market or the loan market are the flotation costs theory, renegotiation and liquidation concerns theory and the information asymmetry theory.[262] The first argument states that since the issuance of bonds involves large issuance costs, bond issues are not cost-efficient in small capital requirements. Only when large amounts of capital are needed, the firm would turn to the bond market. The second argument implies that firms that are more likely to suffer from financial distress are less likely to loan from the capital market than from the loan market. The reason for this is that it is easier to renegotiate the terms of loans than the terms of bonds.[263] Finally, the third argument implies that the firm´s choice of financial source is connected to the level of asymmetric information the firm is exposed to. The result of information asymmetries is that lenders unable to watch over the borrower´s business require higher returns on their investments and therefore these firms commonly chose to borrow from banks instead of capital markets.[264]

Over the years, multiple studies have tried to point out individual characteristics of firms that affect the choice of whether to raise additional funds through bank loans or bond issues. Some studies have shown that larger companies with a high level of leverage, profitability, fixed assets and fewer growth options tend to choose loan over bonds while firm´s with higher level of short-term debts and bigger growth opportunities tend to turn to the bond markets in a higher degree.[265] Studies have also shown that companies that are less likely to default tend to choose bond financing over loan financing. Factors affecting the companies likelihood to default are the size and stability of the cash flow and the level of profitability.[266]
Even though these results seem reasonable provided that the firm is large and creditable enough to get access to the capital and loan markets, I think it is very difficult to identify such determinants. Studies have indicated that the growth potential of firms highly affect the choice of whether to turn to the bond markets or the loan markets to raise additional funds. It is easy to understand that profitability is an important factor when a lender is considering whether to grant a loan or not. A high level of profitability

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[261] See also Valdez & Molyneaux; *An Interoduction to Global Financial Markets*, p.171, on the effects of capital ration constraints on the loan market.
[262] Esho & Lung & Sharpe; *Choice of Financial source in International Debt Markets*, p. 281.
[263] Yener & Kara & Marques-Ibanez; *Large debt financing: syndicated loans versus corporate bonds*, p. 440.
[264] Yener & Kara & Marques-Ibanez; *Large debt financing: syndicated loans versus corporate bonds*, p. 447.
[265] Yener & Kara & Marques-Ibanez; *Large debt financing: syndicated loans versus corporate bonds*, p. 455.
[266] Neil & Lung & Sharpe; *Choice of Financial source in International Debt Markets*, p.

reduces the credit risk since it is less likely that the borrower goes insolvent. It is also reasonable to believe that high profitable companies will be able to acquire loans on better terms than companies with lower levels of profitability. Companies with high growth potential are often associated with a higher credit risk than more mature companies. Even though high credit risk companies may find it hard to get bank loans on good terms, they may still be attractive to bond investors due to the flexibility of the bond instruments.

However, most companies use a mix of different financial sources to secure sufficient flow of funds. As observed in the Introduction, many companies uses both shorter debt instruments such as CPs and longer debt instruments such as Notes or Bonds together with bank loans and revolving credit facilities.

In investment strategies, the benefits of diversification are well-known and a common method to reduce the risk of the portfolio of assets. By combining different types of assets, the total risk of the portfolio could be reduced. Commonly, the risks associated with an asset are divided between firm-specific risks and systematic risks. The firm-specific risks are risks associated with the company itself and systematic risks are market-wide risks affecting the market as a whole and all assets. By diversifying and buying different types of assets, the firm-specific risks could be reduced or even eliminated. However, there is no way to eliminate the systematic risk.[267] Consequently, investors are compensated for holding systematic risk but not for holding firm-specific and diversifiable risks.[268] For investors, buying bonds is a way to diversify the portfolio of assets. By combining bonds with other assets such as stocks, derivatives or raw materials, the total risk of the portfolio could be reduced.

However, theories about and the benefits of diversification could also be applied to the capital structure of companies and the used set of financial source. A good mix allows the individual company to create a flexible and diversified funding structure and gives the firm access to reliable and stable source of funding on suitable terms. The diversification benefit is important since the company then becomes less dependent on one of the sources and more resistant to temporary disruptions in the markets. Furthermore, by diversifying the company can also achieve a satisfying spread between long and short term commitments, fixed and floating rate of interest, different levels of interest, etc. Accordingly, by diversifying and use different sources of funding the company can create a capital and cost structure that is unique to the company and matches the individual requirements and desires of the company.

[267] Berk & DeMarzo; *Corporate Finance*, p. 311.
[268] Berk & DeMarzo; *Corporate Finance*, p. 312.

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