Background note

Unlisted bond issuers in Latin America

2023 OECD-Latin America Roundtable on Corporate Governance

OECD

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1. Introduction

The main objective of this background note is to provide information on the current relevance of unlisted bond issuers and some of the challenges related to the regulation of these issuers. This background note aims to assist discussions on whether and how to apply the G20/OECD Principles of Corporate Governance (*G20/OECD Principles*) to unlisted bond issuers.

Bonds represent important rights and obligations for issuers and creditors. Companies globally and in Latin America are increasingly using this financing mechanism. Bondholders may play a crucial role in the decision-making process of their issuers, depending on the characteristics of the debt instrument. Despite not being shareholders or holding specific positions in the management of companies, bondholders investing significant resources have certain prerogatives. For example, they might have the right to limit the distribution of dividends, to reject the disposal or acquisition of assets, to impose pecuniary penalties in case of non-compliance with certain financial covenants, and to demand changes in the ordinary course of business.

In that direction, the *G20/OECD Principles*, in the annotations to subprinciple IV.A.10, state the following:

> *[u]nder normal circumstances, shareholders and directors control the major decisions taken by a company. However, certain provisions in corporate bonds and other debt contracts may significantly limit the discretion of management and shareholders, such as covenants that restrict dividend payouts, require creditors' approval for the divestment of major assets, or penalise debtors if financial leverage exceeds a predetermined threshold. Moreover, under financial stress but before bankruptcy, companies may choose to negotiate a waiver of compliance with a covenant, when existing creditors may require changes in the business. As a consequence, the timely disclosure of material information on debt contracts, including the impact of material risks related to a covenant breach and the likelihood of their occurrence, in accordance with applicable standards, is necessary for investors to understand a company's business risks.*

Bondholders are exposed to possible disclosure failures by issuers, non-compliance of the fiduciary duties by the management and possible violations of legal or regulatory obligations of the issuance intermediaries. Even qualified and sophisticated bondholders face challenges when bonds are publicly offered without solid information available about the issuer. Therefore, corporate governance frameworks and practices should be evaluated to address such challenges.

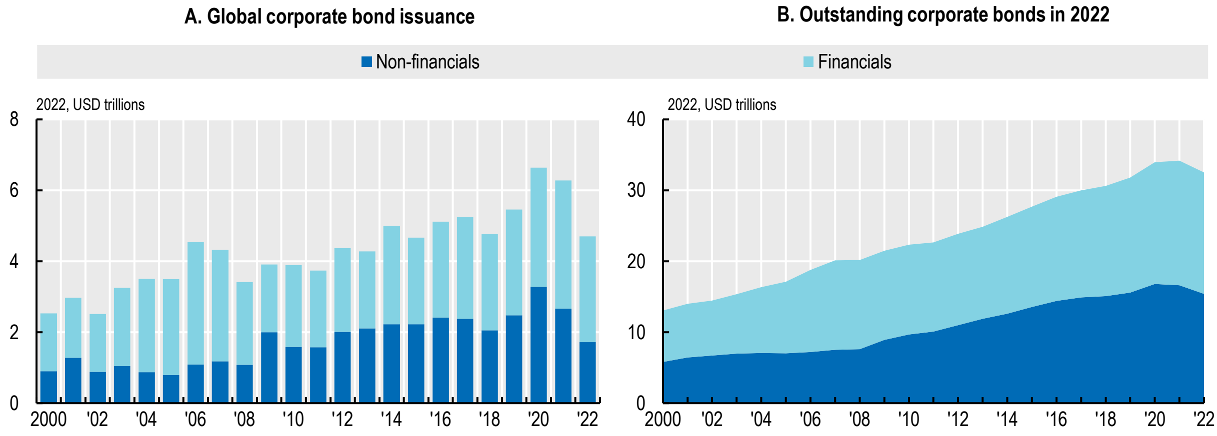
This background note highlights the scenarios in which the issuer of the debt is not a public company and the informational regime and other existing rules for the listed companies are not applicable. Despite being financed through the issuance of bonds, the legal and regulatory framework imposed on these debtors tends not to have the same depth as that applicable to listed companies. This note will explore some of these repercussions.

