

**DISCIPLINARY COMMITTEE
NASDAQ ICELAND**

Decision in case no. 1/2015

Bonds of Veðskuldabréfasjóðurinn Virðing (“**the Fund**” or “**the Issuer**”) are traded on NASDAQ OMX Iceland hf. (“**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, version of 17 December 2013 (“the Rules”).

The Exchange has requested that the Disciplinary Committee take a decision as to whether sanctions should be applied against the Issuer in accordance with the above-mentioned Rules.

The Decision by the Disciplinary Committee is based on the written documentation which is available.

I.

According to the information of the Exchange and the documentation in the case, the main circumstances of the case are as follows:

On 10 July 2014 bonds issued by Veðskuldabréfasjóðurinn Virðing 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 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 material adverse changes in the Issuer's financial situation stated that no major undesirable 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:

On 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 for Issuers an 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 equity had been 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 this 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 cash payment of over ISK 400 million due to the Fund's high liquidity position.

On 4 September 2014 the Exchange requested explanations from the Issuer, among other things, as to when unit holders had received a payment of ISK 400 million and when the Fund's equity had become negative. If either of these events had taken place before the Fund applied to have the bonds admitted to trading the Exchange requested explanations as to where and in what manner this had been disclosed in the prospectus. If this had not been disclosed in the prospectus the Exchange requested explanations as to why this had not been done. Finally the Exchange requested information as to whether the Issuer's equity was still negative and, if this was the case, when the Issuer considered it likely that the position would become positive.

The Issuer's reply of 18 September 2014 explained, among other things, the background to the Fund's equity becoming negative, in addition to responding to the Exchange's questions. The Issuer pointed out that the difference in the value of the Fund and the value of the bond was to be distributed to unit holders. A settlement in connection with the issue of the bonds and the distribution had taken place on 4 June 2014, but when the amount of payment was calculated it had been neglected to recalculate the bond to take the CPI increase into consideration, with the result that

overpayment was made to investors. In the end the cash payment amounted to around ISK 482 million.

The Issuer also stated that its equity had become negative on 4 June 2014, upon the settlement of cash payment to unit holders. This payment had not been disclosed in the prospectus but in the summary section, item B33, it had been stated that unit holders had decided to exchange their unit shares for bonds. It was also stated that the negative equity position had been disclosed as soon as it came to light upon the publication of results. However, it was disclosed that the situation had been clear to the Issuer when the draft interim financial statements were available on 19 August 2014. It was also stated that the Issuer had expected the Fund's equity to become positive around the end of October/beginning of November.

On 31 October 2014 the Issuer published an announcement to the effect that it had decided to activate a prepayment option to make a payment on the principal of the bond as provided for in the terms and conditions and the Fund's prospectus. Later that same day the Exchange sent an e-mail to the Issuer to obtain information as to whether the Fund's equity position was now positive. The Issuer confirmed that this was so. The Issuer then published an announcement saying that the Fund's net assets had become positive, at the suggestion of the Exchange. Thereafter the Exchange removed the observation status of the bonds, making reference to the Issuer's announcement.

On 11 November 2014 the Exchange requested explanations as to when the Fund's equity had become positive and why an announcement to this effect had not been published without delay.

The Issuer's response of 25 November 2014 stated that the Fund's equity had become positive on 31 October 2014. It also referred to an announcement from the Fund accompanying its 6M results, which was published on 22 August 2014, stating that due to its positive interest margin the Fund's net assets would become positive by the end of October 2014. In light of this the Issuer did not consider itself to have been too late in notifying publicly that the Fund's equity had become positive, as it had become positive at the time which had already been announced in the Fund's prognosis of 22 August 2014.

On 1 December 2014 the Exchange requested further explanations from the Issuer. In the estimation of the Exchange, after examining the case further it had come to light

that the ISK 482 million payment to unit holders alone should not have resulted in the Fund's negative equity position. More had been needed. Among other things, the Issuer was requested to explain what had caused a drop in the price of the fixed-income securities owned by the Fund, when the Issuer had become aware of this decrease and why information on the decrease had not been provided in the prospectus. This was done making reference to the fact that the Issuer's interim financial statements, which were published on 22 August 2014, stated among other things that the value of the fixed-income securities had decreased from ISK 10,825,250,000 to ISK 10,303,729,568, making a drop of ISK 522 million. Having regard to communications between the parties and that the Fund's equity had been negative for around two and a half months without the Issuer becoming aware of it, the Exchange requested that the Issuer provide justification that its information systems were satisfactory, cf. Section 3.1.4 of the Rules, which states that the Issuer's information system must 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.

