Legal framework for secured corporate bonds in Latvia: proposal for a new regulation introducing the concept of a collateral agent

MASTER'S THESIS

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DECLARATION OF HONOUR:

I declare that this thesis is my own work, and that all references to, or quotations from, the work of others are fully and correctly cited.

(Signed) ……………………………………

RIGA, 2019

ABSTRACT

Access to finance is considered as one of the key factors to successful financial market development. European companies face problems with corporate funding which is treated as one of the main barriers to the corporate growth and innovation capacity. Corporate bonds represent an alternative source of funding, contributing to a reduction of dependency on more traditional bank financing. Despite the present growth of the corporate bond market in Latvia, current legal environment for collateralization of the corporate bond in Latvia remains comparatively inflexible for the changes ongoing.

The goal of this thesis is to provide a theoretical background for procedure of issuance of secured corporate bonds in Latvia, to identify the key missing elements for favourable collateralization environment, and to produce recommendations to reform the legal and regulatory framework for introduction of the concept of a collateral agent in Latvia.

To achieve the goal, the study observes the current regulatory framework as regards to the secured corporate bond issuances and their collateralization procedure in Latvia and the reasons why it should be developed so that it stimulates the use of corporate bonds as an alternative to bank financing and establishes more favourable environment for the Latvian corporate bond market.

Legal and comparative analysis research methods are applied in this research: secondary and primary sources of law, books and scientific literature.

The main findings reveal that the current Latvian legislation regarding collateral arrangements for secured corporate bonds is outdated, inflexible and potentially obstructs the development of the Latvian corporate bond market. Specific adjustments introducing a clear concept of a collateral agent (security trustee) able to hold security in favour of investors are needed in order to efficiently exercise the creditors' rights and administer the secured assets. The study recommends creating a legal framework to ensure the enforceability of a collateral agent structures and a suitable regime for secured corporate bond transactions in Latvia. The Author suggests that it is done via amendments to the existing legislation and adoption of a new law, which specifically governs collateralization and introduces the concept of a collateral agent.

Key words*:* Bond market development, secured corporate bonds, commercial pledge, collateral agent, collateralization

SUMMARY

This thesis provides a comprehensive analysis of the current legal framework as regards to the secured corporate bond issuances and the collateralization procedure in Latvia and compares it with the applicable regulatory framework in the other two Baltic countries – Estonia and Lithuania. This study further examines whether the current legal environment is favourable for engagement of a collateral agent (security trustee) in respect to the secured corporate bond transactions in Latvia. The thesis provides the recommended further steps in achieving implementation of an effective collateral agent regime in the country. Following the conclusions and recommendations given in the thesis, the general framework of the new legislative proposal for introduction of the concept of a collateral agent shall be developed and set out in thesis, to be, possibly, further developed and implemented by Latvian legislator.

The thesis provides the reader with a general overview of a corporate bond issuance process and the applicable legislation at both European and national level when preparing a corporate bond issue prospectus for sale of bonds to the investors. It furthermore analyses laws and regulations applicable to collateral arrangements for secured corporate bond issuances and actions and powers of a collateral agent as well as the format and key pillars of the bond prospectus and collateral agent agreement. This study identifies the differences in conditions and requirements between the various EU countries. It identifies various shortfalls of the existing legislation and provides a proposal for a new law governing collateral agent's rights and obligations.

First part of the thesis describes corporate bond issuance process and provides a general overview of the key characteristics of a secured corporate bond. It further presents the role of a collateral agent, who holds the collateral on behalf of the investors as an independent third party and identifies types of collateral typically used to secure a bond.

Second part presents an analysis of the current European and national legislation governing secured corporate bond issue process and procedure for establishment of the collateral. Moreover, it provides the reader with an analysis of the most recent precedents – secured corporate bond issue transactions in Baltics and conditions for ensuring use of a collateral agent concept. It further provides an insight into Estonian and Lithuanian legal framework as regards to the security and collateral agent arrangements.

The third part of the thesis provides the general framework of the new legislative proposal to be further developed and implemented by Latvian legislator that would ensure the enforceability of a collateral agent concept and create a suitable regime for secured corporate bond transactions in Latvia.

Due to its comprehensive approach, the thesis is important as a general basis for guidelines in the European and national legislation concerning the current regime for secured corporate bond issuances and engagement of a collateral agent. The respective research and appropriate analysis were made because there are no academic papers outstanding of the topic as identified by the Author offering a comprehensive overview of the current European and national legislation in force regarding procedure on execution of the secured corporate bond transaction in Latvia, simultaneously depicting the key existing requirements for collateral arrangements as well as proposed changes to be introduced.

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List of Abbreviations

CMU	Capital Markets Union
CSD	Central securities depository
Civil Law	The Civil Law of Latvia of 28 January 1937
Commercial Law	The Commercial Law of Latvia of 13 April 2000
Commercial Pledge Law	The Law on Commercial Pledge of Latvia of 21 October 1998
DVP	Delivery versus payment
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EC	European Commission
EU	European Union
EUR	Euro
FCMC	Financial and Capital Market Commission
Financial Instrument Market Law	The Law on the Financial Instruments Market of Latvia of 10 November 2003
Financial Collateral Law	The Financial Collateral Law of Latvia of 21 April 2005
Insolvency Law	The Insolvency Law of Latvia of 26 July 2010
IPO	Initial public offering
Nasdaq Riga	Nasdaq Riga stock exchange
Nasdaq CSD	Nasdaq CSD SE (Societas Europaea)
New Prospectus Regulation	Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017
SME	Small and Medium Enterprise
Prospectus Directive	Directive No 2003/71/EC of 4 November 2003
Prospectus Regulation	Commission Regulation (EC) No 809/2004 of 29 April 2004

INTRODUCTION

Background and topicality

In Latvia the debt market is small by international standards, however it has developed a versatile legal and regulatory framework, as well as corresponding market infrastructure. The Latvian debt market consists of the governmental bonds, mortgage bonds and corporate bonds. Development of the Latvian bond market started back in 1993 and for some years no other securities than governmental bonds were offered in the public market. Historically, one of the basic characteristics of the Latvian capital market was the preference that non-financial sector entities had for banks' loans over the issuance of bonds. Bond yields are usually higher than loan interest rates, therefore issuance of bonds is not so attractive to private companies.

Even though government bonds strongly dominate the Latvian capital market in the aspect of both amount and liquidity, there are, however, positive signals confirming future growth in the volume of public-issue corporate bonds. Moreover, debt securities of longer maturity are being issued, which is a sign of stability in the market and can promote inflow of long-term investment from pension funds, institutional investors and insurers.

The Baltics is still a new and rapidly developing corporate bond market with current capitalization of around EUR 4 billion[1]. Financial sector entities (banks, short-term consumer lenders) are the most active issuers in the corporate bond segment, but other sectors include electronics, telecommunications and energy. In Latvia, there are every year new issues in the amount of around EUR 500 million, and bond market activity is increasing by continuously improving market infrastructure and state involvement in stimulating development of the Latvian capital market. The turnover in the corporate bond market is negligible, and the majority comes from transactions on bank bonds. Further, many companies decide attracting funds through closed issues of such debt securities that cannot be traded at the Nasdaq Riga.

Notwithstanding its continuous growth, the size of the Latvian corporate bond market remains relatively low. It is still challenging to attract not only the attention of the international investors to the Latvian bond market, but also attention of the local regulatory bodies and investment community in respect to the local bond market environment. However, recent growth has stimulated the development of the overall competence for local community. Nevertheless, Latvian business and investment culture is still in the continuous formation and growth process. At the same time, recent increase in the number of issues of corporate bonds and their listing on the Nasdaq Riga both serves as an important milestone in the development of capital raising market in Latvia and also sends a positive signal to foreign capital markets.

Emerging corporate bond market in Latvia requires also more flexibility as regards to the conditions of the bond issue offered by the issuers. While bonds issued by Latvian corporates are mostly unsecured, more and more companies are willing to issue also secured or collateralized bonds, by offering to investors certain type of security for their bonds – asset pledge, mortgage or cash flow protection. Hence, it is expected that the competence of both the legislator and law enforcement authorities is constantly increased in order to facilitate improvement of the legal environment pursuant to the latest trends. Accordingly, by considering the recent trends in the corporate bond market, the legislation in the respect to the

[1] Baltic International Bank. *The Baltics - new and rapidly developing corporate bonds market.* Available on: https://www.bib.eu/en/news/02/28/baltics-new-rapidly-developing-corporate-bonds-market. Accessed: May 19, 2019.

collateralization process should be also continuously assessed and efficiently adapted to the latest industry trends.

Last amendments to the Latvian Commercial Pledge Law were adopted back in 2014. For the purpose of secured bond and collateralization frameworks, specific adjustments introducing a clear concept of a collateral agent (security trustee) able to hold security in favour of investors are needed. This would enable to more efficiently exercise the creditors' rights and administer the secured assets. Neither the concept of a collateral agent nor other legal concepts in Latvian law cover usage or specifics of a trust (as it is understood in common law) as the holder of security on behalf of other beneficiaries.

The topicality of the research is formed by various factors. *The first factor* being the need to reveal the current legal framework for the secured corporate bond issue and collateralization procedure in Latvia and compare it with the applicable framework in the other two Baltic countries – Estonia and Lithuania. Despite its ongoing growth process and the direction of the development of the corporate bond market in Latvia, current legal environment for collateralization of the corporate bond in Latvia remains comparatively inflexible. An appropriate legal and regulatory framework for the purpose of collateral arrangements is essential for enabling efficient exercise of the creditors' rights and administration of the secured assets. Absence of a proper legal framework would hinder further development of the Latvian corporate bond market. The Ministries of Finance in Latvia, Lithuania and Estonia signed in November 2017 a Memorandum of Understanding with the intent to create a pan-Baltic covered bond framework. The aim of this work is for the three Baltics States to adopt covered bond laws that would be as similar as possible and that would facilitate the issuance of covered bonds with underlying assets from one, two or three of the Baltic States. However, a covered bond can only be issued by a credit institution (i.e., by the bank), has full recourse to the issuer, is subject to special public supervision and can only be backed by certain specific assets. Thus, development of the collateralization regime for corporate bonds issued by private companies apparently would not fall under this initiative. Identification and analysis of the current legal framework for the secured corporate bond and collateral arrangements will help to determine the missing elements of the required legal concepts.

By considering the ongoing growth of the corporate bond market, *the second factor* is the need to develop an appropriate and up-to date legal framework in Latvia by introducing a clear concept of a collateral agent (security trustee) who would be able to hold security in favour of investors in a secured bond issue transaction. There may be revealed legal factors that indicate the presence of a more favourable environment for the corporate bond market in Latvia. The respective mechanisms for improvement of the current legal framework when revealed should be scrutinised by other Baltic countries and applied if possible.

The third factor is the ongoing Capital Markets Union (CMU) initiatives and action plan on improving European corporate bond markets. One of the key priorities within the CMU is strengthening the capacity of EU capital markets and making it easier for companies to enter and raise capital on public markets. Obviously, it concerns also the need of continuous assessment and improvement of the legal and regulatory framework of corporate bond offerings on public markets. Corporate bonds can be an important source of funding for Latvian companies, which can use the proceeds from bond sales to invest in growth and job creation thus stimulating economic activity in the country. Corporate bonds offer businesses access to alternative, more diverse sources of funding. They also offer new investment

opportunities for Latvian savers. One of the key objectives of the EC's flagship CMU project is to help corporate bonds become a larger source of funding for European businesses. Hence, it is necessary to discover the respective opportunities for development of the Latvian corporate bond market. Establishment of an appropriate legal and regulatory framework is one of the preconditions for development of the Latvian bond market.

The fourth factor is the need to discover the corporate bonds as an alternative to the traditional bank financing in Latvia. The recent growth of the Latvian corporate bond market has revealed a clear potential for corporate bonds as the alternative to bank financing. Corporate bonds represent an alternative source of funding for the businesses, contributing to a reduction of dependency on more traditional bank financing. The prominence of corporate bonds as a means for companies to finance themselves has grown significantly over the last decade, as corporate bonds have been the main beneficiary of the reduction in bank funding after the financial crisis and the decrease in interest rates. Moreover, corporate bonds reduce the over-reliance of the financial system on bank funding and hence the sensibility of the wider economy to bank deleveraging. The availability of an alternative source of funding for productive investment in the EU supports the wider economy, enables greater risk sharing and a more sustainable and smoother credit supply.

The fifth factor is the fact, that by considering the importance of capital market in economy, Latvia, Estonia and Lithuania have agreed to create a pan-Baltic capital market, by harmonising regulation to strengthen the economies of the Baltic States and stimulate investment to create jobs with support of the European Commission (EC) and the EBRD. Hence, it is necessary to discover the respective mechanisms for improvement of the current legal framework for the secured corporate bond market in Latvia and when discovered, it should be evaluated by other Baltic countries and if needed, introduced in the regulatory environment of Estonia and Lithuania.

By considering the recent growth, there is a need for improvement of the legal environment for ensuring the development of the corporate bond market in Latvia. The Author could neither identify the unified legal framework for secured corporate bond and collateralization arrangements nor ascertain a comprehensive analysis or assessment of the respective issues in Latvia. This research provides the first study on the concept of a collateral agent in Latvia along with an assessment of the current legal framework as regards to the collateralization.

The *goal* of this thesis is to provide a theoretical background for procedure of issuance of secured corporate bonds in Latvia, to identify the key missing elements for favourable collateralization environment, and to produce recommendations to reform the legal and regulatory framework for introduction of the concept of a collateral agent in Latvia needed for the development of the corporate bond market in Latvia within the Capital Markets Union.

It is intended to aid Latvian legislator in preparation of a new law and amendments to existing Latvian law that will ensure the enforceability of a collateral agent regime and create a suitable concept for secured corporate bond transactions in Latvia. This will contribute to the development of capital markets in both Latvia and Baltics.

To achieve the goal of the research, the following *tasks* should be accomplished:

1) an analysis of the existing legal and regulatory framework at EU level;

2) an analysis of the existing pertinent legal and regulatory framework in Latvia;

3) an analysis and comparison with the existing legal framework in Estonia and Lithuania;
4) advise with regard to legal and regulatory changes that are required to facilitate the development of the secured corporate bond market.

Research methodology

In this study the Author will use legal and comparative analysis *research methods* in order to obtain the most comprehensive insight into the Latvian legal regulatory framework and to gain the most recent data of the real-life precedents. The present study is descriptive and explanatory in nature. Both secondary and primary sources of law were used for the study. The secondary sources of law required for the study include books, scientific publications, law reviews, citation of official documents and papers, as well as websites. Primary sources of law required for the study were legislation of both the European Union and the Republic of Latvia. The laws of Estonia and Lithuania were used for this research.

In the course of the thesis preparation the following existing laws are examined:

1) *European legislation*, which establishes the current prospectus regime;
2) *Financial Instruments Market Law*, which currently regulates, inter alia, secured corporate bond issue transactions;
3) *Commercial Law*, being the law regulating commercial activities in Latvia;
4) *Law on Commercial Pledge*, being the law regulating commercial pledge establishment and registration procedure in Latvia;
5) *Financial Collateral Law*, which recognizes the concept of establishment and enforcement of collateral in respect of financial collateral arrangements;
6) *Insolvency Law*, being the primary law governing insolvency in Latvia, applied in most cases to legal entities as well as private individuals. Provisions of the Insolvency Law are applicable to insolvency proceedings of financial and capital market participants supervised by the FCMC insofar as it is not stated otherwise by the special laws governing their activities;
7) *Civil Law*, which is the principal law governing private law relations;
8) *Law on Commercial Pledge of Estonia*, being the law regulating commercial pledge establishment and registration procedure in Estonia.
9) *Law on the Pledge of Movable Property of Lithuania*, being the law regulating commercial pledge establishment and registration procedure in Lithuania.

Limitations

It is not within the scope of this thesis to research in-depth the European legislation that could possibly apply to public trading of financial instruments or to explain the exact content of diverse national laws, which issuers have to observe when applying for corporate bond issuances and publishing of the prospectus.

Moreover, the respective research will not examine issues related to equity capital (stock) Initial public offerings (IPOs) and unsecured debt security (bond) issuances, but instead is focused particularly on secured debt securities (bonds), procedure for collateral arrangements and engagement of a collateral agent. The analysis is made from the Baltic Market point of view.

1. THEORETICAL BACKGROUND AND CORPORATE BOND ISSUANCE PROCESS

When companies or other entities need to raise money for financing new projects, retain ongoing business operations, or refinance existing debts, they may issue bonds directly to investors.