2. Trends and key issues

2.1 Increasing relevance of bond issuances by unlisted companies

Since the global financial crisis, there has been a surge in the use of corporate bonds. Globally, annual corporate bond issuance by non-financial companies doubled from an average of USD 1 trillion between 2000 and 2007 to an average of USD 2.1 trillion between 2008 and 2022 (Figure 1, Panel A). As a result, outstanding corporate bonds reached a record level of USD 34.2 trillion at the end of 2021, which represented a 69% increase since 2008 (Figure 1, Panel B).

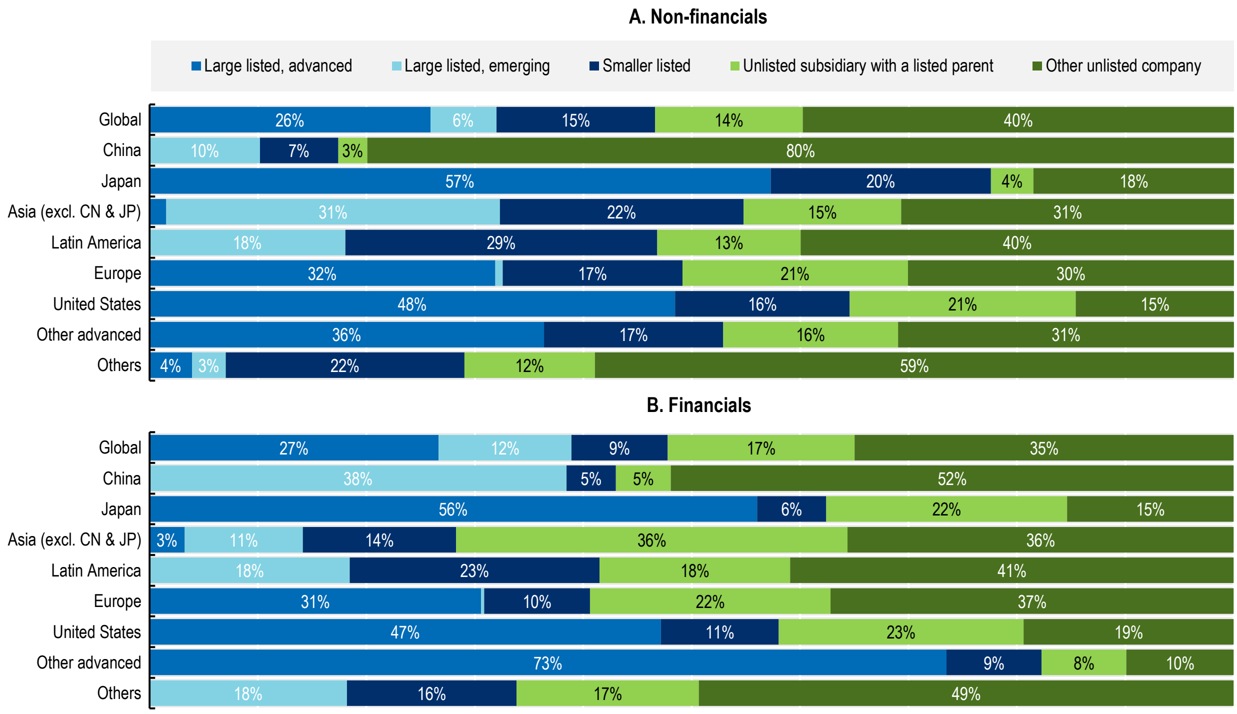
Figure 1. Global corporate bonds issuance and outstanding amount



Source: OECD Capital Market Series Dataset, LSEG.

