

## **Decision of NASDAQ Iceland in a case concerning Veðskuldabréfasjóðurinn Virðing**

Bonds of Veðskuldabréfasjóðurinn Virðing (“**the Fund**” or “**the Issuer**”) are traded on NASDAQ OMX Iceland (“**the Exchange**”). Fund management is in the hands of the management company Rekstrarfélag Virðingar hf., which has obliged itself to comply with the Exchange's Rules for Issuers of Financial Instruments. The Exchange has recently been examining disclosure of Veðskuldabréfasjóðurinn Virðing, having regard to specific provisions of Chapter 3 of the Exchange's Rules for Issuers of Financial Instruments, version of 17 December 2013 (“**the Rules**”), and whether sanctions should be applied against the Issuer due to violations of the said provisions.

Section 8.4 of the Rules states that, if the Exchange is of the opinion that an Issuer has violated provisions on disclosure requirements in Chapters 2, 4 or 6 and the violation is liable for sanctions as provided for in Points 4-7 of Section 8.3, such a case shall be referred to the Exchange's Disciplinary Committee. From this it can be concluded that violation of provisions of other chapters of the Rules than stated above, such as Chapter 3, are not subject to the decision-making powers of the Disciplinary Committee but are entirely under the authority of the Exchange.

For this reason the Exchange requested that the Disciplinary Committee provide an Advisory Opinion as to whether the Issuer had violated the said provisions of Chapter 3. There is nothing to prevent the Committee, whose operations are based on civil procedure, from providing such an Opinion; the decision-making power remains with the Exchange. The Opinion provided took into consideration the written documentation available. The Exchange's decision to apply sanctions is based upon the opinion of the Disciplinary Committee.

### **I. Circumstances of the case**

On 10 July 2014 bonds issued by the Virðing Mortgage Fund were admitted to trading on the Exchange's main market on the basis of a prospectus which was approved on 30 June 2014. The prospectus was based on financial information from the 2013 accounts, which stated that the

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Fund's total assets amounted to ISK 11,290 million, its equity (unit shares) was ISK 11,287 million and other liabilities around ISK 3 million.

The bonds themselves, with the ticker symbol VEDS1 14 01, were issued on 27 May 2014 and sold in exchange for units in the Fund. The total amount of the issue was ISK 10,800 million. These are inflation-indexed bonds with fixed annual interest of 3.5%. Interest is paid at three-month intervals, in the first instance on 15 August 2014. The Issuer's assets are also inflation-indexed with their average interest rate 5.2% according to information in the prospectus.

The section in the prospectus summary on major negative changes in the Issuer's financial situation stated that no material adverse changes had occurred in the Issuer's future prospects from 26 March 2014 until the date of issue of the prospectus. Section 13.3 of the prospectus (changes to unit shares) then stated:

*“As of 31 December 2013 the Issuer had issued 5,690,039,659 unit shares the price of which that same day was 1.98. According to Section 12 of the rules of the Issuer the Issuer may not pay a dividend to unit holders until the Fund is wound up.”*

*On 27 May 2014 unit holders received bonds of VEDS1 14 01 in exchange for their units and the Issuer redeemed the major portion of the units in this manner, in accordance with the Fund's rules. Upon the admission to trading of the bond series the number of unit shares in the Issuer has been reduced to 600,000 units.”*

On 22 August 2014 the Issuer published its interim financial statements for the first half of 2014. The announcement accompanying the results stated, among other things, that the Fund's net assets were negative by ISK 25.5 million as a result of distributions to unit holders in connection with the bond issue. That same day the Exchange decided to give the bonds observation status in view of their situation. With regard to the issue itself it was stated that the bonds had been delivered to unit holders in return for their units, in addition to which unit holders received a payment of over ISK 400 million due to the Fund's high liquidity position.

### **III. NASDAQ OMX Iceland Rules**

The requirement for an approved prospectus is one of the general requirements which must be satisfied before bonds are admitted to trading in accordance with section 3.2.4 of the Rules. Section 3.3.1 of the rules, *“Information in the prospectus”*, states that the prospectus must include

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such information as is necessary, given the nature of the Issuer and the securities, for investors to assess the assets and liabilities, financial situation, performance and future prospects of the Issuer and guarantors, as appropriate, as well as the rights conveyed by the securities. The information must be presented clearly and comprehensibly. This provision is identical to the first paragraph of Art. 45 of Act No. 108/2007, on Securities Transactions.

Section 3.1.4 of the Rules states that the Issuer's information system must, in the assessment of the Exchange, be such as to make it probable that the company will be able to comply with the demands of the Exchange, and give a realistic picture of the Issuer's operations.

#### **IV. Issuer's views**

The Issuer points out that the prospectus covered a series of asset-backed bonds with payment of the obligation secured by the Issuer's mortgages. Due to the interest spread the expected annual interest income on the Issuer assets was considerably higher than the annual interest payments on its obligations. Furthermore, the bonds were not sold by the Issuer in a public offering but delivered to the Issuer's owners in exchange for their units.