Bonds, which represent the seller's pledge to make scheduled interest payments and principal repayments to the buyer, can be either "secured" or "unsecured." Each of these bond types presents different opportunities and challenges for the buyer.

The corporate bond market is one of the largest bond markets in the world with approximately USD 8 trillion in outstanding securities. In its simplest form, a corporate bond is an IOU (abbreviated from the phrase "I owe you") from a company given to the investors that have agreed to lend the company money. This market is dominated by institutional investors such as pension funds, insurance companies, mutual funds, and ETFs-the latter two are often held by individual investors[2].

In the world of financial markets, there is no unified definition of a corporate bond. According to the Financial Instrument Market Law, debt securities are bonds or other forms of transferable securitised debts, except securities that are equivalent to equity securities[3]. Another definition of same:

> A corporate bond is a transferable long-term debt security providing from one side the proof of investment of investor's resources and from another side issuer's (company's) liability to repay nominal and coupon/s of the bond within the fixed period. The structure of the corporate bond is defined by the issue prospectus. Corporate bonds may be publicly listed or issued as a private issue and not publicly listed (or publicly listed later).[4]

However, the definition of a corporate bond as used in this research is:

> A corporate bond is a debt security issued by a company and sold to investors (also called – "bondholders"). The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations. In some cases, the company's assets may be used as collateral for bonds.[5]

Corporate bonds are a form of debt financing. Bonds can be a major source of capital for many businesses, along with equity, bank loans and other types of financing. A company needs to have some consistent earnings potential to be able to offer debt securities to the public at a favourable coupon rate.[6] If a company's perceived credit quality is higher, it becomes easier to issue more debt at low rates. When an investor buys a corporate bond, he/she lends money to the company. Conversely, when an investor purchases shares, he/she essentially buys an interest in the company. The value of shares rises and falls with the value

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[2] Gary Strumeyer, *Capital Markets: Evolution of the Financial Ecosystem* (John Wiley & Sons, 2017), pp. 254-285.

[3] The Law on the Financial Instruments Market of Latvia (10 November 2003). Available on: https://likumi.lv/ta/en/en/id/81995-financial-instrument-market-law. Accessed April 2, 2019.

[4] Natalja Tocelovska. Development of the Corporate Bond Market in Latvia. *Doctoral Thesis in Economic science* (2018): p. 24, available on: https://dspace.lu.lv/dspace/bitstream/handle/7/45625/298-67343-Tocelovska_Natalja_VadZ991263.pdf?sequence=1&isAllowed=y. Accessed April 2, 2019.

[5] Roy Goode, Herbert Kronke, Ewan McKendrick and Jeffrey Wool, *Transnational Commercial Law, International Instruments and Commentary: Second Edition* (Great Britain: Oxford University Press, 2012), p. 687.

[6] Charles Proctor, *The Law and Practice of International Banking* (Great Britain: Oxford University Press, 2010), p. 533.

of the company, allowing the investors to earn profits but also subjecting the investors to losses. In case of bonds, investors only earn interest (a bond's coupon rate) rather than profits. If a company goes into bankruptcy, it pays its bondholders along with other creditors before its shareholders, making bonds arguably safer investment than shares.[7]

Unsecured bonds are not secured by a specific asset, but rather by "the full faith and credit" of the issuer. In other words, the investor has the issuer's promise to repay but has no claim on specific collateral. This doesn't necessarily have to be a bad thing: keep in mind that U.S. Treasuries – regarded as the lowest risk investment in the world when it comes to the possibility of default – are all unsecured bonds. Even owners of unsecured do have a claim on the assets of the defaulted issuer, but only after investors whose securities are higher in the "capital structure" are paid first. Debt, such as unsecured bond debt, is said to be "subordinated," or junior, to secured debt.

Secured bonds are those that are collateralized by an asset – for instance, property or equipment (as is commonly the case for bonds issued by airlines, railroads and transportation companies), or by another income stream. Mortgage-backed bonds are an example of a single bond-type secured by both the physical assets of the borrowers – the titles to the borrowers' residences – and by the income stream from the borrowers' mortgage payments. It means that in the event that the issuer "defaults" – or fails to make interest and principal payments – the investors have a claim on the issuer's assets that will enable them to get their money back. This claim on the issuer's assets, however, may sometimes be challenged, or it may be that an asset sale will not make the bond's investors whole. In both cases, the likelihood is that after some delay – which may range from weeks to years – the bondholders will have only a portion of their investment returned, perhaps only after the deduction of legal fees that can be considerable.

1.1 Why companies issue bonds as a source of finance

A large number of reasons exist for a company to decide to issue bonds as a source of finance, such as obtaining financing outside of the banking system or selecting other methods of raising money. When companies need to raise money, issuing bonds is one way to do it.

According to Hardie and Rethel[8], in the period from the 1990s emerging market financial crises until the North Atlantic financial crisis of 2008, the development of domestic bond markets in developing economies was a prominent agenda item in international financial reform circles. The authors of the article "Financial structure and the development of domestic bond markets in emerging economies" further reveal:

> The crises of the 1990s drew attention to the vulnerabilities generated by frequently occurring double mismatches of currency denominations and maturities in the borrowing of emerging economies. This led to a series of reform efforts targeted at both increasing liquidity and the range of borrowers in domestic bond markets. In the aggregate, these efforts were successful: For emerging market economies as a whole, domestic debt now exceeds international debt. Moreover, domestic corporate bond markets have emerged in many countries, often for the first time. However, the nature

[7] Louise Gullifer and Stefan Vogenauer, *English and European Perspectives of Contract and Commercial Law, Essays in Honour of Hugh Beale* (Oxford and Portland, Oregon: Hart Publishing, 2014), p. 419.
[8] Ian Hardie and Lena Rethel, "Financial structure and the development of domestic bond markets in emerging economies", (2019): pp. 86-112, available on: Web of Science database, accessed May 19, 2019, doi: 10.1017/bap.2018.11.

of market development has been far from uniform, and often has not been in line with government aims.

A bond functions as a loan between an investor (bondholder) and a company. The bondholder agrees to give the company a specific amount of money for a specific period of time in exchange for a coupon (periodic interest payments at designated intervals). When the bond reaches its maturity date, the investor's "loan" is repaid.

The decision to issue bonds instead of selecting other methods of raising money can be driven by many factors. Comparing the features and benefits of bonds versus other common methods of raising cash provides some insight into why companies often look to bond issuances when they need to raise cash to fund their business activities. Borrowing from a bank is perhaps the approach that comes to mind first for companies when there is a need for additional capital for ensuring growth and expansion of business, purchase of equipment etc. This leads to the question - *why would a corporation issue bonds instead of just borrowing from a bank?*

Like people, companies can borrow from banks, but issuing corporate bonds is often a more attractive option. The interest rate companies pay bondholders is often less than the interest rate they would be required to pay to the bank for the issued loan. Since the money paid out in interest detracts from profits and companies are in business to generate profits, minimizing the interest amount that must be paid to borrow money is an important consideration. It is one of the reasons why healthy companies that don't seem to need the money often issue bonds when interest rates are at extremely low levels. The ability to borrow large sums of money at low interest rates gives companies the ability to invest in growth, improvement of infrastructure and purchase of equipment.

Issuing bonds also gives companies significantly greater freedom to operate as they see fit because it releases them from the restrictions that are often attached to bank loans. For example, that banks often require borrowers to agree to a variety of limitations, such as not making corporate reorganizations or acquisitions until their loans are repaid in full and other.

Such restrictions can hamper a company's ability to do business and limit its operational options. Issuing bonds enables companies to raise money with no such strings attached.

Main benefits as well as key burdens of issuing bonds in more detail are described in the subsequent sections of this thesis.

Main benefits

Charles Proctor found *attraction of financing* and *liquidity* as major advantages for a corporate bond issue[9]. A successful corporate bond issue can generate significant funding for a business, and the attraction of cash offers a company an opportunity to accelerate further growth by hiring more employees, developing infrastructure, buying required equipment or conducting research and development (R&D). Corporate bond issuances range from EUR 1 million or less to EUR 100 million or more.

Many corporate bonds are traded in the secondary market, which allows investors to buy and sell the bonds after they have been issued. Hence, investors can potentially benefit from selling bonds that have risen in price, or buying bonds after a price has decreased.

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[9] Charles Proctor, *The Law and Practice of International Banking* (Great Britain: Oxford University Press, 2010), p. 435.

However, there are several other benefits for companies to issue corporate bonds further listed below.

Enhancement of the company's stature, perceived stability and competitive position

An important consideration for many companies contemplating a bond issue and trading on the regulated market is the effect that bonds being publicly traded will have on the company's stature, perceived stability and competitive position. Suppliers and business partners may perceive a company to be a better partner, and therefore may be more inclined to extend favourable terms to the company. The public offering and issue of bonds may generate publicity that raises the company's profile with potential customers. For example, newspapers and magazines more likely cover companies which have issued securities that are traded on the stock exchange.

Access to the public market for future financings

A company that has completed its corporate bond issue may return to the public market for additional (follow-on) bond issues and offerings or even pursuing initial public offering to raise additional cash. A follow-on bond issue often can be completed in a significantly shorter time frame than the first one, since base prospectus is already developed and the company has acquainted with the requirements of the local regulator and stock exchange.

The transparency that comes from the public reporting requirements applicable to companies when bonds are traded on the regulated market makes them more attractive candidates for possible business opportunities.

By considering mentioned above, an entrepreneur may considerably benefit by pursuing a bond issue and thus making the company more public. However, there exit also several burdens that should be considered when making the final decision on execution of an initial public offering.

Disadvantages

Sindhu and Kumar (2014) found *credit risk* and *unforeseen circumstances* or *event risk* as major disadvantages for a corporate bond issuance due to the fact that if the issuer goes out of business, the bondholder may not receive interest payments or get back his/her principal amount[10]. This contrasts with bonds that have been issued by a government with a high credit rating, as this entity could theoretically increase taxes to make payments to bondholders. As regards to event risk, companies might face unforeseen circumstances that could undermine their ability to generate cash flow. The interest payments – or repayment of principal – associated with a bond depend on an issuer's ability to generate cash flow.

According to Bai, Bali and Wen[11], "downside risk is the strongest predictor of future bond returns". The respective authors in their article "Common risk factors in the cross-section of corporate bond returns" further reveal that:

> (…) [R]isk characteristics of corporate bonds downside risk, credit risk, and liquidity risk and find that these novel bond factors have economically and statistically significant risk premiums that cannot be explained by long-established stock and bond market factors.

[10] Dr. Sindhu K. P and Dr. S. Rajitha Kumar, "Influence of Risk Perception of Investors on Investment Decisions: An Empirical Analysis". Available on: http://jfbmnet.com/journals/jfbm/Vol_2_No_2_June_2014/2.pdf. Accessed May 10, 2019.

[11] Jennie Bai, Turan G.Bali and Quan Wen, "Common risk factors in the cross-section of corporate bond returns", (2019): pp. 619-642, available on: Web of Science database, accessed May 19, 2019, doi:10.1016/j.jfineco.2018.08.002.

It is concluded by the three authors that newly proposed risk factors outperform all other models considered in the literature in explaining the returns of the industry-and size/maturity-sorted portfolios of corporate bonds.[12]

Key burdens

Corporate bond issuances have some burdens too. Some of the burdens of the public offering of bonds include the following[13]:

Distraction of management from the operations of the company

One of the greatest frustrations expressed by executives of companies going through the offering process of securities is that they "just cannot seem to get anything else done." The bonds issuance and offering process typically takes three to six months and consists of many time-consuming tasks that cannot be delegated. Issuing agent (investment banker) must be selected. Due diligence process must be executed. Prospectus (offering document) drafting sessions, which can range from a few hours to multi-day marathons, must be prepared for and attended.

Restrictions on publicity and other marketing activities

The securities law regulating issuance and public offering of bonds restrict the manner in which bonds can be offered to the public, and any publicity that could be construed as hyping or conditioning the market for a company's bonds could cause the company to delay its offering or require the company and the issuing agent to take securities law liability with respect to any such publicity. Additionally, following the corporate bond issuance, all publicity must be monitored with an eye toward securities law requirements and potential liability. Public statements made by company officials regarding the company's business may result in securities fraud liability. For example, prior to public bond issuance, a CEO may have few concerns about making public statements regarding the future financial performance of the company, but as an issuer all such statements carry potential risk.

Compliance with competent authority's regulations and reporting requirements

Once a company lists its bonds on the stock exchange, it becomes subject to a host of competent authority's rules and regulations, including the competent authority's periodic reporting requirements. For example, issuers are required to file annual reports and to announce certain events. Preparation of these documents will consume a significant amount of time of company personnel, particularly the CFO and his/her staff.

Issuers of bonds are subject to rules and standards issued by the competent authority and the stock exchange (e.g., in Latvia – rules of the Nasdaq Riga), and these rules affect the manner in which companies govern themselves and make disclosures. A company's ability to comply with these new rules and regulations, as well as the periodic reporting requirements and the other burdens, will come at a cost – both in time and money. Accordingly, a company should plan on spending more to beef up in-house accounting and compliance staffs, more on non-employee directors' fees, more for directors' and officers' liability insurance and more for fees of counsel, auditors and other consultants.

[12] Jennie Bai, Turan G.Bali and Quan Wen, "Common risk factors in the cross-section of corporate bond returns", (2019): pp. 619-642, available on: Web of Science database, accessed May 19, 2019, doi:10.1016/j.jfineco.2018.08.002.

[13] Dr. Sindhu K. P and Dr. S. Rajitha Kumar, "Influence of Risk Perception of Investors on Investment Decisions: An Empirical Analysis". Available on: http://jfbmnet.com/journals/jfbm/Vol_2_No_2_June_2014/2.pdf. Accessed May 10, 2019.

1.2 Why investors buy corporate bonds

Investors generally buy corporate bonds because the bonds' risk-return profile fits well with the investors' investment objectives. Examples include[14]:

- Investors looking for yield above the risk-free rate, but unwilling to accept equity-like risk, may gravitate to corporate bonds. Although corporate bonds do pose credit risk, they offer more attractive yields than comparable-maturity government bonds or certificates of deposit and have lower historical price volatility than shares.
- As retail investors age, they tend to become less willing to take above-average or substantial investment risk and gradually reduce their equity exposure and increase their fixed-income exposure. Once retired, many investors seek to own a collection of assets that generates the highest possible steady income stream given their tolerance for risk.

Corporate bonds are also an important tool for risk management. Examples include:

- European banks hold investment grade corporate bonds on their balance sheets for a variety of reasons. One reason is to serve as inventory for market making operations or for asset-liability management purposes as a way to generate net interest margin. Another reason is to access the ECB's marginal lending facility–i.e. a standing facility of the Eurosystem in which counterparties may receive overnight credit from a national central bank at a pre-specified interest rate against eligible assets. Indeed, corporate bonds can be eligible collateral for ECB market operations, assisting banks in their funding operations.
- Insurance companies use fixed income securities, including corporate bonds, to "match" the expected profile of their liabilities (duration and predictability), which is dictated by the types of products and the nature of the guarantees they write. Insurers face the challenge of investing customer payments to ensure they will have sufficient funds available to satisfy claims and withdrawals in the future. As a result, insurance companies need predictable, long-term cash flows leading them to invest a sizeable portion of their investment portfolio in fixed income securities.
- Pension plans invest in corporate bonds for reasons similar to life insurers-their investments have to cover their long-term liabilities. Contributions paid into the pension fund are invested in the capital markets, and finally paid out in the form of pension benefits. Investing strategies that manage these types of long-term liabilities tend to have higher weights in assets with lower risk or volatility. As a result, pension funds predominantly invest in fixed income securities.

Natalja Tocelovska in her article "Waiting for the Capital Market Union: the Position of Latvian Corporate Bond Market"[15] reveals that:

> The increasing role of the capital market as the alternative to the traditional to Europe banking sector is strongly supported by the European Commission (EC). In 2015 the

[14] The European Commission. *Analysis of European Corporate Bond Markets: Analytical report supporting the main report from the Commission Expert Group on Corporate Bonds. November 2017.* Available on: http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=35768&no=1. Accessed May 19, 2019.

[15] Natalja Tocelovska, "Waiting for the Capital Market Union: the Position of Latvian Corporate Bond Market", (2017): pp. 110-119., available on: Web of Science database, accessed May 20, 2019, doi: 10.5755/j01.eis.0.11.18147.