Between 2021 and 2022, unlisted companies were responsible for raising 53% of the total amount raised by the non-financial corporate sector, and 52% of the total amount raised by the financial sector in bonds. Out of the amount raised by unlisted companies, 14% was raised by companies that had a listed (immediate or ultimate) parent in the non-financial sector, while 17% was raised in the financial sector (as shown in Figure 2). Across various jurisdictions and regions such as the People's Republic of China, Asia (excluding China and Japan), and Europe, unlisted companies dominated as issuers in both the non-financial and financial sectors, accounting for between 46% and 83% of the amount raised between 2021 and 2022. Specifically in Latin America, non-financial (53%) and financial (59%) unlisted companies' bond issuances follow the same direction.

Figure 2. Corporate bond issuance by listed and unlisted issuers in 2021-22



Note: The inclusion of a company in the MSCI World Index or in the MSCI Emerging Markets Index is considered as a proxy for a listed company being large. Unlisted companies were classified as either a subsidiary with a listed parent company or "other unlisted companies".
Source: OECD Capital Market Series dataset, LSEG, MSCI.

2.2 Legal and regulatory frameworks applicable to unlisted issuers

The *G20/OECD Principles* focus on publicly traded companies, as clarified in the 9th paragraph of the "About the Principles" section, and only "[t]o the extent they are deemed applicable, the Principles may also be a useful tool to improve corporate governance in companies whose shares are not publicly traded". The 2023 revisions to the *G20/OECD Principles* added three recommendations that are relevant for bond issuers and bondholders:

- Subprinciple IV.A.10 recommends that corporate disclosure should include material information on "debt contracts, including the risk of non-compliance with covenants".
- Subprinciple VI.C.2 mentions that "[b]oards should assess whether the company's capital structure is compatible with its strategic goals and its associated risk appetite to ensure it is resilient to different scenarios".
- Subprinciple VI.D.6 states that "[t]he exercise of the rights of bondholders of publicly traded companies should be facilitated".

In this context, there are at least four non-mutually exclusive cases that may be considered: (i) a listed company that issues a bond; (ii) an unlisted subsidiary of a listed company issuing a bond; (iii) an unlisted company that makes a public offering of its bonds and/or lists them in a public market; (iv) an unlisted company that only issues bonds privately to financial institutions, insurance companies, pension funds, and other institutional investors.

The first case in the paragraph above related to listed companies issuing bonds presents relatively minor challenges. Chapter IV of the *G20/OECD Principles* already recommends the disclosure of material information in accordance with internationally recognised accounting standards with an annual external audit. Most jurisdictions indeed require listed companies to disclose financial information according to the IFRS Accounting Standards, which are developed for investors, lenders and other creditors, or in line with other similar standards. Likewise, the *ad hoc* disclosure that regulators may require of material facts by listed companies will typically be relevant not only to shareholders but also to bondholders. In both cases, they share an interest in analysing the future cash flows of the issuer: in the case of shareholders, to assess the net-present-value of the cash flows available to them; in the case of bondholders, to evaluate the possibility of the debt payments' default.

The second case – where an unlisted bond issuer is controlled by a listed company – presents some specific challenges. According to IFRS 10, the reporting company must present consolidated financial statements including information from all entities it directly or indirectly controls. This allows investors in bonds issued by an unlisted issuer to access some relevant information in the financial statements if the issuer is significant for the business of the parent listed company, but there may not be enough individualised information if the business of the controlled company is not material for the parent (e.g., if the subsidiary's revenues are inconsequential for the parent company). In addition to the disclosure, securities regulators may not have the mandate to supervise and enforce the rights and equitable treatment of bondholders of an unlisted company.

The third case of an unlisted company that makes a public bond offering raises the same informational asymmetry risks as when a company lists its equity. As mentioned above, material information about a company will typically be relevant not only to shareholders but also to bondholders, who acquired the bond in the public offering or in a public market (an exchange or an over-the-counter market). Moreover, bondholders will need information on the risk of non-compliance with the covenants in the bonds they hold. That is why in some jurisdictions, including the United States and Brazil, unlisted companies that make a public bond offering typically need to comply with disclosure requirements that are similar to the ones followed by listed companies (e.g., CVM Resolution 80 in Brazil). Exemptions to some disclosure requirements are often conditioned to the number and type of eligible investors in the public offering (e.g., unlimited number of accredited investors in Regulation D Rule 506 offerings in the United States).