In January 2014 ISK 500 million had been distributed from the Fund to unit holders as provided for in the second paragraph of Art. 10 of the Issuer rules. This reduced the Fund's position while at the same time reducing its debt owned to unit holders by the same amount.

At the beginning of June 2014 issued bonds of the bond series of a nominal value of ISK 10.8 billion had been exchanged for all the units of the actual owners of the Issuer except for 600,000 units. When the value of the units was calculated it turned out that their value had been ISK 11.282 billion. As a result to redeem these obligations the difference of ISK 482 million had to be distributed from the Issuer's fund, cf. also the second paragraph of Art. 10 of the Issuer rules. Just as before the Fund's position had been reduced while at the same time its debt to unit holders was reduced.

The Issuer states that the above-mentioned distributions were made before the prospectus was finalised but that the the recipients of the bonds, the unit holders, were well aware of them. Although they could agree with the Exchange that such information would have been a desirable addition, this did not comprise a substantial change in the Issuer's financial position nor

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information necessary for an informed investor to assess an investment in the issued bonds on the secondary market.

In assessing whether the contents of information in a prospectus was satisfactory with reference to Section 3.3.1 of the Exchange's Rules the nature of the Issuer and the securities had to be taken into consideration. In this connection it was of principal significance that what was concerned was a series of asset-backed bonds issued by an institutional investor fund of eight pension funds, where the obligation was secured by the Issuer's mortgages and the cash flow from them.

The prospectus had provided comprehensive information on the bonds themselves, the mortgages which secured the obligation, the Issuer's positive cash flow from the above-mentioned assets/obligations and the main risks in connection with the Issuer and the bonds. It derives from the above that necessary information which could have had "a significant impact on the market price" of the bonds was available, and the Exchange has not demonstrated otherwise. The provision of Section 3.3.1 of the Exchange's rules was thereby satisfied.

In preparing the Issuer's interim financial statements in August 2014 it was discovered that the Fund's equity was negative by around ISK 25.5 million. The explanation is that in exchanging the bonds issued for units the impact of inflation on calculations was not taken into consideration. The information on negative equity was not available when the prospectus was prepared and the same applies to this as above in an assessment as to whether Section 3.3.1 of the Exchange's Rules was violated. In assessing an investment in asset-backed bonds such as this the cash flow is of main importance and not a temporary negative equity position which amounted to only around 5% of the 6M profit and had no impact on the Issuer's financial position. All the same, the prospectus included the necessary information which could have had "a significant impact on the market price" of the bonds, and the Exchange has not demonstrated otherwise.

With regard to the information on negative equity, information on this situation was published in the announcement of the 6M results. An employee of the Exchange was consulted on this publication and his instructions were followed. The Exchange gave no instructions to publish a special notification or to accelerate disclosure in connection with the Issuer's temporary negative equity position based on Sections 4.1.2 and 4.2.1. As a result, in assessing the publication of this information regard should be had for their publication as part of the announcement accompanying the 6M results, cf. Section 4.3 of the Rules. In this respect it is established that the interim

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financial statements were endorsed by the Issuer's Board of Directors on 21 August 2014. Thereafter the interim financial statements had to be arranged in suitable format for publication and the announcement prepared, in addition to which in communications with the Exchange on a draft of the announcement suggestions were made which were taken into consideration. The annual financial statements were published once this work was complete, on 22 August 2014, "as promptly as possible" and within two months of the end of the statement period, cf. Section 4.3.1 of the Rules.

The Issuer points out that the Exchange had not made any special analysis or examination of the Issuer's information system despite the contention that the information system did not comply with Section 3.1.4 of the Rules because the Issuer's equity had been negative for two months without it being aware and that the fact that equity had become positive was not published until the Exchange drew attention to the matter.

The Issuer points out that the issuance of the bonds, their exchange for units and their admission to trading on a regulated securities market had been undertaken at the same time as the transfer of the Issuer from the management company Rekstrarfélag ÍV to the management company Rekstrarfélag Virðingar, the transfer of collection from the Akureyri branch of Íslandsbanki to the branch on Suðurlandsbraut, work was underway in merging Auður Capital hf. with Virðing and information systems were being replaced. As a result of these changes in the operating environment it was not discovered that equity was negative by 0.2% of the Issuer's then current asset position until the 6M results were being prepared in August 2014. The long and the short of it is that clearly systems were changed and procedures were also reviewed. The Issuer considers its new information systems to be satisfactory.

Regarding the publication of information on positive equity, the Issuer points out that its announcement with the 6M results in August 2014 stated that based on the cash flow on the underlying assets and the bonds (positive interest margin) equity would have become positive by the end of October 2014. This had nothing to do with the information systems, however, it was regarded as a matter of course to comply with the Exchange's recommendations and publish information in this regard.

The Issuer points out that the Exchange's queries gave no cause to discuss specifically a payment of ISK 500 million to unit holders in January 2014.

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Finally the Issuer states that the Exchange's rules were not violated. If, however, it is concluded that there was a violation then, with reference to non-discrimination it should only be reprimanded, and in this regard the Issuer refers to other cases which have concluded with a reprimand. In addition, it is pointed out that there was no trading in the Issuer's bonds during the period in question. The scope of trading is an important aspect which should be considered in assessing sanctions, for instance, having regard to the principles of administrative proportionality and non-discrimination.