> EC announced the Capital Market Union (CMU) initiative and respective action plan as the reaction to the challenges faced by both banking sector and small and medium enterprise (SME) segment in Europe. As integrated and more diverse capital markets will decrease the cost of funding for companies, the objective of the CMU is to make the financial system more resilient in all 28 Member States (…).

Accordingly, it may be concluded that in the result of the CMU action plan and its associated activities, investments in capital market should become more attractive and more and more European investors should be attracted to the corporate bond market by willing to explore investment opportunities therein.

Underwriting commitment and primary distribution

Most corporate bond issuances are made with the assistance of issuing agents (typically, investment banks) that act as firm commitment underwriters. The underwriting and distribution of the company's bonds to the investors lie at the heart of the corporate bond transaction. In a corporate bond issue, one or more investment banks will agree to "underwrite" the offering, an arrangement memorialized in the agreement on underwriting commitment (the "underwriting agreement").[16]

The underwriting agreement typically provides for the underwriters to purchase particular amount of bonds from the company and effect the distribution and resale of the bonds to the investors.

Pursuant to the terms and subject to certain conditions contained in the underwriting agreement, the underwriter is obliged to purchase the bonds within the offering in the particular amount (usually in the amount of not less than pre-described nominal value). Pursuant to the underwriting commitment the underwriter is usually guaranteed within the offering to receive a particular number of bonds. Usually the underwriter receives certain remuneration for fulfilment of the above-mentioned underwriting commitment. Under certain specified conditions the issuer or the underwriter may typically terminate the underwriting commitment unilaterally.

Primary distribution of bonds

Primary distribution is the original sale of a bond from the issuing company to investors (bondholders). Proceeds from a primary distribution are sent directly to the issuer. This process is also sometimes referred to as a "primary offering".[17]

In the bond prospectus usually the nominal value (face value) of each bond is specified along with the maximum subscription size of the issue and the way by which the bonds are offered (typically, by way of a private placement or public offering). Last but not least, the subscription period shall be also determined by the bond prospectus.

Usually investors shall have the rights to submit several purchase orders during the subscription period. The issuing agent normally registers all submitted purchase orders according to legal requirements and internal procedures of the issuing agent.

Typically, the settlement of the bonds is executed through the depositary (in Latvia - Nasdaq CSD) as DVP (delivery versus payment) transactions according to the applicable depositary rules. The custodians (banks or brokerage companies) execute payments for the bonds based on the results of the subscription provided by the issuing agent.

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[16] Charles Proctor, *The Law and Practice of International Banking* (Great Britain: Oxford University Press, 2010), p. 165.

[17] *Ibid*., p. 164.

1.3 Distinguishing between private and institutional investors

There are two categories of investors in the financial markets: retail investors and institutional investors. Retail investors are also referred to as the "private investors" and institutional investors are also referred to as the "qualified investors". The differences between the two dictates not only the size of the trades they make, but also the types of companies and financial instruments in which they invest their monies.[18]

Both retail investors and institutional investors invest in bonds, options, and futures contracts as well as in shares, but some markets, such as the swaps and forward markets, are primarily institutional investor arenas, largely because of the nature of the instruments and/or the manner in which transactions take place.

Defining a private investor[19]

The term "retail" or "private" investor is synonymous with "individual investor." The majority of retail investors buy and sell securities in round lots. In bond markets, a round lot has typically represented EUR 100 000 (of face value) worth of bonds. This is not to say an individual can't place an order to buy or sell even just a single bond of a company, but it often isn't cost effective to do so because of the commissions that must be paid.

In particular, a private or non-institutional investor is an individual person. Private investors include individuals, venture capital companies, and, sometimes family and friends. If you have a start-up company, you'll probably have to depend on private investors for money.

Defining an institutional investor[20]

The biggest difference between private and institutional investors is the fact that institutional investors are overseen and regulated by committees. You're likely dealing with a board of directors along with an investment committee within the board who oversees the advisor or investment team who is running the investment portfolio. Dynamics of this group may be very difficult to manage, especially when you have competing interests, personalities and a lot of ideas on the table. Communication, implementing the right investment plan and setting the right expectations is crucial in this setting. Whereas, private investors don't have to worry about decisions of the committee.

In accordance with the definition stipulated by the Directive No 2003/71/EC of 4 November 2003 (the "Prospectus Directive")[21],

> 'qualified investors' means persons or entities that are described in points (1) to (4) of Section I of Annex II to Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments[22], and persons or entities

[18] Charles Proctor, *The Law and Practice of International Banking* (Great Britain: Oxford University Press, 2010), p. 164.

[19] Sonny Allison, Chris Hall, David McShea, with special contributing author Katherine VanYe, and contributing authors from Perkins Coie LLP, *The Initial Public Offering Handbook: A Guide for Entrepreneurs, Executives, Directors and Private Investors* (New York: Merrill Corporation, 2008), pp. 62-63.

[20] *Investor guide*. Available on: http://www.investorguide.com/article/11202/what-is-the-difference-between-retail-investors-and-institutional-investors/. Accessed May 2, 2019.

[21] Directive 2003/71/EC of the European Parliament and of the council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, *OJ L* 345, 31.12.2003, p. 64. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32003L0071. Accessed May 4, 2019.

[22] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European

> who are, on request, treated as professional clients in accordance with Annex II to Directive 2004/39/EC, or recognized as eligible counterparties in accordance with Article 24 of Directive 2004/39/EC unless they have requested that they be treated as non-professional clients. Investment firms and credit institutions shall communicate their classification on request to the issuer without prejudice to the relevant legislation on data protection. Investment firms authorized to continue considering existing professional clients as such in accordance with Article 71(6) of Directive 2004/39/EC shall be authorized to treat those clients as qualified investors under this Directive;

However, following the introduction of Directive 2010/73/EU of 24 November 2010 (the "Amending Directive")[23], the definition of "qualified investors" in the Prospectus Directive was aligned to the definitions of "professional clients" and "eligible counterparties" in the Directive 2004/39/EC of 21 April 2004 (the "Markets in Financial Instruments Directive" or "MiFID").[24]

In other words, qualified or institutional investors are organizations whose primary purpose is to invest their own assets or those entrusted to them by others, the most common of which are large institutions, employee pension funds, mutual funds, insurance companies, mutual funds, banks and exchange-traded funds (ETFs) that buy and sell securities for their investment portfolios.

In contrast to retail investors, institutional investors engage in block trades, which is an order to buy or sell a bulk of securities at a time. As might be expected, a large trade by an institutional investor can significantly affect the price of the security being bought or sold.

1.4 General overview of a secured corporate bond

When raising funds in global capital markets, companies are willing to pay as lower interest rate on their debt as possible. One way of doing this is by putting up cash or assets as collateral to secure the debt (commonly ownership interests in the borrower or its subsidiaries, as well as property owned by the borrower or its subsidiaries). Some firms create innovative financial debt and equity products to attract specific investor tastes (i.e., non-monetary preferences unrelated to expected cash flows).[25]

A secured bond is a type of bond that is secured by the issuer's pledge of a specific asset, which is a form of collateral on the loan. In the event of a default, the bond issuer passes title of the asset onto the bondholders. Secured bonds can also be secured with a revenue stream that comes from the project that the bond issue was used to finance, or with pledge on the issuer's and its group companies' debtors. The pledge may be also established on the issuer's and its group companies' shares or real estate owned by the issuer or its associated companies.

Parliament and of the Council and repealing Council Directive 93/22/EEC, *OJ L* 145, 30.4.2004. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0039. Accessed 4 May, 2019.

[23] Directive 2010/73/EU of the European Parliament and of the council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, *OJ L* 327/1, 11.12.2010. Available on: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32010L0073. Accessed May 4, 2019.

[24] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, *OJ L* 145, 30.4.2004. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0039. Accessed 4 May, 2019.

[25] Emily Shafron, "Investor tastes: Implications for asset pricing in the public debt market", (2019): pp. 6-27, available on: Web of Science database, accessed May 20, 2019, doi:10.1016/j.jcorpfin.2018.08.006.

Secured bonds are seen as less risky than unsecured bonds because investors are somehow compensated for their investment in the event of default. If the issuer does not make timely interest and principal payments, bondholders have rights to the underlying collateral as repayment.[26]

Different jurisdictions have versatile laws that govern the manner of protecting the rights of creditors in collateral. This makes things very complicated in case there are many investors for the corporate bond issue transaction, where several institutional and private investors usually subscribe for the issued debt securities. In this case, a collateral agent can be an attractive addition to the issuer's debt financing transaction. As the rights of creditors in pledged collateral are usually determined by local laws, bond investors typically require that a collateral agent be appointed to enforce rights against the collateral in the event of the issuer's default under the corporate bond documentation.

Collateral (security)

In order to secure their bond offerings, companies use different types of assets as collateral. A commonly used security is a commercial pledge, mortgage and cash flow protection. According to Louise Gullifer and Stefan Vogenauer, collateral or legal security is rather a narrow concept:[27]

> It is limited to instances where a debtor grants some sort of proprietary interest in the debtor's property to the creditor in order to support performance of the underlying obligation. Such legal security can be used to support performance of any type of obligation, but its most common use is in debt transactions and, for simplicity, that terminology is used here. As soon as the debt is discharged, so too is the security interest. But if the debt is not paid, then the creditor can have recourse to the secured property in whatever manner is anticipated in the security agreement. Typically, the security allows the creditor to sell the secured asset, and apply the proceeds of sale to discharge the unperformed obligation. The security interest is thus the creditor's 'hostage' against the debtor's failure to perform the secured obligation.

Further, Gullifer and Vogenauer points out that

> All consensual security interests must be created by properly authorized parties; secure identified obligations; attach to specific assets (so as to render the security binding between debtor and creditor); and be perfected as required by law, typically by possession or registration (so as to render the security binding between the insolvent debtor and third parties in favor of the creditor).[28]

Interesting conclusions as regards to defining security can be found in case law, e.g., "[t]here is no security until the obligation exists".[29] Moreover, case law provides also more explicit interpretation:

> Security is created where a person ("the creditor") to who an obligation is owed by another (the "debtor") by statute or contract, in addition to the personal promise of the debtor to discharge the obligation, obtains rights exercisable against some property in

[26] Dr. Sindhu K. P and Dr. S. Rajitha Kumar, "Influence of Risk Perception of Investors on Investment Decisions: An Empirical Analysis", available on: http://jfbmnet.com/journals/jfbm/Vol_2_No_2_June_2014/2.pdf. Accessed May 10, 2019.

[27] Louise Gullifer and Stefan Vogenauer, *English and European Perspectives of Contract and Commercial Law, Essays in Honour of Hugh Beale* (Oxford and Portland, Oregon: Hart Publishing, 2014), p. 418.

[28] *Ibid.*, p. 419.

[29] *See Rogers v Challis,* 1859, 27 Beav 175; 54 ER 68

which the debtor has an interest in order to enforce the discharge of the debtor's obligation to the creditor.[30]

The role of a collateral agent

Collateral agent, also known as a security agent or a trustee is an independent third party that holds the collateral on behalf (and in favour) of the investors under a bond issue documentation as security for performance of the issuer's obligations towards bondholders and performs other assignments stipulated in the bond prospectus and the collateral agent agreement.[31]

The issuer (or the respective collateral provider) grants a security interest in the collateral to the collateral agent on behalf of the investors, and the collateral agent as secured party takes all necessary administrative and enforcement actions with respect to the collateral on behalf of the investors.[32]

Prior to the default, the collateral agent's role is rather of a technical nature. It involves accepting the pledge of the applicable collateral and enforcing rights against that collateral in the event of a default and when directed to do so by the bondholders. Depending on the type of pledged assets, the collateral agent may be required to take custody of the collateral. However, this is most common where there are many bondholders and thus the whole structure of the transaction can only be effective if the collateral agent takes its special role in holding the collateral.

If a default occurs under the secured corporate bond issuance, the collateral agent may be called upon to enforce the rights in the collateral. The agent will do so only at the direction of the bondholders, and should be indemnified for the costs of enforcement, including legal fees. Any proceeds (commonly net of the collateral agent's expense) will be remitted to the bondholders in respect of their investment. Sometimes, though, enforcement of collateral may be difficult and may result in protracted litigation. Additionally, the collateral agent may not desire to foreclose upon certain types of collateral for reputational reasons.

There should be minimal risk for an entity serving as a collateral agent if there is appropriate legal and regulatory framework in place determining collateral agent's rights and obligations in secured corporate bond transactions and if the bond issue documentation is drafted correctly.

Applicable laws and bond issue documentation should clearly provide the collateral agent's duties and responsibilities, so that the collateral agent acts in line with such laws and only at the direction of the bondholders. The applicable law and bond issue documentation should also provide an indemnity of the collateral agent for its actions (typically subject to the collateral agent's gross negligence or wilful misconduct, and should be clear that all costs of enforcement are covered by the bondholders).

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[30] *See Bristol Airport w Powdrill,* 1990, Ch 744, 760 (Browne-Wilkinson V-C) Date: 21 December 1989. Case available on: https://www.swarb.co.uk/c/ca/1989bristol_powdrill.html. Accessed May 19, 2019.

[31] Cornelia Gerster, Germaine Klein, Henning Schoppmann, David Schwander and Christoph Wengler, *European Banking and Financial Services Law* (Hague: Kluwer Law International, 2004).

[32] Fabrizio Barca and Marco Becht, *The Control of Corporate Europe* (New York: Oxford University Press, 2001).

2. ANALYTICAL REVIEW OF THE CURRENT EUROPEAN AND LATVIAN LEGISLATION

In every bond issuance transaction, the appropriate documentation in the form of bond prospectus is developed and presented by the issuer by providing the investors (bondholders) with the terms and conditions of investment. However, the most burdensome work should be done by the issuer and its advisers only when preparing the bond prospectus for the first issuance since for the next issuances similar documentation and information will be needed.

The increasing regulatory burden established by the EC is requiring additional resources of the issuer and thus requiring to engage several advisers for the bond issue – tax consultants, lawyers, issuing agents etc.

The structure and conditions of the corporate bond issue is prescribed by the bond prospectus. Corporate bonds may be publicly listed or issued within a private placement and not listed publicly. However, the bond issued by a private placement may be listed on the stock exchanges also later). General conditions of a corporate bond may vary for different issuances. Terms of every corporate bond issue can be adjusted for particular offering as needed and are disclosed in detail in the bond prospectus.

Directive 2003/71/EC (the "Prospectus Directive") and the Commission Regulation on Prospectuses (EC) No 809/2004 (the "Prospectus Regulation") became effective on 1 July 2005. The Prospectus Directive and accompanying Regulation establish a harmonized format for prospectuses in Europe and allow companies to use the same prospectus prepared for admitting securities to trading on their home market to admit securities to any number of further European markets without having to re-apply for approval from the local regulator. In so doing, the intention is to help companies avoid the inherent delays and cost that any re-application process would involve. The respective legislation also sought to ensure investors had access to more consistent and standardized information that would enable them to compare more effectively the various securities offers available from a wide number of European companies.[33]

2.1 The current prospectus regime

The current prospectus regime in Europe is made up of the following main pieces of the European legislation:

a) Directive 2003/71/EC[34], which was adopted in November 2003. It is a "framework" Level 1 Directive which has been supplemented by the Directive 2010/73/EC (see Level 1 legislation in b. below) and technical implementing measures (see the Level 2 legislation below).

[33] The European Securities and Markets Authority. *Questions and Answers: Prospectuses, 26th updated version, December 2016*. Published on 20 December 2016. Available on: https://www.esma.europa.eu/sites/default/files/library/2016-1674_qa_on_prospectus_related_topics.pdf. Accessed May 4, 2019.

[34] Directive 2003/71/EC of the European Parliament and of the council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, *OJ L* 345, 31.12.2003, p.64. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32003L0071. Accessed May 4, 2019.

b) Directive 2010/73/EU[35], which was adopted in November 2010. It is a Directive amending Directive 2003/71/EC. The deadline for implementation was 1 July 2012.

c) Directive 2014/65/EU[36], which was adopted in 15 May 2014. It is a Directive amending Directive 2002/92/EC and Directive 2011/61/EU.

d) Implementing Regulation 809/2004[37] (Level 2 legislation).

e) Implementing Regulation 211/2007[38] (Level 2 legislation). A Regulation amending Regulation 809/2004.

f) Implementing Commission Delegated Regulation (EU) No 486/2012[39] (Level 2 legislation). A Regulation amending Regulation 809/2004. Entered into force on 1 July 2012.

g) Implementing Commission Delegated Regulation (EU) No 862/2012[40] (Level 2 legislation). A Regulation amending Regulation No 809/2004. Entered into force on 22 September 2012.

h) Implementing Commission Delegated Regulation (EU) No 759/2013[41] (Level 2 legislation). A Regulation amending Regulation No 809/2004. Entered into force on 28 August 2013.

i) Commission Delegated Regulation (EU) No 382/2014[42] (Level 2 legislation). A regulation supplementing Directive 2003/71/EC. Entered into force on 5 May 2014.