The Issuer's reply of 19 December 2014 referred with regard to the former point to explanations from the Issuer of 18 September 2014. With regard to the information systems the Issuer considered them to be satisfactory. After the errors were discovered the Issuer had placed special emphasis on improving procedures in connection with the Fund; the system used today calculated the daily position of the securities with accrued indexation and movements from the Icelandic Banks Data Centre (RB), installments paid and defaults were reconciled daily and each month the outcome was reconciled with a bank account.

At a meeting between the Exchange and the Issuer on 12 January 2015 the matter was reviewed in its entirety. Following that meeting the Exchange sent a request for further explanations in an e-mail. The Exchange was endeavouring to understand what had caused the decrease in the value of the Fund's assets since year-end 2013 until the bonds were admitted to trading. Based on previous communications and discussions at the meeting the changes were attributable, firstly, to a cash distribution to investors and, secondly, to a decrease in the value of fixed-income securities due to paybacks. It was pointed out that the cash payment had been discussed in previous replies from the Fund but there remained the decrease in the value of the securities and the Issuer was asked to explain whether, and if so in what manner, this had been disclosed in the prospectus.

The Issuer's reply of 22 January 2015 explained that in mid-January 2014 the Fund's cash position had been ISK 550 million, and a decision had been taken to distribute ISK 500 million to investors on 22 January 2014, as the Fund's investment period had concluded.

II.

Section 8.4 of the Rules for Issuers of Financial Instruments 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 cases shall be referred to the Exchange's Disciplinary Committee.

The Exchange is of the opinion that the Issuer had seriously violated Sections 4.2.1 and 4.1.2 of the Rules for Issuers of Financial Instruments and requests a decision of the Disciplinary Committee as to whether the Issuer's conduct should be liable to sanctions pursuant to the Exchange's Rules. In the estimation of the Exchange, by its conduct *Veðskuldabréfasjóðurinn* also violated Sections 3.1.4 and 3.3.1 of the Rules. Since violations of provisions of Section 3 of the Rules are not subject to the decision-making powers of the Disciplinary Committee, cf. Section 8.4, no position is taken on those provisions in this decision.

III.

The Exchange points out that the Issuer nowhere mentioned the ISK 500 million cash payment to unit holders on 22 January 2014 and the cash payment of ISK 482 million on 4 June 2014, together totalling around ISK 1 billion, or equivalent to around 9% of the Fund's total assets based on the financial information in the prospectus. The Exchange also points out that, despite repeated queries, the Issuer only informed the Exchange of the ISK 500 million payment to unit holders which had taken place in January 2014 in an e-mail of 22 January 2015, although this directly concerned a central point in the Exchange's previous queries.

By neither disclosing the said cash payment to unit holders nor the Fund's actual financial position in the prospectus and the fact that its equity was negative, in the Exchange's estimation the Issuer violated Section 3.3.1 of the Rules. A violation of this provision is not being resolved in the present instance, as previously mentioned. However, since this concerns information which was likely to have a significant impact on the market price of its bonds the Issuer should have made this public

without delay once the bonds were admitted to trading, as provided for in Sections 4.2.1 and 4.1.2 of the Rules.

IV.

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's 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 cash funds to unit holders as provided for in the second paragraph of Art. 10 of the Issuer's rules. This reduced the cash position while at the same time reducing debt owed 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 cash, cf. also the second paragraph of Art. 10 of the Issuer's rules. Just as before the cash position had been reduced while at the same time debt to unit holders was reduced.

The Issuer states that the above-mentioned distributions were made before the prospectus was finalised but that 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 information necessary for an informed investor to assess an investment in the issued bonds on the secondary market.

The Issuer states that, 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.