## **V. Conclusion**

According to Section 3.3.1 a prospectus must include such information as is necessary, given the nature of the Issuer and the securities, for investors to assess the assets and liabilities, financial situation, performance and future prospects of the Issuer and guarantors, as appropriate, as well as the rights conveyed by the securities. The information must be presented clearly and comprehensibly. A summary of the information which is to be provided is given in Act No. 108/2007, on Securities Transactions and Regulations issued based on the Act.

It is established that on 10 July 2014 bonds issued by the Virðing Mortgage Fund on 27 May 2014 were admitted to trading on the Exchange's main market on the basis of a prospectus which was approved on 30 June 2014. The financial information in the prospectus was as of 31 December 2013. The Fund's total assets were said to amount to ISK 11,290 million. It was nowhere directly stated in the prospectus that after the financial information date ISK 500 million had been paid to the unit holders on 22 January 2014 and ISK 482 million on 4 June 2014. In this respect the prospectus did not fulfil the requirements set forth in Section 3.3.1 of the Rules. In this connection it should be recalled that the rules on prospectuses are all intended to ensure that investors can take an informed decision as to whether they wish to conclude transactions in the securities in question. In assessing the seriousness of the violation consideration must be given, in the estimation of the Exchange, to the fact that this was a substantial change in the Issuer's financial situation, as the disbursements amounted to approximately 9% of its total assets. Accordingly, it is the conclusion of the Exchange that the Issuer seriously violated Section 3.3.1 of the Rules by the above-mentioned conduct.

Section 3.1.4 of the Rules states that the Issuer's information system must, in the assessment of the Exchange, be such as to make it probable that the company will be able to comply with the

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demands of the Exchange, and give a realistic picture of the Issuer's operations. In assessing whether an issuer is regarded as having violated this provision it is of significance how long a period elapsed from the time the information should have been published until this was actually done. Generally speaking the longer the time which elapses in this regard the more likely it is that the Issuer's information system cannot be considered to satisfy the requirements laid down in Section 3.1.4 of the Rules. In the case under consideration here it was not until 22 August 2014, when the 6M results for 2014 were made public, that the information was revealed that the Fund's net assets were negative by ISK 25.5 million, due to disbursements to unit holders in connection with the bond issue. That same day the Exchange decided to give the bonds observation status. The Exchange's inquiries to the Issuer revealed that on 4 June 2014 the Fund's equity had become negative upon the settlement of the payment of ISK 482 million to unit holders.

After examining the case further, the Exchange regarded it as evident that the ISK 482 million payment to unit holders alone should not have resulted in the Fund's negative equity position. The Issuer confirmed in a letter of 22 January 2015 that a decision had been taken to pay ISK 500 million to investors on 22 January 2014.

The Exchange is of the opinion that, without regards to the question of the Issuer's authorisation to make the above-mentioned payments to unit holders with reference to the authorisation in the second paragraph of Art. 10 of the Fund's rules, the Issuer should have made this information public if it had not previously been made public, as it should have known that this could have a significant impact on the market price of the said bonds. For the same reason, the Issuer's contention that this did not comprise a major change in its financial position must be rejected, since the disbursements amounted to around 9% of the Issuer's total assets.

Having regard to the above, the Exchange considers it evident that the Issuer, in its conduct, violated Sections 3.3.1 and 3.1.4 of the Rules. In accordance with the opinion of the Disciplinary Committee, the Exchange is of the opinion that the management company Rekstrarfélag Virðingar hf. should be reprimanded publicly, on behalf of the Issuer, for the above-mentioned violation of the Rules of NASDAQ OMX Iceland. The decision on a public reprimand is taken on the basis of the agreement between Rekstrarfélag Virðingar hf., on behalf of the Issuer, with the Exchange for the admission of financial instruments to trading on the Exchange, cf. Section 8.3 of the Rules. Point 4 of the provision states, among other things, that in the event of the Issuer's



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violation of the Exchange's Rules for Issuers, the Exchange may make a public announcement concerning the said matter.

Point 6 of Section 8.3 authorises NASDAQ OMX Iceland to levy sanctions on the Issuer in the form of fines. In light of the fact that the Disciplinary Committee has already taken a decision to levy a fine on the Issuer in addition to a reprimand, cf. the decision in case no. 1/2015, the Exchange is of the opinion that the above-mentioned decision of the Committee should be considered in determining further sanctions, since both cases concern the same issuer and can be traced to the same circumstances. It is therefore considered appropriate, in determining what are considered suitable sanctions in this instance to take into consideration the fact that the Committee has already recommended that Rekstrarfélag Virðingar hf., on behalf of the Issuer, be reprimanded and assessed a fine in the amount of ISK 1.5 million in case no. 1/2015.

Having regard to all of the above, it is the opinion of NASDAQ OMX Iceland that in addition to a public reprimand a fine of ISK 1.0 million is considered a suitable sanction.