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[35] Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information, *OJ L* 327/1, 11.12.2010. Available on: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32010L0073. Accessed May 4, 2019.

[36] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, *OV L* 173, 12.6.2014. Available on: https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32014L0065. Accessed May 3, 2019.

[37] Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, 30.4.2004, *OJ L* 149/1, as corrected by *OJ L* 215, 16.6.2004, p. 3. Available on: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:32004R0809. Accessed May 3, 2019.

[38] Commission Regulation (EC) No 211/2007 of 27 February 2007 amending Regulation (EC) No 809/2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards financial information in prospectuses where the issuer has a complex financial history or has made a significant financial commitment, *OJ L* 61/24, 28.2.2007. Available on: https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32007R0211. Accessed May 2, 2019.

[39] Commission Delegated Regulation (EU) No 486/2012 of 30 March 2012 amending Regulation (EC) No 809/2004 as regards the format and the content of the prospectus, the base prospectus, the summary and the final terms and as regards the disclosure requirements, *OJ L* 150/1, 9.6.2012. Available on: https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32012R0486. Accessed May 1, 2019.

[40] Commission Delegated Regulation (EU) No 862/2012 of 4 June 2012 amending Regulation (EC) No 809/2004 as regards information on the consent to use of the prospectus, information on underlying indexes and the requirement for a report prepared by independent accountants or auditors, *OJ L* 265/4, 22.09.2012. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32012R0862. Accessed May 1, 2019.

[41] Commission Delegated Regulation (EU) No 759/2013 of 30 April 2013 amending Regulation (EC) No 809/2004 as regards the disclosure requirements for convertible and exchangeable debt securities, *OJ L* 213/1, 8.8.2013. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1558097289922&uri=CELEX:32013R0759. Accessed May 5, 2019.

[42] Commission Delegated Regulation (EU) No 382/2014 of 7 March 2014 supplementing Directive 2003/71/EC of the European Parliament and of the Council with regard to regulatory technical standards for publication of supplements to the prospectus, *OJ L* 111/36, 15.4.2014. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1558097665844&uri=CELEX:32014R0382. Accessed May 5, 2019.

One of the main questions regarding the prospectus regime has always been the following: *How can information which is already published be used in a prospectus?* The EC has delivered a pure answer:[43]

> "When preparing a prospectus, issuers can refer to certain information which has been previously or simultaneously published electronically and filed with a supervisor. This practice, known as "incorporation by reference", helps avoid unnecessary duplication of information in prospectuses. Compared with the current prospectus regime, the proposal significantly widens the range of information that an issuer may incorporate by reference in a prospectus, and places issuers on regulated markets and those on multilateral trading facilities on equal footing in terms of their ability to incorporate information by reference. Under the new proposal, information that may be incorporated by reference in a prospectus can come from the following sources:
>
> - prospectuses, supplements and final terms,
> - documents prepared in the context of takeovers, mergers and divisions;
> - regulated information which needs to be disclosed under the Transparency Directive and the Market Abuse Regulation;
> - annual and interim financial information, audit reports and financial statements, management reports and corporate governance statements, for those issuers outside the scope of the Transparency directive, or exempted from some of its disclosure requirements and
> - memoranda and articles of association.
>
> To ensure adequate investor protection, such information must be the most recent available to the issuer."

One of the principal objectives of the existing prospectus regime is investor protection. This entails the need to ensure that complete and accurate information is provided concerning the issuer and the relevant financial instruments in order to facilitate access by investors to the necessary information to allow them to take the appropriate investment decisions.

To achieve this objective, the Prospectus Directive and its implementing Regulation take into consideration, among other elements, the nature of the investors. For instance, the Prospectus Directive aims to ensure that the information provided is sufficient and adequate to cover the needs of retail investors.

The prospectus regime appears to have made it easier to offer securities and admit them to trading, either in one country or in several countries at the same time. After some initial difficulties, both regulators and market participants are gaining experience of the prospectus regime, and most of the early problems have been overcome, progressively generating better quality prospectuses and reducing the average approval time. Similarly, the cost of compliance decreased once participants had become used to the regime.

There may be areas in which the legislative framework might be improved. Nevertheless, it should be borne in mind that any change in regulations entails a cost. This aspect should be taken duly into account when proposing legislative amendments. Legislative amendments will be put forward only if they are necessary and sufficiently evidence-based as well as subject to a thorough impact assessment.

Concerns have been expressed that there are divergences in the national implementation of the definition. The breadth and generality of the definition render it

[43] The European Commission. *Revamping the prospectus, the gateway to European capital markets*. Available on: http://europa.eu/rapid/press-release_MEMO-15-6198_en.htm#_ftn1. Accessed May 5, 2019.

susceptible to varying interpretation in accordance with the specificities of national law. For example, it appears that some Member States have transposed the definition to include a requirement that a "public offer" must be a contractual offer under national law, while others do not do so.

Another concern expressed is that the current regime allows long and complex prospectuses because there are no limits on the overall length of the documents (other than the summary), and there are potentially very severe penalties if information is omitted. Since currently there are no limits on the overall length of the prospectus, concern that a legally accepted prospectus may serve as one of the main regulatory hurdles for execution of an IPO for a typical European company even increase. Especially SMEs based in small European countries (where capital market is rather inactive) may be even more concerned.

In this context, market participants argue that changes to the current rules on the overall length of the documents are needed in order to simplify the prospectus and ensure a more harmonized approach among different categories of products.

2.2 Anticipated changes to the prospectus regime

Prospectus rules are set to change significantly. On 5 April 2017, the European Parliament adopted new Prospectus Regulation (the "New Prospectus Regulation")[44]. The New Prospectus Regulation has entered into force on 20 July 2017. The New Prospectus Regulation will replace the previous Directive 2003/71/EC (the "Prospectus Directive") and its implementing legislation, including, but not limited to, the Regulation No 809/2004 (the "**P**rospectus Regulation"). Unlike directives, regulations do not require further implementation measures by EU Member States to be effective. The New Prospectus Regulation will be directly applicable in all Member States from 21 July 2019.

Among other things, the New Prospectus Regulation seeks to facilitate increased access to funding by small and medium enterprises ("SMEs") and to introduce a simplified and more flexible regulatory framework for secondary issuances and for frequent issuers. Significantly, the New Prospectus Regulation removes the lighter disclosure standards for a prospectus published solely for the offering or admission to trading on a regulated market of "wholesale" debt securities.

In another development, the European Commission has adopted a new draft Delegated Regulation containing technical standards for the approval and publication of prospectuses and dissemination of advertisements ("Delegated Regulation").

The New Prospectus Regulation has its roots in the CMU, which is a major EC initiative designed to tackle fragmentation and market inefficiencies. One of the CMU's key objectives is to improve access to funding for business, including in particular SMEs, and to diversify funding sources. When the EC launched its CMU Action plan in February 2015, it identified a review of the existing prospectus regime as a priority for early action and published a related consultation paper. Subsequently, at the end of September 2015, the EC indicated in its Action Plan on Building a Capital Markets Union that it would modernize the

[44] The European Parliament. *Text of the adopted Regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading*. Available on: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2F%2FEP%2F%2FNONSGML%20TA%20P8-TA-2017-0110%200%20DOC%20PDF%20V0%2F%2FEN. Accessed May 3, 2019.

Prospectus Directive to make it less costly for businesses to raise funds publicly and review regulatory barriers to small firms listing on equity and debt markets.

The New Prospectus Regulation is intended to repeal and replace the Prospectus Directive along with its corresponding implementing measures. It has two main objectives, namely to alleviate the administrative burden for companies which draw up a prospectus, and to make the prospectus a more valuable information tool for potential investors. The New Prospectus Regulation also further aligns the prospectus rules with other EU disclosure rules, including the Transparency Directive 2004/109 and Regulation 1286/2014 on key information documents for packaged retail and insurance-based investment products ("PRIIPs").

The changes introduced by the New Prospectus Regulation will affect both when a prospectus is required and the information to be included in it. The New Prospectus Regulation also provides for specific disclosure requirements for SMEs and secondary issuances, as well as an optional fast-track approval mechanism for frequent issuers.

2.3 Applicable Latvian law governing a secured corporate bond issue

The Financial Instruments Market Law[45] is the main legal act governing the procedure of public offering and trading of securities in Latvia. The Financial Instruments Market Law, *inter alia*, regulates the organization and business of regulated markets in Latvia, the operation of the central depositary, provision of core and non-core investment services, market abuse regulations, the licensing requirements of investment brokerage companies and the provision of investment services by investment companies from other EU Member States in Latvia, as well as by Latvian investment companies in other EU Member States.

Distribution of bonds issued by way of public offering is governed by the Financial Instruments Market Law. According to this law, the distribution by way of public offering may trigger prospectus requirement. Public offer means a communication to persons in any form and by any means offering securities and presenting sufficient information on the terms of the offer and the securities to be offered so as to enable an investor to decide to purchase or subscribe to these securities. For the public offer of bonds, the issuer must prepare and publish a bond prospectus (an offering document which describes the conditions of the offering in detail), unless the particular offer falls under exemption which discharge the issuer from the previously said obligations.

Hence, the bonds are being offered to the public in Latvia in accordance with the requirements of the Financial Instrument Market Law and Commission Regulation (EC) No 809/2004 of 29 April 2004, as amended, implementing the Directive 2003/71/EC (the "Prospectus Regulation").

The Prospectus Regulation determining the prospectus contents and information to be included in the prospectus is rather of complex nature. At the European level, the rules on preparing/publishing of the prospectus are not only time by time improved by introducing various amendments (the New Prospectus Regulation adopted on 5 April 2017 as the latter), but are also in contact with the other European Directives and Regulations. One of the most important connecting Regulation is, for instance, recently introduced Regulation (EU) No

[45] The Law on the Financial Instruments Market of Latvia (10 November 2003). Available on: https://likumi.lv/ta/en/en/id/81995-financial-instrument-market-law. Accessed May 2, 2019.

596/2014 concerning certain aspects on financial market abuse (the "Market Abuse Regulation") as well as other.

The respective complexity mentioned above is not only the case at the European level, but also at the national level. At the national level, rather complicated national laws govern the procedures for making a public offer of financial instruments and public circulation of financial instruments. For instance, in Latvia transactions in capital market are governed by the Latvian Financial Instruments Market Law (in Latvian: *Finanšu instrumentu tirgus likums*), the Commercial Law (in Latvian: *Komerclikums*), the regulations of Nasdaq Riga and other. Regulations and recommendations issued by the national competent authority, the FCMC (in Latvian: *Finanšu un kapitāla tirgus komisija*) apply in Latvia as well. As regards to the laws regulating collateral arrangements, the Civil Law (in Latvian: *Civillikums*) and Law on Commercial Pledge (in Latvian: *Komercķīlas likums*) applies.

The FCMC in its capacity is the competent authority in Latvia for the purposes of Directive No 2003/71/EC (the "Prospectus Directive"), as amended, to the extent as implemented in each relevant member state of the European Economic Area (the "EEA"), in accordance with the requirements of the Financial Instruments Market Law of Latvia, as amended (the "Financial Instruments Market Law") and Regulation (EC) No 809/2004, as amended (the "Prospectus Regulation").

2.3.1 Financial Instruments Market Law

Provisions for issuance, registration and trading with securities are included in the Financial Instruments Market Law, which also determines the obligations of the parties involved, together with other legal acts, including the Nasdaq Riga regulations. The Financial Instruments Market Law implements existing EU legal norms in areas of capital and financial instruments and regulates transactions in capital markets as well as supervision of market participants and transactions performed, rules of prudent behaviour and investor protection. Transaction settlement, custody and management of securities are ensured through the central depositary (Nasdaq CSD) or the Bank of Latvia. The FCMC performs supervision of trade in securities.

The Financial Instruments Market Law regulates *the procedures for making a public offer of financial instruments*, public circulation of financial instruments, provision of investment services and non-core investment services and licensing and supervision of financial instrument market participants, determines the rights and duties of financial instrument market participants, as well as the liability for failure to comply with the requirements laid down in the Financial Instruments Market Law.

The general principle for the public offering of corporate bonds is the necessity to prepare and publish a bond prospectus (the issue terms).[46] The bond prospectus includes information about the issuer and the transferrable securities that would be publicly offered, and the information necessary to enable the investor to duly assess the issuer's financial position, balance sheet, results of operations and forecast of development, transferable securities and the rights attached thereto, as well as to assess possible future financial situation of the issuer and any guarantor.[47]

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[46] Section 15 and 20(1) of the Law on the Financial Instruments Market of Latvia (10 November 2003). Available on: https://likumi.lv/ta/en/en/id/81995-financial-instrument-market-law. Accessed May 2, 2019.
[47] *Ibid.,* Section 17.

The bond prospectus must be registered with the FCMC, after which the company may proceed with the public offering of bonds (unless the particular offer falls under exemption which discharge the issuer from the previously said obligations).[48]

2.3.1 Commercial Law

The Commercial Code in Latvia was established by the Latvian Civil Code in 1937. Due to the fact it was outdated, new amendments have been brought in order to bring it up to date and in accordance to the EU laws. Thus, the Commercial Law of Latvia was adopted on 13 April 2000, being the law regulating commercial activities in Latvia. This law, inter alia, describes activities of limited liability companies and joint stock companies as being the most popular forms of doing business in Latvia. Hence, also the corporate bonds in Latvia are issued either by limited liability companies and joint stock companies.

The Commercial Law regulates procedures for issuance of securities, such as dematerialized bearer shares and convertible bonds. However, this law is silent as regards to the corporate bond issuance procedures. Moreover, Commercial Law also does not contain the structures of a trustee, security agent or a collateral agent.

2.3.2 Civil Law

Latvian Civil Law along with the Commercial Pledge Law is one of two main legal acts in Latvia regulating commercial pledge establishment procedure in Latvia. The Civil Law of Latvia prescribes the following three types of pledges: (i) usufructuary pledge[49] (if movable or immovable property bearing fruits is pledged so that the creditor possesses and derives fruits from it); (ii) possessory pledge (in regard to movable property if possession of it is transferred to the creditor); and (iii) mortgage (pledging of an immovable property without transfer of possession)[50].

Unfortunately, the Civil Law does not contain the concept of a trustee, security agent or a collateral agent.

2.3.3 Commercial Pledge Law

Both security over floating charges and the overall assets of an enterprise are accepted in Latvia under the Commercial Pledge Law. The commercial pledge provides an opportunity to pledge the movable property (tangible or intangible property) or the aggregation of property of an enterprise – shares, claim rights against other entity, vehicles, trademarks, equipment and other registered property – without transferring it into the possession of the pledgee, but registering a lien in the Commercial Pledge Register.

Respectively, a commercial pledge is a bailment or delivery of personal property to a creditor as security for a debt or for the performance of obligations. As previously mentioned, the commercial pledge may be separate item of property or it may be complete assets of an enterprise (i.e., all property owned by the pledgor as the aggregation of property at the moment of pledging as well as its future components). Companies use commercial pledge to

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[48] *Ibid.,* Section 1.
[49] The Civil Law of Latvia (28 January 1937). *If movable or immovable property bearing fruit is pledged so that the creditor possesses and derives fruits from it, then such a pledge is called a usufructuary pledge.* Available on: https://likumi.lv/ta/en/en/id/225418-the-civil-law. Accessed May 11, 2019.
[50] The Civil Law of Latvia (28 January 1937). Available on: https://likumi.lv/ta/en/en/id/225418-the-civil-law. Accessed May 11, 2019.

receive loans or issue bonds for development and growth of their business. A commercial pledge may be used to secure any claim, either existing, or contingent on the basis of an existing liability. It may secure not only the principal claim but also auxiliary claims.[51]

Detailed provisions for establishment, registration and enforcement of the commercial pledge in Latvia are included in the Law on Commercial Pledge, which was adopted in 1998 and also determines the rights and obligations of the parties involved. The Law on Commercial Pledge modified the principles of the pledge rights under the guidelines established by the Civil Law of Latvia[52].