The Issuer points out that in its comments of 4 May 2015 the Exchange states that the “information” should have been made public without delay after the bonds were admitted to trading. It is not clear whether this refers to publication of information on both the above-mentioned distributions and the fact that equity was negative or only the latter. In this connection it should be pointed out that in previous communications with the Exchange it was not contended on the Exchange's part that information concerning the distributions should have been published pursuant to Sections 4.1.2 and 4.2.1 of the Rules. The Issuer had agreed with this assessment, as this was information on events which had occurred prior to the admission of the bonds to trading and which was not likely to have “a significant impact on the market price of the bonds”, as previously explained.

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 guidance on publishing 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 its 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 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 interim 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 said that the Exchange's queries gave no cause to discuss specifically the payment of ISK 500 million to unit holders in January 2014.

Finally the Issuer states that the Exchange's rules were not violated. If, however, it is concluded that there is 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 shares 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.

The dispute in this case concerns whether Veðskuldabréfasjóðurinn Virðing violated Sections 4.2.1 and 4.1.2 of the Rules for Issuers of Financial Instruments.

The objective of Section 4.1.2 of the Rules is to ensure that investors have at all times access to the most recent information necessary to be able to form an opinion on the investment options on offer. The management of the issuer should therefore always make every effort to make public information which in their opinion could have a significant impact on the market price of securities. Section 4.2.1 of the Rules states that an issuer shall make every effort to make public without delay all previously unpublished information on decisions or events which it knew, or should have known, to have a significant impact on the price of its bonds.

It is established that on 10 July 2014 bonds issued by the Veðskuldabréfasjóðurinn Virðing 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.

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. 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 on 22 January 2015 that a decision had been taken to pay ISK 500 million to investors a year earlier, on 22 January 2014.

The Issuer has objected to the Exchange's position on the grounds related in Section IV. With reference thereto it should be pointed out that it is the responsibility of the

Issuer, having had bonds admitted to trading, to comply at all times with the Rules laid down in Section 4 of the Rules for Issuers regarding the information disclosure of bond Issuers, cf. for instance Section 4.1.1. The Disciplinary Committee is also of the opinion that, disregarding 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. The Issuer's contention that this did not comprise a major change in its financial position must also be rejected, since the disbursements amounted to around 9% of the Issuer's total assets.

Provisions of Section 4 of the Rules regarding bond Issuers' information disclosure are intended in part to encourage equal treatment of investors, increase market transparency and with it the trust and credibility which must prevail there. As related above the Issuer allowed a lengthy period to elapse before disclosing that distributions, firstly, of ISK 500 million and, secondly, of ISK 482 million had been made to unit holders. In the estimation of the Disciplinary Committee this comprises important information.

After considering all of the above, it is evident that by its conduct the Issuer violated Sections 4.1.2 and 4.2.1 of Rules for Issuers of Financial Instruments. Furthermore, the Exchange's contention that this comprised a serious violation must be accepted. It is not considered to make any difference in this connection that the Issuer's behaviour may also violate provisions of Section 3 of the Rules on admission of bonds to trading, as violations of provisions of that Section are not under consideration in this case, cf. Section 8.4 of the Exchange's Rules.

As previously mentioned, management of Veðskuldabréfasjóðurinn Virðing is in the hands of the management company Rekstrarfélag Virðingar hf. With reference to the above, it is deemed appropriate to publicly reprimand the management company Rekstrarfélag Virðingar hf. on behalf of the Issuer for the above-mentioned violations 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, and 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 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 of the Rules authorises the Exchange to levy sanctions on the Issuer in the form of fines. Having regard to all of the above, in the opinion of the Disciplinary Committee it is appropriate to levy a fine of ISK 1.5 million on the management company Rekstrarfélag Virðingar hf. on behalf of the Issuer.

DECISION:

The management company Rekstrarfélag Virðingar hf., on behalf of the Virðing Mortgage Fund, is to be publicly reprimanded for violations of Sections 4.1.2 and 4.2.1 of the Rules for Issuers of Financial Instruments. Furthermore, Rekstrarfélag Virðingar hf. shall pay a fine of ISK 1,500,000 for the same violations.