Portugal's new financial instruments

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Since 1997 the Portuguese securities market has been considered a developed market and has evolved to become increasingly sophisticated and competitive at a European Union (EU) level.

A significant step towards a modern capital market has been the integration of the Lisbon and Oporto Stock Exchanges into Euronext, which took place on January 30 2002. The merger has allowed Euronext Lisbon's stock exchange to participate in a wider European capital market that also includes the stock markets of Euronext Paris, Euronext Amsterdam and Euronext Brussels. This integration process envisages the creation of a common European capital market, in which investors may have access to a single equity and derivatives trading platform with common netting, clearing and settlement services and harmonized market rules and procedures.

The evolution of the Portuguese capital market has been accompanied by the creation of a new legal framework for the securities market implemented through the 1999 Securities Code, as well as by the introduction of new financial instruments or structures, such as warrants, securitization operations, certificates, credit-linked notes or convertible bonds.

Most of these new securities (due to their debt nature) are proving to be very useful for Portuguese public companies considering the adverse current financial and economic circumstances. In fact, since traditional equity solutions such as rights issue are often inadequate within the current securities market context, market players are searching for new financial approaches specifically designed around debt securities.

The Portuguese securities market commission , the Comissão do Mercado de Valores Mobiliários (CMVM), has recently enacted two regulations that recognized new debt securities available to the Portuguese market: convertible bonds and credit linked notes.

Convertible bonds

Under the convertible bonds regulation, it is now possible to issue reverse convertibles or mandatory convertibles in the Portuguese securities market.

According to international practice, companies usually issue convertibles as deferred equity which may be an especially attractive option in case of adverse market conditions or other constraints. On the other hand, it is also common to issue convertibles instead of straight debt instruments because of convertibles greater appeal as a sweetener whose equity element compensates for the risk.

Convertible bonds may also be used by issuers as or within a monetization instrument or structure. From investors' perspective, exchangeable bonds may also be attractive as a medium or long term investment that associates periodic revenues with the eventual or mandatory right to receive the securities of a specific issuer.

From a conceptual point of view, reverse convertibles essentially consist of a combined financial instrument that assembles a typical bond instrument with a put option right over a certain underlying security.

Under Portuguese law, these put options may be exercised at the bonds issuer's discretion if the underlying security market price is equal to or lower than a pre-determined reference price indicated in the offering materials. If this is the case the issuer may on the maturity date choose to either settle the transaction by delivering the underlying securities or by paying the corresponding amount. If the underlying security's market price is higher than the reference price on the maturity date then the issuer must settle the convertible in cash.

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Mandatory convertible bonds, on the other hand, are compulsorily exchanged into shares or bonds on maturity, in accordance with the terms laid down in the offering decision. However, the applicable regulation requires that the exchangeable shares or bonds are issued by the convertibles offeror or by group related companies, which results in a certain limitation in the use of this financial instrument.

In order to protect the interests of investors, both types of convertibles may only be issued by banks or by entities that have entered into a suitable agreement with a bank (subject to supervision rules similar to those applicable within EU countries) or with the parent company, in which the offeror's obligations are guaranteed by such bank or parent company.

Other investors protection rules have been implemented. On the one hand, if redemption of convertibles is due in a period of more than five years the offeror must ensure investors the right to exercise earlier redemption at the end of a five-year period under equitable conditions. On the other hand, advertisement of convertible bonds must include a reference to the characteristics of those securities emphasizing eventual cash settlement alternative and conditions for the delivery of the underlying securities, as well as the risk of partial or total loss of their investment.

Credit-linked notes

The other type of debt security introduced by recent CMVM regulations is credit-linked notes.

Credit-linked notes' major attraction lies on the capacity to make an economic investment in a certain underlying asset without the necessity to make a direct investment in such security.

The demand for credit-linked notes is often driven, from the investor's perspective, by the need for diversification or hedging of credit risk In the case of banks and financial institutions, credit-linked notes are often used to restructure credit portfolio risk profiles.

Credit-linked notes constitute an advantageous instrument to deal with the lack of specific underlying securities sought by investors or a difficulty in trading in the underlying security because of a lack of liquidity.

Under the new Portuguese regulation, the investor's credit right under the credit-linked notes may be conditioned by credit events set out in the offering materials. These credit events may trigger either a reduction or increase in the cash redemption amount or the delivery of debt securities listed in regulated markets (or markets subject to similar regulatory framework) issued by other entities.

The CMVM regulation on credit-linked notes also requires full disclosure of the securities' characteristics and of the risks associated to the investment in such financial products. The Commission's regulation also states that only banks and entities that have a suitable agreement with a bank or parent company may issue credit-linked notes. Subject to supervision rules and those of EU member states, an entity which issues credit-linked notes must have an agreement where its obligations are guaranteed by the bank or parent company.

The special risks involved in this type of security have lead the CMVM to impose a minimum nominal value of €25,000 ($26,775) for credit-linked notes with no guaranteed reimbursement. With this measure, it is expected that credit-linked notes are mostly addressed to qualified investors, which may have easier access to financial advisory when investing in these instruments.

Conclusion

The securities described in this article allow issuers to use more attractive instruments to raise financial resources in the Portuguese debt securities market, albeit with a higher risk profile.

As the number and type of securities available to issuers and investors in the Portuguese securities market is subject to previous legal recognition, Portuguese law does not allow as much flexibility as other jurisdictions. But it is irrefutable that important steps have been taken to keep financial players interested in investing in the Portuguese capital market while also attracting foreign investors. New competitive financial products accompanies by an adequate tax treatment have become an incentive for foreign entities to increase or initiate investment in Portugal. ∎