Object of the commercial pledge

Pursuant to the Law on Commercial Pledge, a commercial pledge is the right of pledge registered in the Commercial Pledge Register of Latvia under the procedure laid down in this law.[53] The object of a commercial pledge may be:

- a tangible or an intangible asset (including the right to claim) owned by a merchant or other legal person;
- assets subject to registration, including the company as an aggregation of assets, shares, shares and bonds may constitute the subject of a commercial pledge, regardless of the owner of these assets.[54]

The object of a commercial pledge may not be a vessel, financial instruments entered in a securities account, credit claims within the meaning of the Financial Collateral Law of Latvia, financial resources, and a claim arising out of a cheque or a bill of exchange.[55] If the overall assets of an enterprise or an aggregate of things have been pledged, the real estate and vessels shall be considered to be excluded from the pledged property.

A commercial pledge is established on the basis of a contract or a court judgement. A pledge right shall be registered with the Commercial Pledge Register of Latvia in accordance with the procedure prescribed by the Law on Commercial Law.

Creation of a commercial pledge

A commercial pledge shall be created on the basis of an agreement or court judgment and registered with the Commercial Pledge Register.

If the parties have entered into an agreement on the establishment of a commercial pledge but the commercial pledge has not been registered with the Commercial Pledge Register, the pledgee shall not be able to exercise its rights and the commercial pledge shall not be effective against third parties, however, the agreement on establishment of the commercial pledge shall not become ineffective.

The pledgee shall have the right to file a personal claim against the pledgor. The basis of the claim shall be the right to register the pledge and neither of the parties shall have the right to default the commitment without the consent of the other party on the grounds of the

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[51] Charles Proctor, *The Law and Practice of International Banking* (Great Britain: Oxford University Press, 2010), p. 511.
[52] *See* section 2.3.2 ("Civil Law") of this thesis.
[53] Section 2 of the Law on Commercial Pledge of Latvia (21 October 1998). Available on: https://likumi.lv/doc.php?id=50685/. Accessed May 9, 2019.
[54] *Ibid.,* Section 3.
[55] *Ibid.,* Section 4.

failure to have the commercial pledge duly registered. The priority right for such a commercial pledge shall be determined as of the moment of its registration.[56]

Registration of commercial pledge in Latvia

The application for registering commercial pledge shall be submitted with the Commercial Pledge Register of the Companies Register of Latvia. Prior to or at the time of submission of the application, payment of State duty (fee) for new commercial pledge registration shall be carried out. The following list of documents should be submitted to the Commercial Pledge Register along with the application for registration of the pledge: (i) the pledge agreement; (ii) the document establishing the secured claim; and (iii) a document on the payment of the filing fee.

After submission, the State notary is examining submitted documents and adopt decision on a commercial pledge registration, the suspension of registration or refusal to register the commercial pledge. If all the documents are in good order, the commercial pledge will be registered in the Commercial Pledge Register within 5 business days (excluding the day of the submission of the application and the accompanying documents).

About each of the commercial pledges registered in the Commercial Pledge Register, one can find out the following information:

- description of the pledged property;
- maximum amount of the pledgee's claims secured by the object of pledge;
- parties of the commercial pledge registration act - pledgor, pledgee, debtor and their respective data of identification;
- date of registration and removal (release) of commercial pledge (in case, the commercial pledge has been released);
- comments about the registration.

According to the provisions of regulatory enactments in Latvia, the pledgee may exercise its rights and commercial pledge shall be effective against third parties only if such pledge is registered with the Commercial Pledge Register.

Unfortunately, the Commercial Pledge Law currently does not contain the concept of a trustee, security agent or a collateral agent. The current definition in the Commercial Pledge Law – *a pledgee is a party that accepts a commercial pledge as collateral for **its** claim* – may lead to ambiguities. In the event of secured bonds, secured claims are granted to the bondholders and not to the collateral agent (assignee). Therefore, based on the example of Anglo-Saxon law, a "parallel debt" concept is established which is not known within the Latvian law system and has not been interpreted also in court practice.

In corporate bond issues, collateral is provided for the benefit of a wide range of investors which may change, therefore regulation of the Commercial Pledge Law should allow a specific possibility of noting in the bond prospectus, issue terms or in some other type of bond issue documentation (as the case may be) that a right of claim or commercial pledge right to bond securities in favour of creditors (bondholders) would be registered in favour of a third-party trustee of the issuer – a collateral agent who may not be a creditor themselves.

[56] The Law on Commercial Pledge of Latvia (21 October 1998), *supra* note 41, section 9.

2.3.4 Financial Collateral Law

The Financial Collateral Law of Latvia, deriving from the EU Directive 2002/47/EC (Financial Collateral Directive)[57] is particularly important for the purposes of the secured corporate bond transactions. It has established an effective legal framework for financial collateral arrangements, which often form part of the corporate bond transactions. It sets out a number of rules that effectively protect financial collateral arrangements from winding-up and insolvency proceedings of the (potential issuer).

However, it is important to note certain restrictions in terms of eligible parties that may benefit from the financial collateral regulation. In accordance with the Financial Collateral Directive[58], this law requires that at least one of the parties (i.e., either the pledgor or the pledgee) to the financial collateral arrangement must be:

- Latvian State and some of its derivative entities;
- Latvian Central Bank, central banks of other Member States, ECB, Bank of International Settlements, International Monetary Fund, European Investment Bank;
- A number of specific multilateral development banks;
- The following financial institutions supervised by competent financial and capital market supervisory authorities:
  - Credit institutions;
  - Investment brokerage firms;
  - Insurance companies;
  - Investment funds or their equivalents;
  - Investment management firms;
  - Other financial institutions;
- Central securities depositary, central counterparty or settlement agent.[59]

Financial institutions widely use floating charges or security overall assets as financial collateral of the pledgor's account. However, the Financial Collateral Law does not clearly state whether the account can be charged with floating charge instead of fixed amount. Besides, such floating charges in respect of financial collateral are not verified by the Latvian

[57] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, *OJ L* 168, 27.6.2002, p. 43. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32002L0047. Accessed May 19, 2019.

[58] The Financial Collateral Directive requires that at least one of the parties to the financial collateral arrangement must be either a public authority, a central bank or an international financial organisation, a financial institution subject to prudential supervision, a central counterparty, a settlement agent or clearing house, or a non-natural person acting in a trust or representative for another eligible party. Member States are allowed under Article 1(3) of this Directive to require that this must apply to both parties.

[59] Article 3 of the Financial Collateral Law of Latvia (21 April 2005). Available on: https://likumi.lv/ta/en/en/id/107799-financial-collateral-law. Accessed May 4, 2019.

courts. In case of financial collateral, registration terms depend on pricing of the particular bank; however, in general, the written pledge agreement is needed.

In cases when the pledge is registered under the Financial Collateral Law, the pledgee is entitled to freely dispose of the financial pledge observing the provisions and conditions of the financial pledge arrangement, without performance of any additional procedures.

However, since the financial collateral regulation may be utilised only when one of the parties to the financial collateral arrangement is one of the financial institutions mentioned above, the respective type of collateral arrangement obviously may be provided in a limited number of cases as regards to the corporate bond issues (namely, when the issuer of a corporate bond is a financial institution).

2.3.5 Insolvency Law

The Insolvency Law, being the primary law governing insolvency in Latvia, applies in most cases to legal entities as well as private individuals.[60] In respect of the state, local government or other legal entities governed by public law, the insolvency and legal protection proceedings specified in the Insolvency Law are not applied.

Importantly, insolvency proceedings of credit institutions (i.e. banks to a large extent) are regulated by Credit Institutions Law. However, provisions of the Insolvency Law are applicable to insolvency proceedings of financial and capital market participants supervised by the FCMC (and thus also the issuers of public secured corporate bond) insofar as it is not stated otherwise by the special laws governing their activities.

One of the key principles established under this law is what the law refers to as the 'principle of creditor equality', i.e. creditors are given equal opportunities to participate in the proceedings and get their claims satisfied in accordance with the obligations they have established with the debtor prior to the commencement of the proceedings.[61] Thus, the principal purpose of insolvency proceedings is to satisfy the claims of creditors as much as possible, obtaining maximum income from the disposal of the debtor's property. Sale of the assets mostly takes place in open auctions organized by the administrator.

The Insolvency Law authorizes the administrator to choose termination or execution of any agreement following an event of default. If the agreement entered into by the debtor has not been executed or has been partially executed on the day of the declaration of the insolvency proceedings of a legal person, the administrator is entitled to request from the other party the execution of the agreement or to unilaterally terminate the respective agreement. The administrator has the right to execute the agreement if such action does not reduce the debtor's assets. If the administrator unilaterally terminates the agreement, the other party has the right to submit his or her creditor's claim.[62]

In accordance with the principles of EU insolvency law, a juridical act unfairly detrimental to the creditors performed by the debtor within a certain period of time before the

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[60] Section 2 of the Insolvency Law of Latvia (26 July 2010). Available on: https://likumi.lv/ta/en/en/id/214590-insolvency-law. Accessed May 2, 2019.
[61] *Ibid.*, section 6.
[62] *Ibid.*, section 101

opening of the proceeding, is subject to reversal. The administrator can recover or seek annulment of any benefit obtained from the debtor.[63]

The respective principle is well established in the Insolvency Law, hence the administrator has the duty to evaluate the debtor's transactions and bring an action to court regarding the recognition of the respective transaction as invalid regardless of the type of transaction, if it has been concluded:

1) following the day of the declaration of the insolvency proceedings of a legal person or four months prior to the day of the declaration of the insolvency proceedings of a legal person and thereby losses have been incurred to the debtor regardless of whether the person with whom or for whose benefit the respective transaction has been concluded, knew or did not know of the losses caused to the creditors;
2) within three years prior to the day of the declaration of the insolvency proceedings of a legal person and thereby losses have been incurred by the debtor, moreover the person with whom or for whose benefit the transaction has been concluded, knew or should have known of the causing of such losses.[64]

Moreover, the administrator may, after declaration of the insolvency proceedings of a legal entity, refuse any claim or enter into any settlement in the name of the debtor with respect to claims of the debtor against third parties.[65]

The Insolvency Law also stipulates consequences of declaration of insolvency affecting enforcement of collateral. Firstly, two months from the declaration of insolvency, a secured creditor is prohibited from requesting the sale of the pledged property of the debtor.[66] Secondly, a collateral agreement is recognized as invalid if the pledge rights have been established after declaration of the insolvency proceedings. In this case, the administrator has a duty to bring an action to court regarding invalidation of the respective pledge agreement.[67]

Finally, as to the procedure of inspection and recognition of creditors' claims stipulated by the Insolvency Law, it should be noted that the administrator enjoys much flexibility. Creditors' claims must be submitted to the administrator within one month from the day declaration of insolvency, following which the administrator inspects their validity and conformity with the requirements of laws and regulations.[68] After the inspection, the administrator must make a justified decision on recognition, non-recognition or partial recognition of the claim. The administrator may not recognize a secured creditor's claim against a third person that is secured by a commercial pledge, or mortgage on the property owned by the debtor if there are reasonable doubts that the condition would materialize.[69]

In terms of a collateral agent arrangements in secured debt transactions, specific provisions are currently not available under the Insolvency Law.

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[63] International Insolvency Institute. *Principles of European Insolvency Law*. Available on: https://www.iiiglobal.org/sites/default/files/21-_PEILABIjournal_appended.pdf. Accessed April 26, 2019.
[64] Section 96 of the Insolvency Law of Latvia (26 July 2010). Available on: https://likumi.lv/ta/en/en/id/214590-insolvency-law. Accessed May 2, 2019.
[65] *Ibid.,* section 67.
[66] *Ibid.,* section 63.
[67] *Ibid.,* section 98.
[68] *Ibid.,* section 73 and 74.
[69] *Ibid.,* section 75.

2.4 Current regulation in Latvia: collateralization and structures of a collateral agent

Pursuant to the findings in the research above, the Author concludes that in Latvia, assets can be secured, charged and encumbered. In general, there are no exemptions for such activities. The Civil Law of Latvia prescribes the following three types of pledges: (i) usufructuary pledge[70] (if movable or immovable property bearing fruits is pledged so that the creditor possesses and derives fruits from it); (ii) possessory pledge (in regard to movable property if possession of it is transferred to the creditor); and (iii) mortgage (pledging of an immovable property without transfer of possession)[71].

Collateral arrangements shall be valid and binding on third parties in cases when these arrangements are entered and registered in relevant pledge registers. In Latvia are following types of pledge registers which establish a secured claim and are valid in respect with third parties: the Land Register (in Latvian: *Zemesgrāmata*) for a pledge on a real estate (mortgage), the Commercial Pledge Register (in Latvian: *Komercķīlu reģistrs*) for a pledge of a movable tangible or intangible property (or an aggregation of property) or the complete assets of an enterprise, the Latvian Ship Register (in Latvian: *Kuģu reģistrs*) of the Maritime Administration of Latvia for pledge of vessels. The Nasdaq CSD in cooperation with its participants (generally credit institutions (banks) and brokerage companies) can register liens on securities entered in a securities account.

In Latvia, parties are free to determine the law, under which their mutual relations shall be adjudged. Such agreement shall be in effect, insofar it is not in conflict with mandatory or prohibitory norms of Latvian law. In cases when the law is not determined in an agreement in respect of its substance and consequences it is subject to the laws of the state where the obligation is to be performed.

There are exemptions when collateral arrangements can only be subject to Latvian law, which are regarding the following types of pledges: (i) mortgage of a real estate located in Latvia; and (ii) financial collateral of financial instruments which are transferred into an account or in a register in the form of an entry (booking), and the relevant account or the register is located in Latvia. In these cases, Latvian law is applicable.

Enforcement of a collateral governed by another jurisdiction shall be in effect, insofar it is not in conflict with mandatory or prohibitory norms of Latvian law; however, it is highly recommended to refer to Latvian law as the governing law to charge assets located in Latvia, as in general Latvian law is the applicable law for securities. In cases when the pledge is registered as mortgage with the Land Registry and ship mortgage with the Latvian Ship Register, the pledgee may request the enforcement of liabilities on no contestation basis by way of judicial procedure. In cases when the pledge is registered under the Financial Collateral Law, a financial pledgee is entitled to freely dispose of the financial pledge observing the provisions and conditions of the financial pledge arrangement, without performance of any additional procedures.

Latvian law facilitates the issuing of mortgage bonds, however, in practise this instrument is rarely used. To the knowledge of the Author, until the date of this thesis only one Latvian bank has in practice attempted to issue mortgage bonds, however no mortgage

[70] *Ibid.*

[71] Section 75 of the Insolvency Law of Latvia (26 July 2010). Available on: https://likumi.lv/ta/en/en/id/214590-insolvency-law. Accessed May 2, 2019.

bonds currently remain outstanding. Moreover, the Law on Mortgage Bonds, last amended back in 2006, is also outdated.

Unfortunately, Latvian law does not contain the concept of a trustee, security agent or a collateral agent. As a result, the reference to the trustee, security agent or collateral agent could be interpreted as meaning an authorized person holding the collateral (security) without any specific legal regulation and requirements.

However, it is allowed to use a collateral agent concept in Latvia. Rights and obligations of the collateral agent, bondholders and issuer shall be determined on contractual basis, and the role of the collateral agent currently would be as of an authorised person, i.e., attorney.

2.5 Initiatives for development of the Latvian capital market

Within the scope of the Financial Sector Development Plan 2017-2019[72] adopted by Latvian government as well as to ensure sustainable economic growth and development of capital markets in Latvia, EBRD and Latvian Ministry of Finance have initiated a cooperation project to develop a state support instrument programme giving Latvian SMEs an opportunity to receive state support in attracting alternative finance in capital markets.

The key objectives of the state support instrument programme are to increase the number of those Latvian enterprises that use capital market instruments in attracting finance, to ensure accessibility of alternative finance attracting tools as well as to expand investment opportunities and encourage institutional and private investor activity in the local capital market.

It is intended that when launched, the respective instrument should contribute also to the development of the corporate bond market in Latvia, since the instrument prescribes that SMEs will be able to apply for an EU structural funds support also in respect to the corporate bond issuances.[73]

Further, the Ministries of Finance in Latvia, Lithuania and Estonia signed in November 2017 a Memorandum of Understanding with the intent to create a pan-Baltic covered bond framework. The aim of this work is for the three Baltics States to adopt covered bond laws that would be as similar as possible and that would facilitate the issuance of covered bonds with underlying assets from one, two or three of the Baltic States.[74] However, a covered bond can only be issued by a credit institution (i.e., by the bank), has full recourse to the issuer, is subject to special public supervision and can only be backed by certain specific assets. Thus, development of the collateralization regime for corporate bonds issued by private companies apparently would not fall under this initiative.