The last case – where an unlisted company that only issues bonds privately to institutional investors and financial institutions – is probably the least obvious for policy makers. From the perspective of securities regulators, all directly involved parts are sophisticated market participants who can negotiate the optimal level of disclosure and protection to be included in the bond contracts. The intervention of policy makers, therefore, may not be warranted. From the perspective of banking, insurance and pension funds regulators, however, the bond market for unlisted issuers may have become too big to be ignored (Figure 2). Notably, out of the 44 000 bonds issued in 2021-22 globally, almost 14 000 are not publicly listed and 74% of these bonds were privately placed (OECD Capital Market Series dataset, LSEG). From a financial stability perspective, supervisors may need to have high-quality and timely information on the bonds held by financial institutions, which would enable an accurate valuation of their fixed income assets and risk exposure. From an investor protection perspective, it is not always clear that the incentives of insurance companies' and pension funds' managers are aligned with their clients' risk preferences and interests. In such cases, the lack of information on bond issuers may reduce the accountability of executives of insurance companies and pension funds, because both supervisors and clients may find it difficult to find information on the success or failure of the investments in bonds issued by unlisted companies.

In all four cases, but especially where the investor base of corporate bonds is dispersed, there are some bondholder rights issues that deserve special attention. First, investors may not have the scale or incentives to monitor and engage with their debtors, in which circumstance independent bond trustees may play an important role in monitoring bond issuers, and corporate governance frameworks may spur investors to be more active as creditors. Second, bondholders effectively may want to engage with their debtors, but they might not have opportunities to communicate with the investee companies as shareholders do. Third, if the rights and duties of bondholders are not clearly and adequately set, out-of-court debt restructuring that is in the best interest of the company may not be achievable, forcing the company into formal bankruptcy proceedings.

Brazil's CVM issued in 2022 Resolution 160, which regulates the public offering of securities, including bonds, by both listed and unlisted companies. Under this new framework, Brazilian regulators have approved a matrix of offerings that takes into account several factors, such as the type of security being issued, the issuer, the target investors, the registration process, and the information disclosure requirements (CVM, 2022). Depending on the combination of these factors, there may be varying levels of disclosure requirements. The goal of this procedure is to strike a balance between investor protection and market dynamism.

For example, a listed company that is already subject to a transparent information regime, regularly issues securities and intends to offer bonds to a sophisticated public of investors can use an automatic registration process, which is faster and requires less information and less intervention from the regulator. Conversely, if an unlisted company that has no publicly available information about its activities, has no track record of previous issuances and wants to finance itself through bond issuance destinated to retail investors will have to meet more requirements and comply with a robust new set of procedures and disclosure rules.

2.3 Intermediaries on the issuance of bonds by unlisted companies

The role of intermediaries and trustees is crucial in bond issuance, where each market participant has a specific function and shares responsibility in assuring the issue regularity. Most importantly, these agents are responsible for ensuring the accuracy of information provided in prospectuses and other documents related to the bond issuance. They play a pivotal role in promoting the proper functioning of the capital markets, reducing information asymmetry, improving efficiency in terms of price definition, and protecting investors. They usually conduct legal due diligence and engage third parties to verify that the information provided by the bond issuer adequately reflects the financial and economic situation of the company.

It is important that the actors involved have the appropriate incentives, aligned with the interests of the final investor, and that the obligations assumed by the debtor are fulfilled in accordance with the bond issuance documents. The information provided to investors during the decision-making process must be reliable and accurate. Any errors or inaccuracies in the information can lead to a poor investment decision and potentially financial losses. Therefore, it is crucial to ensure that the data is thoroughly verified, and presented in a clear and concise manner.

3. References

CVM. (2022). *Matriz de Ofertas Públicas.* Retrieved from https://conteudo.cvm.gov.br/export/sites/cvm/audiencias_publicas/ap_sdm/anexos/2021/sdm0221_Matriz_de_Ofertas_Publicas.pdf