2.6 Analysis of the recent precedents: secured corporate bond issuances in Baltics

[72] Cabinet of Ministers of Latvia. *Financial Sector Development Plan*. Available on: https://www.fm.gov.lv/en/s/financial_market_policy/financial_sector_development_plan/. Accessed May 9, 2019.
[73] The Ministry of Finance of Latvia. *Informative Report on SME Listing Support Instrument*. Available on: http://tap.mk.gov.lv/lv/mk/tap/?pid=40466169&mode=mk&date=2018-12-04. Accessed May 19, 2019.
[74] The Ministry of Finance of Latvia. *Consultation on Pan-Baltic Covered bond framework*. Available on: https://www.fm.gov.lv/en/news/60230-consultation-on-pan-baltic-covered-bond-framework. Accessed May 19, 2019.

In this part of the thesis, the Author will provide a brief analysis of the recent bond issuance precedents in Baltics where the structures of a collateral agent were used for establishment of the collateral arrangements for the transaction.

UPP Olaines OÜ 7% subordinated bond issue (ISIN EE3300111350)[75]

UPP Olaines OÜ (the issuer) is a SPV founded in 2017 and incorporated in Estonia. It is a subsidiary and wholly owned by United Partners Property OÜ. It holds 100% of shares in the Latvian SPV, who in turn is the owner of Olaines Logistics Park.

The issuer was established for the purpose of funding and acquiring Olaines Logistics Park. The funds raised from the issue were given as a subordinated loan to SIA Olaines Logistics, which in turn utilized the funds to acquire SIA Olaines Logistics Parks, legal owner of Olaines Logistics Park. The sole business of UPP Olaines OÜ is, indirectly through the holding of SIA Olaines Logistics, to own, rent out and manage Olaines Logistics Park. More specifically, it services its debt obligations to investors from rental income up-streamed from SIA Olaines Logistics. Therefore, the issuer's business performance and ability to service financial obligations is dependent on the performance of its subsidiary, the Latvian SPV and its owned Olaines Logistics Park.

Collateral arrangements

The respective bond issuance involves a collateral agent structure. Collateral agent for this bond issue is Law Firm Eversheds Sutherland Bitāns (the "Collateral Agent").

As according to the bond prospectus (Note Terms), the issued bonds are secured by a 3rd rank mortgage in the maximum amount of EUR 8,079,500 over the Property, in favour of the Collateral Agent as the pledgee (held for the benefit of the investors in accordance with Note Terms and the Collateral Agent Agreement). As per the Note Terms, the Property is Olaines Logistics Park, a modern storage facility with cold storage capabilities constructed in 2007 and located in Olaine, Latvia. It is the largest cold-storage facility in Latvia.

In the respective secured corporate bond issue, the Collateral Agent holds the collateral on behalf of the investors and is entitled to enforce the collateral for the benefit of the Investors in case of an Extraordinary Early Redemption Event, pursuant to the Note Terms and terms of the Collateral Agent Agreement.

Upon enforcement of the Collateral, the proceeds from the Collateral shall be applied as a first priority to the satisfaction and payment of all fees, costs and expenses and damages (including, without limitation, state duties, notary fees and valuation costs and fees, costs and expenses of third parties engaged in by the Collateral Agent) related to performance of its duties by, or otherwise payable to, the Collateral Agent under the Note Terms.

To the knowledge of the Author, UPP Olaines OÜ secured bond issue is one of only a few precedents in Latvia, where the structure of a collateral agent and collateralization arrangements for the bond is used. In this precedent, a mortgage on the real estate is registered

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[75] UPP Olaines 7.00% subordinated bond issue (ISIN EE3300111350). Available on: https://www.nasdaqbaltic.com/market/?pg=details&instrument=EE3300111350&list=1. Accessed May 16, 2019.

in the Land Register in Latvia in favour of the Collateral Agent, but for the benefit of the bondholders.

AS Capitalia 12% secured bond (ISIN LV0000801488)[76]

AS Capitalia is the largest non-bank lender to small and medium enterprises in Latvia, Lithuania and Estonia. To date, Capitalia has financed working capital and investment needs of more than 1000 companies investing over EUR 20 million in growth of these businesses.

In 2016 Capitalia has made closed secured bond issue for the total amount of EUR 500,000 with nominal value of each bond set at EUR 1,000 and maturity October 25, 2019. Bonds are secured with pledge on all assets of AS Capitalia and offers to investors 6% coupon rate, paid quarterly. Bonds are issued to diversify financing sources of the company as well as to accelerate lending to small and medium sized businesses.

Collateral arrangements

The respective bond issuance involves a collateral agent structure. Collateral agent for this bond issue is Law Firm Loze & Partneri (the Collateral Agent).

As previously mentioned, the bonds are secured with pledge on all assets of AS Capitalia (commercial pledge arrangement). To the knowledge of the Author, AS Capitalia secured bond issue is the only precedent in Latvia, where the bond is secured by the commercial pledge in favour of an independent third party (the Collateral Agent). In this precedent, a commercial pledge is registered in the Commercial Pledge Register of Latvia in favour of the Collateral Agent, but for the benefit of the bondholders.

UPP & CO Kauno 53 OÜ 8% bond (ISIN EE3300111152)[77]

In 2017 UPP & CO KAUNO 53 OÜ, a company owned by Estonian asset management company United Partners Property, issued and admitted to trading on Nasdaq Baltic First North market the subordinated, commercial property backed bond issue.

The size of the subordinated, commercial property backed bond issue is EUR 4.7 million. The nominal value of one bond is EUR 1,000. The annual coupon rate is 8% which is paid out quarterly. The maturity date of the bond issue is April 17, 2022.

United Partners is an independent investment banking firm established in 2003 and its core businesses are corporate finance advisory services (United Partners Advisory), direct equity investments (United Partners Investments), asset management services (United Partners Asset Management), and real estate development (United Partners Property).

Collateral arrangements

[76] AS Capitalia 12% secured bond (ISIN LV0000801488). Available on: https://cns.omxgroup.com/cdsPublic/viewDisclosure.action?disclosureId=744835&messageId=933029. Accessed May 16, 2019.

[77] UPP & CO Kauno" 53 8% bond (ISIN EE3300111152). Available on: https://www.nasdaqbaltic.com/market/?instrument=EE3300111152&list=9&date=2019-04-26&pg=details&tab=security&lang=lv. Accessed May 16, 2019.

The respective bond issuance involves a collateral agent structure. Collateral agent for this bond issue is K53 Collateral Agent OÜ (register code 14236479, legal address: Ahtri 6a, 10151 Tallinn, Estonia, Estonia). As it may be noticed by the name of the collateral agent, a SPV is established in order to ensure collateral agent structures.

As according to the bond prospectus (Terms and Conditions of UPP & CO KAUNO 53 OÜ Note Issue), the issued bonds are secured with a second rank mortgage in the maximum amount of EUR 7,150,000 over the Rimi LC Property in favour of the Collateral Agent as the pledgee (held for the benefit of the Investors in accordance with these Terms and the Collateral Agent Agreement). In this precedent, a mortgage on the real estate is registered in the Lithuanian Mortgage Register in favour of the Collateral Agent, but for the benefit of the bondholders.

To the knowledge of the Author, UPP Olaines OÜ, AS Capitalia and UPP & CO Kauno" 53 OÜ secured bond issuances are currently the only precedents in Baltics, where the structure of a collateral agent and collateralization arrangements for the bond is used. However, bond prospectus (issue terms) of the respective issues provide an insight on how the collateral structures of the secured bonds should be established, as well as provides a very useful information on the application of the concept of a collateral agent.

2.7 A comparison of the relevant legislation across the Baltics

The table below illustrates a summary and comparison of the applicable regulations as regards to the collateral arrangements and recognition of a collateral agent structures in the three Baltic countries.

	Latvia	**Lithuania**	**Estonia**
Governing law with respect to issuance, public offering and trading of securities	Financial Instrument Market Law	Law on Markets in Financial Instruments of the Republic of Lithuania	Securities Market Act
Governing law with respect to creation of a collateral	Civil Law, Commercial Pledge Law	Civil Code, the Law on the Pledge of Movable Property of Lithuania	Law on Commercial Pledge of Estonia, Law of Property Act
Types of security	Personal guarantees (including corporate guarantees), pledges, mortgages, financial collateral (*certain restrictions in terms of eligible parties*)	Letters of guarantee, deposit, forfeit, Suretyship, Movable assets and rights, mortgage, financial collateral. No floating charge is accepted.	Personal guarantees (including corporate guarantees), pledges, mortgages, financial collateral
The concept of a collateral agent	Latvian law does not contain the concept of a trust or trustee; however, it is allowed to use a security agent structure	Security agent structures are available under Lithuanian law	Allowed
Recent precedents	UPP Olaines OÜ 7% subordinated bond	Not discovered	UPP & CO Kauno 53 OÜ 8% secured bond

	issue		

Table 1. Source: A summary and comparison of the applicable regulations

2.7.1 An insight into Estonian legal framework

Establishment of a commercial pledge

Commercial pledges are regulated in Estonia primarily by the Law on Commercial Pledge of Estonia. Under this law[78], a commercial pledge is an undertaking that is registered in the Commercial Pledge Register, whereby a pledgor uses its movable property as a security for a claim without transferring the possession of the property to the pledgee. Essentially all encumberable property can be included in a commercial pledge that is owned by the pledgor at the time of the pledge and that is acquired afterwards. However, certain items are exempt from commercial pledges such as monies in banks, as well as shares and stocks. The extent of the claim secured by a commercial pledge is limited to the amount pledged, provided that it is considered unpaid interest within three years before the sale of the pledged property and other costs as a part of the security covered by the respective pledge.

A commercial pledge in Estonia shall be created on the basis of a notarised agreement or a court judgement and registered in the Commercial Pledge Register of Estonia[79]. In the event of the pledgee sending an application to the Estonian Commercial Pledge Register, the notarised consent of the pledgor will be required.

The legal effect of a commercial pledge begins when the respective entry is made in the Commercial Pledge Register. The commercial pledge is released by the removal of the relevant entry form the Commercial Pledge Register. Commercial pledges are removed from the Commercial Pledge Register by providing an application from the pledgee or, alternatively, also the pledgor may provide an application to the register, if it includes the notarised consent of the pledgee. In a situation where the commercial pledge has been lawfully ended prior to its removal from the Commercial Pledge Register, the commercial pledge will be deleted by the Commercial Pledge Register.

The concept of a collateral agent

Estonian law does not contain the concept of a collateral agent; however, it is allowed to use such structures in this jurisdiction.

2.7.2 An insight into Lithuanian legal framework

Collateral arrangements

Under Lithuanian law, object of the pledge can be movable assets and rights. Pledge cannot be established over the assets in respect of which enforcement may not be levied. Whereas, the object of a mortgage may be individual immovable asset, which is registered in the public

[78] The Law on Commercial Pledge of Estonia (1 January 1997). Available on: https://www.ebrd.com/downloads/legal/facts/estonia.pdf. Accessed May 9, 2019.
[79] *Ibid.*

register, not withdrawn from the public circulation and eligible for a public foreclosure sale (i.e. the respective asset is transferable).

Collateral arrangements in Lithuania is governed by the Civil Code[80] and the Law on the Pledge of Movable Property of Lithuania. Under Lithuanian law, a pledge is a device of granting security for the discharge of obligations when the collateral is transferred to the creditor, a third person or remains in the pledgor's possession.

In Lithuania, object of the pledge can be movable assets and rights, including securities, intellectual property rights, money in the bank account of the debtor, etc. Floating charges are not available under Lithuanian law.

Security arrangements over the assets located in Lithuania may be governed by foreign law. However, in such a case it would be typical, that the relevant foreign court would have jurisdiction to decide on enforcement of the security interest. A final and conclusive foreign court judgment would then need to be recognised by competent Lithuanian court in order to be enforceable in Lithuania.

The security over the immovable property in Lithuania may be created by means of Mortgage Bond – a standardised form document to be executed in front of the notary public in Lithuania and registered with the Mortgage Register of the Republic of Lithuania. Vessels and Aircrafts are considered immovable property for the purposes of mortgage. All movable property and property rights may be pledged under Lithuanian law as long as there are no restrictions to their transfer/ assignment (both imposed by virtue of contract or statute). As a general rule, only existing property may be pledged. The only two categories of future assets that may be subject to pledge under Lithuanian law are funds in the bank accounts and inventories and trading stocks. Creating security over business as ongoing concern is problematic under Lithuanian law due to the fact that floating charges are not recognised. In order to achieve a similar result, it is common to use in Lithuania a combination of the pledge of shares of the relevant entity and its assets (according to the itemised list)

Enforcement of a registered pledge and mortgage takes form of extra-judicial proceedings, unless the debtor contests the amount of the debt obligation. Enforcement from the pledged property may take any of the following three forms: (a) public auction organised by the creditor; (b) private sale organised by the creditor; (c) by taking over the pledged asset into the ownership of the creditor and applying the value of the collateral for the satisfaction of the secured obligation.

Enforcement from the mortgaged property is organised by the bailiffs and leave almost no room for the secured creditor to influence them. The secured creditor may satisfy its claim from proceeds gained either: (a) by enforcement sale of the mortgaged property through an auction; or (b) by administration of the mortgaged property. In Lithuania it is possible to enforce security governed by another jurisdiction by procedure of recognition of judgements of foreign courts.

The concept of a collateral agent

Security agent structures are available under Lithuanian law. In order to apply the concept of a collateral agent, it is important that the collateral agent has a right to claim satisfaction of the whole secured obligation (i.e., not only the funds it has lent to borrower) from the pledged

[80] The Law on the Pledge of Movable Property of Lithuania (10 June 1997). Available on: https://e-seimas.lrs.lt/portal/legalActPrint/lt?jfwid=-je7i1t1yb&documentId=TAIS.59985&category=TAD. Accessed May 9, 2019.

asset. Most commonly used structure therefore is so called parallel debt – an abstract debt obligation owed by the borrower to the collateral agent, which is mirroring the overall indebtedness of the borrower to the investors. Parallel debt as an abstract obligation is not known in Lithuanian law; however, as long as this is a valid debt obligation under the foreign law governing the loan agreement (usually English law), it is feasible of being secured by a Lithuanian law governed security instrument.

3. PROPOSAL FOR A NEW REGULATION INTRODUCING THE CONCEPT OF A COLLATERAL AGENT

As concluded in the previous parts of this thesis, in Latvian law there is currently absence of specific legal provisions in legislation related to the structures of a collateral agent. The main risk associated to this is that the lack of precise reference in laws related to the agent's powers, duties and responsibilities may lead to conflicting terms and conditions in bond issue documentation and inability to enforce the collateral as it is currently observed with the existing rules under the Commercial Pledge Law.

Further, there is no appropriate and up-to date legal framework for collateralization in Latvia. Collateralization in Latvia could be made mainly by applying the general provisions of the Civil Law regulating the creation of security, alongside the Commercial Pledge Law and laws normally regulating securities market.

For the purpose of secured bond and collateralization frameworks, specific adjustments introducing a clear concept of a collateral agent, who would be able to hold security in favour of investors are needed. This would enable suitable regime to efficiently exercise the creditors' rights and administer the secured assets. Neither the concept of a collateral agent nor other legal concepts in Latvian law cover usage or specifics of a trust (as it is understood in common law) as the holder of security on behalf of other beneficiaries.

As mentioned in the Introduction section of this thesis[81], the goal of the thesis is, inter alia, to identify the key missing elements for favourable collateralization environment, and to produce recommendations to reform the legal and regulatory framework for introduction of the concept of a collateral agent in Latvia needed for the development of the corporate bond market in Latvia within the Capital Markets Union.

By considering that the Author has proved the need for changes in Latvian regulation, Author recommends a creation of a legal framework to provide for collateralization and introduction of the concept of a collateral agent. The Author suggests that it may be realized via amendments to the existing legislation and adoption of a new law, which specifically governs collateralization and introduces the concept of a collateral agent.

Hence, in this part of the study the Author will provide key considerations for the legislative instruments proposal.

3.1 Legislative instruments proposal

Following the Author's research, it is concluded that development of the current legislation in respect of collateral agent structures and collateralization procedure with respect to the secured debt (including corporate bond) transactions is required in Latvia and a new standalone (law) governing these issues would ultimately be the best route to take.

On the basis of the analysis conducted on the current legislation and recent secured corporate bond precedents in Baltics, as well as following the analysis on the legal framework for these arrangements in Estonia and Lithuania, the Author provides recommendations and considerations for a new standalone law regulating collateralization and introducing the concept of a collateral agent. The key elements of effective secured corporate bond transactions regime are set out in detail further below.

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[81] *See* Introduction section of this thesis.

3.1.1 Subjects of the new regulation

It is proposed by the Author that the new legal act shall regulate collateral (security) agent engagement and collateral (security) enforcement procedure only in cases where the parties of the secured debt transaction (subjects of the new legislative act) are:

i. *issuers* of secured debt securities (secured corporate bonds). Presumably, the scope of subjects for the new law may be extended also to the borrowers in other type of secured debt transactions (e.g., secured loan facility arrangements etc.);

ii. *private and institutional investors (bondholders)* holding the respective secured debt securities (corporate bonds). Presumably, the scope of subjects for the new law may be extended also to the lenders in other type of secured debt transactions (e.g., secured loan facility arrangements etc.);

iii. *collateral/security agents, trustees* - legal entities registered in Latvia acting as an independent third parties, who holds the collateral in favour of the investors, bondholders or other lenders (if the scope of subjects for the new law may be extended) and performs other assignments stipulated in the bond issue documentation, including, the collateral agent agreement (or other type of secured loan documentation should the scope of subjects for the new law may be extended).

In addition, other financial market participants as subjects of the new regulation may be also considered by the legislator, e.g., appropriate registers in Latvia: the Land Register, the Commercial Pledge Register, the Latvian Ship Register of the Maritime Administration, the Nasdaq CSD and other).

3.1.2 A parallel debt concept

In order to achieve collateral agent structures under Latvian law, it is important that the collateral agent has a right to claim satisfaction of the whole secured obligation (i.e., not only the funds the bondholders have “lent” to the issuer but also ancillary claims) from the secured asset.

As a matter of practice, in other jurisdictions (e.g., Lithuania) most commonly used concept for satisfaction of the whole secured obligation is so-called “parallel debt” – an abstract debt obligation owed by the issuer to the collateral agent, which is mirroring the overall indebtedness of the issuer to the syndicate of bondholders.

Currently parallel debt as an abstract obligation is not known in Latvian law; however, as long as this is a valid debt obligation under the foreign law governing the issue terms (e.g., English law), it is capable of being secured by a Latvian law governed security instrument.

With regard to securing corporate bonds, the Author considers it necessary to regulate provision of collateral in a clear and undisputable fashion. Collateral is provided for the benefit of a wide range of bondholders which may change, therefore regulations should allow a specific possibility of noting in the bond prospectus, issue terms or in some other type of bond issue documentation (as the case may be) that a right of claim or commercial pledge right to bond securities in favour of creditors (bondholders) would be registered in favour of a third-party trustee of the issuer – a collateral agent who may not be a creditor themselves.

The current definition in the Law on Commercial Pledge – *a pledgee is a party that accepts a commercial pledge as collateral for **its** claim* – may lead to ambiguities. In the event of secured bonds, secured claims are granted to the bondholders and not to the collateral agent

(assignee). Therefore, based on the example of Anglo-Saxon law, a "parallel debt" concept is established which is not known within the Latvian law system and has not been interpreted also in court practice.

By considering all the above mentioned, it is required to introduce in Latvian law a parallel debt concept in securing corporate bonds, by providing, inter alia, amendments to the Law on Commercial Pledge, envisaging that the right of commercial pledge for the benefit of the creditors on assets of debt securities or rights of claim can be secured also in favour of a third party (i.e., collateral/security agent or trustee), who may not be a creditor himself, and who is appointed by the issuer.

Accordingly, in the new regulation the following extended provisions for introducing a parallel debt concept are further suggested to be prescribed by the Author:

- notwithstanding any provisions of the bond prospectus, for the purpose of ensuring and preserving the enforceability of the collateral, the issuer shall irrevocably and unconditionally undertake to pay to the collateral agent, as creditor in its own right and not as representative of the investors (bondholders) and as a solidary creditor together with the investors (bondholders) for the purposes of Latvian law, sums equal to and in the currency of each amount payable by the issuer to each of the bondholders (whether present or future and whether actual or contingent) under the bond prospectus as and when the amount falls due for payment under the bond prospectus.
- the collateral agent shall be a solidary creditor (together with the bondholders) of each and every bond (whether present or future and whether actual or contingent) of the issuer to the bondholders or any of them and, accordingly, the collateral agent shall have its own independent right to demand performance by the issuer of any of those obligations.
- the aggregate amount due by the issuer under the parallel debt shall be decreased to the extent the issuer has paid any amounts to the bondholders under the bond issuance.
- to the extent the issuer has paid any amounts to the collateral agent under the parallel debt the aggregate amount due by the issuer to the bondholders under the bond issuance shall be decreased accordingly.
- to the extent the collateral agent receives any amount in payment of the parallel debt following its respective specific written claim made to the issuer, the collateral agent shall transfer such amount to the bondholders in accordance with the procedure prescribed further by the bond prospectus.
- for the purpose of clarification, the parallel debt shall become due and payable at the same time and to the same extent as the obligations of the issuer to the bondholders under the bond prospectus become due and payable.
- the parallel debt may be transferred only to a successor of the collateral agent.

3.1.3 Functions of the collateral agent

As suggested by the Author, the new legislation shall prescribe that the functions and obligations of the collateral agent shall be limited to those expressly specified in the collateral

agent agreement and the bond prospectus of the particular transaction and, notwithstanding any other provisions of the bond prospectus, such functions shall be limited to exercising of those rights which belong to the collateral agent in its capacity as the holder of the collateral.

Independence

Upon the performance of its obligations and exercising its rights the collateral agent shall act at its own discretion in the interests and on the account of the bondholders collectively and generally (and not any particular bondholder) without having any independent interests of its own.

The collateral agent shall have the right to withhold the proceeds necessary for satisfying the fees, costs, expenses, damages and claims of the collateral agent and without any obligation to consider any interests of the issuer.

The issuer shall not have any right to give any instructions to the collateral agent. In particular, the collateral agent shall be entitled to decide at its sole discretion as to what would be in the best interests of the bondholders upon failure to obtain instructions from the majority bondholders, however the collateral agent shall not have right to start the enforcement of the collateral without instructions provided by the majority bondholders.

Liability

The collateral agent shall not be a party to the legal relationship between the issuer and the bondholders and is under no circumstances liable for the performance of the obligations of the issuer.

The collateral agent shall not liable for any circumstances relating to or affecting the validity of the collateral that are outside the control or sphere of influence of the collateral agent.

Further, collateral agent shall be required to perform its obligations in relation to the collateral only if the collateral provider establishes the collateral in the interest of bondholders and in favour of the collateral agent (as the holder of the collateral) in accordance with the bond prospectus to secure the bonds.

The collateral agent shall evaluate that no conflict of interest exists with regard to the issuer and/or the bondholders, and, the existence of conflict of interest shall not prevent the collateral agent from fulfilling its obligations to the extent and scope provided for in the bond prospectus and the collateral agent agreement.

3.1.4 Rights and obligations of the collateral agent

It is recommended to be envisaged by the new regulation that the collateral agent *shall not have* any obligation:

- to take any action to commence legal proceedings, compulsory enforcement proceedings, bankruptcy proceedings or any other proceedings with the purpose to satisfy any claims arising under the bond prospectus on the account of any assets of the issuer, except for enforcing the collateral in accordance with the bond prospectus and the collateral agreements upon the collateral becoming enforceable and receiving the relevant instructions from the bondholders as per the terms and conditions of the bond prospectus.

- to ensure the existence or validity of the collateral or to preserve the collateral or its value or to assess any rights arising from or relating to the collateral (except for the validity of the collateral after its establishment to the extent within the control or sphere of influence of the collateral agent and to the extent within the scope of its obligations under the bond prospectus.
- to inform the bondholders or the issuer about any circumstances relating to the collateral except to the extent such obligation to provide information is explicitly set forth in the bond prospectus or the collateral agent agreement.
- to provide any advice to the bondholders in legal, accounting, tax or other matters.

The right to receive compensation

It would be recommended to be included in the new regulation that the collateral agent shall have the right to receive fees from the issuer of bonds and to be compensated by the issuer for the costs relating to the performance of its obligations under the bond prospectus and the collateral agreement(s) in accordance with the terms and conditions of the collateral agent agreement and shall have the right to withhold the performance of its duties and obligations in case of delay of payment of the relevant fees and costs. However, the collateral agent should not have a right to withhold the performance of its duties and obligations in case the investors (bondholders) have compensated such fees and costs to the collateral agent in accordance with the collateral agent agreement (as the case may be).

The right to use the services of third parties

Sometimes it may be required by the collateral agent to engage third parties in order to ensure that tasks and acts of the collateral agent stipulated by the bond prospectus, collateral agent agreement and collateral agreement(s) are duly performed. For example, it may be required to engage qualified evaluator for appraisal of the property (collateral), to cooperate with professional litigators (attorneys) in the event of an enforcement of the collateral etc.)

Thus, it is suggested that upon the performance of its obligations and exercising of its rights the collateral agent shall have the right at its own cost to use the services of third parties and to appoint third party representatives (including in the course of performance of its tasks and acts as stipulated in the bond prospectus and the collateral agreement(s)).

In case of use of the services of third parties and/or appointment of third-party representatives, the collateral agent shall evaluate and appoint only reputable third-parties having professional expertise for the fulfilment of the tasks and acts as stipulated in the bond prospectus and the collateral agent agreement.

In case of use of the services of third parties and/or appointment of third-party representatives, the collateral agent shall ensure that: (i) no conflict of interest exists in respect to the issuer and the bondholders; (ii) the fees, costs and expenses of such third party services are at a reasonable market price; (iii) the fees, costs and expenses for using the services of third parties and/or appointment of third-party representatives would not exceed costs, fees and expenses of the collateral agent if the latter would perform its obligations under the bond prospectus, the collateral agreement(s) and the collateral agent agreement on its own; and (iv) it shall remain duty and obligation of the collateral Agent to perform its obligations under the bond prospectus and the collateral agent agreement and not of the appointed third party.

In case the use of services of third parties or appointment of third-party representatives is required for the fulfilment of obligations arising from the bond prospectus or the collateral agreement(s), the issuer shall have an obligation to compensate to the collateral agent also all

payments made by the collateral agent to third parties for the purposes of establishment, amendment, termination and enforcement of the collateral in accordance with the bond prospectus and the collateral agreement(s) (e.g., state fees and taxes, other fees and payments established by laws and regulations, costs and expenses incurred by the collateral agent) as well as all damages incurred by the collateral agent in relation to the same.

The right to terminate the collateral agent agreement

In the new specific legislation, the collateral agent shall be assigned with the right to unilaterally terminate the performance of its duties (including, without limitation, terminate the enforcement of the collateral) and terminate the collateral agent agreement. It is advised by the Author, that the collateral agent may terminate the collateral agent agreement in the following cases:

i. the collateral prescribed by the bond prospectus has not been established within the relevant term stipulated in the bond prospectus; and/or

ii. in the reasonable opinion of the collateral agent, (further) enforcement of the collateral on reasonable terms is not possible or feasible due to the commencement of the bankruptcy or reorganisation proceedings of the issuer or the relevant collateral provider or for any other reason;

iii. the estimated proceeds of the enforcement of the collateral will not be sufficient to cover the claims under the bond prospectus; or

iv. in the professional opinion of the collateral agent, the collateral (or the substantial part thereof) ceases to exist for any reason;

v. in case the issuer decides not to proceed with the issue of bonds at any stage of a secured bond issue transaction.

It should be prescribed that in the event of termination of a collateral agent agreement, fees and payments already paid to the collateral agent shall not be refunded.

3.1.5 Rights and obligations of bondholders

As suggested by the Author, the new regulation shall prescribe that by submitting the purchase order in primary distribution or acquiring the corporate bonds on the secondary market, each investor (bondholder) shall represent and warrant at least the following:

- the investor (bondholder) has understood and consents to the circumstance that the bonds are secured solely by the pledge established in the interest of investor (bondholder) and in favour of the collateral agent.
- the investor (bondholder) has understood and consents to the circumstance that the collateral agent will not be liable for any loss sustained by the investor (bondholder), unless the collateral agent is culpable for the loss due to intent or gross negligence.
- the investor (bondholder) appoints the collateral (security) agent to act as its agent (trustee) and to perform the obligations and exercise the rights in connection with the collateral as set in the bond prospectus, the collateral agreement(s) and the collateral agent agreement.
- the investor (bondholder) authorises the collateral agent to exercise the rights, powers, authorities and discretions specifically given to the collateral agent under or in

connection with the bond prospectus, the collateral agreement(s), and the collateral agent agreement.

- the investor (bondholder) shall acknowledge that the issuer would conclude the collateral agent agreement with the collateral agent and confirm that the fact that the collateral agent acts under the collateral agent agreement concluded with the issuer does not constitute any conflict with the interests of the investor (bondholder).

- the investor (bondholder) shall confirm that the fact that the collateral secures, *inter alia*, the issuer's obligations towards the collateral agent (i.e., payment of collateral agent's fees) does not constitute any conflict of interest *vis-ą-vis* the investor (bondholder). Such confirmation would be suggested by the Author to be included in the new regulation because the collateral agent shall have the right to withhold the proceeds necessary for satisfying the fees, costs, expenses, damages and claims of the collateral agent.

- the investor (bondholder) shall acknowledge that the fact that the collateral secures, inter alia, the issuer's obligations towards the collateral agent shall not prevent the collateral agent from fulfilling its obligations and acting in accordance with the bond prospectus and the collateral agent agreement at its own discretion in the interests and on the account of the bondholders without having any independent interests of its own.

- the investor (bondholder) shall agree that upon the performance of its obligations and exercising of its rights in connection with the collateral, the collateral agent shall be entitled to act at its discretion, considering the interests of the bondholders collectively and generally (and not of any particular bondholder), unless specifically instructed otherwise by the majority of bondholders (such majority to be determined in the respective bond prospectus of a particular issuance).

- the investor (bondholder) shall agree that the collateral agent shall have the right to advise the issuer in any matters and in any fields of activity which do not directly relate to the performance of obligations of the collateral agent prescribed by the respective bond prospectus, and that the bondholder does not consider this to be in conflict with any of its interests.

- at the request of the collateral agent, the investor (bondholder) shall provide the collateral Agent with any information required by the latter for the purposes of identification of the Investor and/or for the performance of other obligations arising from applicable laws and regulations.

Further, it is suggested that the bondholders shall not have any independent power to enforce the collateral or to exercise any rights or powers arising under the collateral agreement. Bondholders may exercise their rights in relation to the collateral only through the collateral agent as prescribed by the applicable law and pursuant to the terms and conditions of the bond prospectus, collateral agent agreement and the collateral agreement(s).

3.1.6 Rights and obligations of the issuer

As recommended by the Author, the issuer of secured corporate bonds shall have the following obligations under the new law:

- the issuer shall ensure that the collateral provider(s) will sign the respective application(s) and/or conclude the relevant collateral agreement(s) for securing the bonds with the collateral agent.
- the issuer shall be responsible for providing a confirmation on the registration of the collateral in the relevant register to the collateral agent and the bondholders within [pre-defined number] of days after registration has taken place.
- the issuer shall ensure payment to the collateral agent of all fees, costs and expenses incurred by the collateral agent or any of the third parties engaged by the collateral agent (including, without limitation, state duties, notary fees, valuation costs and fees, costs and expenses of third parties engaged in by the collateral agent) related to the establishment, amendment and termination of the collateral (excluding costs of the enforcement which shall be borne by the bondholders), provided that the fees, costs and expenses have occurred pursuant to conditions specified in the bond prospectus.
- the issuer shall immediately notify the collateral agent and bondholders of the occurrence of any early redemption event of the bonds. In the absence of such notice, the collateral agent and the bondholders shall be entitled to proceed on the basis that no such early redemption event of the bonds has occurred or is expected to occur.
- at the request of the collateral agent, the issuer shall provide the collateral agent with an (updated) list of investors (bondholders) stating the outstanding nominal value of the bonds each of bondholders is holding and their latest known contact information (e.g., e-mail addresses, telephone numbers etc.).

3.1.7 Establishment, release and enforcement of the collateral

In order to achieve collateral agent structures under Latvian law, it is important that the collateral prescribed by the bond prospectus is duly established in favour of the collateral agent (as the holder of the collateral), but in the interest of bondholders under the collateral agreement(s) which, in legal terms, serves as a security for the bonds of the issuer towards the collateral agent (but in favour of the bondholders).

The respective collateral shall be established for the purpose of constituting security for the due and punctual payment, discharge and performance of the bonds. In the Author's opinion, the issuer shall be responsible for ensuring that the collateral providers conclude the relevant collateral agreement(s) and/or amend the existing collateral agreement(s) to secure the bonds with the collateral agent and ensure that the respective collateral is registered in the relevant register within [pre-defined number] of days from the bond issuance date. Further responsibilities of the parties involved are described in more detail below.

Responsibilities of the parties related to establishment of the collateral

In the new regulation establishing a collateral agent structures in Latvian, the following obligations and responsibilities of the parties involved should be prescribed in relation to establishment of the collateral:

- *the bondholders* shall be responsible for providing the collateral agent and the issuer with all the necessary mandates for authorising the collateral agent to act as its agent and to perform the obligations and exercise the rights in connection with the collateral as further prescribed in the bond prospectus, the collateral agreement(s) and the collateral agent agreement and authorising the collateral agent to exercise all the rights, powers, authorities and discretions specifically given to the collateral agent in

connection with the bond prospectus, the collateral agreement(s) and the collateral agent agreement.

- *the collateral agent* in cooperation with the issuer and the relevant collateral provider(s) shall be responsible for submission of the necessary applications and documents to the relevant registers where the respective collateral shall be registered. For the avoidance of doubt, *the issuer* shall ensure that the collateral provider(s) will sign the respective application(s) and/or conclude the relevant collateral agreement(s) for securing the bonds with the collateral agent.
- *the issuer* shall be responsible for providing a confirmation on the registration of the collateral in the relevant register to the collateral agent and the bondholders within [pre-defined number] of days after registration has taken place.

Supporting documents that may be required for securing the bonds

In some cases, additional documents may be required in order to register the security for bonds in the relevant registers. For example, in order to register the mortgage in the Land Register in Latvia, in addition to the application, bond prospectus and the respective mortgage agreement(s), an additional document such as a promissory note or similar document of a technical nature may be required by the Land Register.

If a promissory note (or similar document of a technical nature) is required to register, e.g., the mortgage in Latvia, the issuer and the collateral agent shall be obliged to conclude such promissory note in the form suitable to the relevant register (i.e., the Land Register of Latvia).

For the avoidance of doubt, a promissory note shall not constitute an independent or separate claim and the collateral agent may demand payment of any sum under a promissory note only in the amount and to the extent such equivalent sum has become due and payable under the respective bond prospectus. A promissory note shall be required only if the respective collateral has not been registered in the relevant register within [pre-defined number] of business days from the issuance date due to refusal of respective register to register the collateral.

Enforcement of the collateral

In case the bonds are not performed by the issuer in accordance with the bond prospectus and the collateral agent has been informed on such non-performance in accordance with the procedure prescribed by the bond prospectus and the majority bondholders of a respective bond issue have instructed the collateral agent to enforce the collateral, the collateral agent shall take all actions that the collateral agent as the holder of the collateral may reasonably take with the purpose to enforce the collateral according to the procedure provided for in the bond prospectus and the collateral agreement(s). For the avoidance of doubt, the majority bondholders shall have such right to instruct the collateral agent to enforce the collateral only if the bonds are not performed in accordance with the bond prospectus, and the majority bondholders have to specify in their instructions to enforce the collateral which obligation(s) has been breached by the issuer pursuant to the bond prospectus). Further, the following conditions are suggested by the Author to be applied for the enforcement procedure:

- if the majority bondholders in accordance with the bond prospectus have instructed the collateral agent to enforce the collateral, the collateral agent shall be obliged to immediately inform all the bondholders of the respective bond issue.

- majority bondholders shall have the right to instruct the collateral agent to take specific actions to enforce the collateral according to the procedure provided for in the collateral agreement(s) in case the specific conditions set out in the bond prospectus have been fulfilled. The collateral agent shall have a right (but not an obligation) to refuse to follow such instructions until the majority bondholders have explicitly confirmed such instructions. However, the collateral agent shall not be obligated to make any sale of any collateral if it shall determine not to do so, regardless of the fact that notice of sale of such collateral shall have been given.
- the collateral agent may assume that no violation of the bonds has occurred unless the collateral agent has received notice to the contrary from the issuer, or has been notified accordingly by the majority bondholders (for the avoidance of doubt, the majority bondholders shall have such right only if the bonds are not performed in accordance with the bond prospectus).
- the collateral agent shall be entitled (but shall be not under any circumstances obliged) to request instructions, or clarification of any direction, from the majority bondholders as to whether, and in what manner, the collateral agent should exercise or refrain from exercising any rights, powers and discretions with regard to the enforcement of the collateral. Upon such request, the majority bondholders shall be obliged to give their instructions or clarifications to the collateral agent within the time period specified in the collateral agent's request for instructions or clarifications. The collateral agent may refrain from acting unless and until majority bondholders have together provided the collateral agent with requested instructions or clarifications.
- if under the bond prospectus or following the request of the collateral agent submitted under the bond prospectus, the majority bondholders have duly instructed the collateral agent to enforce the collateral, the collateral agent shall be obligated to comply with such instructions. Important - any such instructions from the majority bondholders should be binding on all bondholders of the respective bond issue. The collateral agent shall not be liable for any consequences or damages that result from complying with the instructions.
- if the collateral agent has been notified in accordance with the bond prospectus that the notes have not been performed in accordance with their terms and the majority bondholders of the bond issue in accordance with the bond prospectus have instructed the collateral agent to enforce the collateral, all bonds of the respective issue shall be subject to extraordinary early redemption and the date of adoption of such decision by the majority bondholders shall be considered the early maturity date.
- notwithstanding the terms and conditions prescribed by the bond prospectus, the collateral agent shall have the right to refrain from doing anything which in its opinion will or may be contrary to the bond prospectus, the collateral agreement(s), the collateral agent agreement or applicable legislation or otherwise render it liable to any person and may do anything which is in collateral agent's opinion necessary to comply with such legislation. The collateral agent may refrain from acting in accordance with the instructions of the majority bondholders until it has received such indemnification or security as it may require for all costs, claims, losses, expenses (including but not limited to legal fees) and liabilities which it will or may expend or incur in complying with such instructions.

- without prejudice to the bond prospectus, the collateral agent may (but should not obligated to) act (or refrain from acting) as it in its discretion reasonably believes would be in the best interest of the bondholders. The collateral agent shall not be liable in front of bondholders for acting (or refraining from acting) as described in this paragraph.
- the collateral agent shall not be liable in front of bondholders for the outcome of the enforcement of the collateral, provided the collateral agent has acted in accordance with the bond prospectus, the collateral agent agreement and the collateral agreement(s).
- the collateral agent shall have the right to unilaterally terminate the enforcement of the collateral in the following cases (i) in the reasonable opinion of the collateral agent, further enforcement of the collateral on reasonable terms is not possible or feasible due to the commencement of the bankruptcy or reorganisation proceedings of the issuer or the relevant collateral provider or for any other reason; (ii) the estimated proceeds of the enforcement of the collateral would not be sufficient to cover the claims under the bond prospectus; and/or (iii) in the professional opinion of the collateral agent, the collateral (or the substantial part thereof) ceases to exist for any reason.
- in order to exercise its right of termination of the enforcement of the collateral, the collateral agent shall be obliged to submit a respective written notice to the issuer and all of the bondholders. The duties and obligations of the collateral agent shall be deemed to have terminated from the moment when a new collateral agent designated by the issuer and/or majority bondholders takes over the obligations of the old collateral agent. For the avoidance of doubt, under the laws governing the relevant collateral agreement(s) and/or the establishment and discharge of the collateral, the collateral agent may have an obligation to perform certain actions to release (discharge) the collateral as a result of the termination of the enforcement of the collateral.
- the collateral agent shall evaluate that no conflict of interest exists with regard to the issuer and/or the bondholders, and, the existence of conflict of interest shall not prevent the collateral agent from fulfilling its obligations to the extent and scope provided for in the bond prospectus and the collateral agent agreement.

Release of the collateral

When the bonds are duly performed by the issuer in accordance with the bond prospectus (i.e., the bonds have mature and/or all the payments under the bond prospectus are duly made), the collateral agent as the pledgee shall perform all the actions, produce and ensure submission of all the necessary applications and documents to the relevant registers (where the respective collateral is registered) for release (discharge) of the collateral securing the bonds.

3.1.8 Application of the proceeds from enforcement of the collateral

The list of the general and individual characteristics for corporate bonds are disclosed in the respective bond prospectus. Thus, also the order of priority for application of the proceeds is usually prescribed in the relevant bond prospectus.

Order of priority

According to the best market practice[82], commonly the proceeds from the enforcement of the collateral shall be applied in the following order of priority:

1) *as a first priority* - to the satisfaction and payment of all fees, costs and expenses and damages (including, without limitation, state duties, notary fees, valuation costs and fees, costs and expenses of third parties engaged in by the collateral agent) *related to performance of its duties by, or otherwise payable to, the collateral agent* under the bond prospectus, the collateral agent agreement and the collateral agreement(s) securing the issuer's obligations relating to the bond issue, including but not limited to the establishment, amendment, termination and enforcement of the collateral incurred by the collateral agent or any of the third parties engaged by the collateral agent, provided that the fees, costs and expenses have occurred on a reasonable market price and pursuant to conditions specified in the bond prospectus;
2) *as a second priority* (after the full satisfaction, payment and deduction of all claims and amounts of the collateral agent) - *in payment of the claims of the bondholders* arising under the terms of the respective bond issuance, including, but not limited to, the claims arising from the bonds.

The collateral agent shall withhold the proceeds necessary for satisfying the fees, costs, expenses, damages and claims of the collateral agent specified in item 1) above and transfer the remaining proceeds to the bondholders for satisfying the claims under item 2) above. The collateral agent shall return the proceeds from the enforcement of the collateral remaining after satisfying all claims described in items 1) and 2) above to the relevant collateral provider(s).

Further, in case the proceeds remaining after satisfying the fees, costs, expenses, damages and claims under item 1) above do not cover the claims under item 2) above in full, the claims arising from the bonds shall be satisfied *pro rata*. Moreover, the collateral agent shall not be obliged to pay to the bondholders or any other persons any interest on the proceeds from the enforcement of the collateral (whether deposited or not).

Taxation

In case the collateral agent is required, under applicable laws, to withhold or pay any taxes in connection with payments to be made by the collateral agent, the amount to be paid by the collateral agent shall be reduced by the amount of respective taxes and only the net amount shall be paid by the collateral agent.

[82] *See* section 2.6 ("Analysis of the recent precedents: secured corporate bond issuances in Baltics") of this thesis.

CONCLUSION

The goal of this thesis was to examine a theoretical background for procedure of issuance of secured corporate bonds in Latvia, to identify the key missing elements for favourable collateralization environment, and to produce recommendations to reform the legal and regulatory framework for introduction of the concept of a collateral agent in Latvia that would contribute for the development of the corporate bond market in Latvia within the Capital Markets Union. Having discovered that there is no appropriate and up-to date legal framework for collateralization in Latvia, the Author has proved the need for changes in Latvian regulation. Collateralization in Latvia could be made primarily by applying the general provisions of the Civil Law regulating the creation of security, alongside the Commercial Pledge Law and laws normally regulating securities market. The studies discussed in this paper are largely aimed at promoting the use of the corporate bonds as an alternative to bank financing.

Research reveals that in Latvian law there is currently absence of specific legal provisions in legislation related to the structures of a collateral agent. Assessing the main risks associated to this, it becomes evident that the lack of precise reference in laws related to the agent's powers, duties and responsibilities may lead to conflicting terms and conditions in bond issue documentation and inability to enforce the collateral as it is currently observed with the existing rules under the Commercial Pledge Law.

In the first part of the work the Author concluded that prior to the default, the collateral agent's role is rather of a technical nature. It involves accepting the pledge of the applicable collateral and enforcing rights against that collateral in the event of a default and when directed to do so by the bondholders. Different jurisdictions have diverse laws governing the manner of protecting the rights of creditors in collateral. This makes things very complicated in case there are, e.g., many investors for the corporate bond issue transaction, where several institutional and private investors usually subscribe for the issued debt securities. In this case, a collateral agent can be an attractive addition to the issuer's debt financing transaction. As the rights of creditors in pledged collateral are usually determined by local laws, bond investors typically require that a collateral agent be appointed to enforce rights against the collateral in the event of the issuer's default under the corporate bond documentation.

In the second part the Author reveals that the Commercial Law, being the the law regulating commercial activities in Latvia, is silent as regards to the corporate bond issuance procedures. The study reveals, that both the Civil Law and the Commercial Pledge Law do not contain the concept of a trustee, security agent or a collateral agent. In terms of a collateral agent arrangements in secured debt transactions, specific provisions are currently not available also under the Insolvency Law.

Latvian law facilitates the issuing of mortgage bonds, however, in practise this instrument is rarely used. To the knowledge of the Author, until the date of this thesis only one Latvian bank has in practice attempted to issue mortgage bonds, however no mortgage bonds currently remain outstanding. Moreover, the Law on Mortgage Bonds, last amended back in 2006, is also outdated.

The study also looked at the collateralization arrangements under Latvian law. The current definition in the Commercial Pledge Law – *a pledgee is a party that accepts a commercial pledge as collateral for its claim* – may lead to ambiguities. In the event of

secured bonds, secured claims are granted to the bondholders and not to the collateral agent (assignee). Therefore, based on the example of Anglo-Saxon law, a "parallel debt" concept is established which is not known within the Latvian law system and has not been interpreted also in court practice.

Currently parallel debt as an abstract obligation is not known in Latvian law; however, as long as this is a valid debt obligation under the foreign law governing the issue terms (e.g., English law), it is capable of being secured by a Latvian law governed security instrument. In this regard, it is obviously required to introduce in Latvian law a parallel debt concept in securing corporate bonds, by providing, inter alia, amendments to the Law on Commercial Pledge, envisaging that the right of commercial pledge for the benefit of the creditors on assets of debt securities or rights of claim can be secured also in favour of a third party (i.e., collateral/security agent or trustee), who may not be a creditor himself, and who is appointed by the issuer.

With regard to securing corporate bonds, the Author considers it necessary to regulate provision of collateral in a clear and undisputable fashion. In corporate bond issues, collateral is provided for the benefit of a wide range of bondholders which may change, therefore regulations should allow a specific possibility of noting in the bond prospectus, issue terms or in some other type of bond issue documentation (as the case may be) that a right of claim or commercial pledge right to bond securities in favour of creditors (bondholders) would be registered in favour of a third-party trustee of the issuer – a collateral agent who may not be a creditor themselves. Moreover, the Author concluded that under the Financial Collateral Law, the financial collateral regulation may be utilised only when one of the parties to the financial collateral arrangement is a financial institutions and thus, the respective type of collateral arrangement obviously may be provided in a limited number of cases as regards to the corporate bond issues (apparently, when the issuer of a corporate bond is a financial institution).

In the third part of the work the Author recommended a creation of a legal framework to provide for collateralization and introduction of the concept of a collateral agent. The Author suggests that it may be realized via amendments to the existing legislation and adoption of a new law, which specifically governs collateralization and introduces the concept of a collateral agent. Since Latvian law does not contain the concept of a trustee, security agent or a collateral agent, the reference to the trustee, security agent or collateral agent could be interpreted as meaning an authorized person holding the collateral (security) without any specific legal regulation and requirements. However, it is allowed to use a collateral agent concept in Latvia. Rights and obligations of the collateral agent, bondholders and issuer are determined on contractual basis, and the role of the collateral agent currently would be as of an authorised person, i.e., attorney.

Consequently, it seems possible to conclude that creation of a legal framework to provide for collateralization and introduction of the concept of a collateral agent in a clear and undisputable fashion would establish more favourable environment for the corporate bonds and thus would contribute positively to the development of the Latvian capital market.

Following the Author's research, it is advised that development of the current legislation in respect of collateral agent structures and collateralization procedure with respect to the secured debt (including corporate bond) transactions is required in Latvia and a new standalone (law) governing these issues would ultimately be the best route to take. This study recommends the further research in this area.

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