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Ruling

Category: Capital Structure

NOTICE*

Subject: Conversion of subordinated debt

No: **2005-01**

Issue: A bank proposed to issue subordinated debt fully paid for in money that would automatically be converted to shares if a specified event were to occur. The issue was whether the conversion of this subordinated debt of the bank to shares would constitute an issuance of shares of the bank for property that would require prior approval of the Superintendent pursuant to subsection 65(1) of the *Bank Act* (BA).

Background: The bank proposed to issue subordinated debt, fully paid for in money, with terms and conditions providing that the debt would convert to shares of the bank if a specified event were to occur. The bank was of the view that the conversion of its subordinated debt to shares was an "issuance of shares" and that the money paid into the bank's stated capital for the shares was the consideration for the issuance of such subordinated debt. The bank was of the view that it did not require the Superintendent's approval pursuant to subsection 65(1) of the BA when the conversion of the subordinated debt (property) resulted in the issuance of shares.

Considerations: OSFI concluded that, until the specified event occurs, the debtholders only have a contingent right to the class or series of the shares of the FRFI that the shareholders will acquire on the exercise of the conversion privilege. This is supported by subsection 69(3) of the BA, which requires a bank to reserve sufficient authorized shares to meet the exercise of the conversion privileges attached to its issued and outstanding debt. Therefore, the conversion of subordinated debt of a FRFI into a class or series of shares of the FRFI represents a new issue of shares.

OSFI further concluded that the consideration paid in respect of issued and outstanding subordinated debt (of a FRFI) that has a conversion privilege could be the consideration paid in respect of a class or series of shares that the FRFI will issue on the exercise of the conversion privilege. Thus, if the outstanding debt was paid for in money, the shares that the FRFI will issue on the exercise of the conversion privilege will be deemed to have been paid for in money. OSFI concluded that, since one bundle of rights is being substituted for another bundle of rights, the monies paid for the first bundle of rights could be said to have been paid in respect of the second bundle of rights. This is supported by section 78 of the BA, which prescribes the adjustments that a bank must make to its liabilities and stated capital account on the conversion of any outstanding debt obligation of the bank into shares of the bank. It should be noted that the facts of issue are similar to those of Ruling 2001-01: Conversion of Shares.

Conclusion: OSFI concluded that the subsequent issuance of shares resulting from the conversion of the subordinated debt that had been originally fully paid for in money does not require the Superintendent's approval pursuant to subsection 65(1) of the BA.

In addition, even if the issuance of the subordinated debt had been originally fully paid for with property and required the Superintendent's approval at that time under subsection 80(1) of the BA, an additional approval would be required from the Superintendent pursuant to subsection 65(1) of the BA for the conversion of the debt into shares. OSFI is willing to grant the subsection 65(1) approval concurrently with the subsection 80(1) approval.

Legislative References:

Subsection 65(1) of the BA states that no share of any class of shares of a bank shall be issued until it is fully paid for in money or, with the approval of the Superintendent, in property.

Subsection 69(3) of the BA states that where a bank has granted privileges to convert any securities issued by the bank into shares, or into shares of another class or series, or has issued or granted options or rights to acquire shares, if the by-laws limit the number of authorized shares, the bank shall reserve and continue to reserve sufficient authorized shares to meet the exercise of such conversion privileges, options and rights.

Section 78 of the BA states that on a conversion of any debt obligation of a bank into shares of a class or series of shares, the bank shall

(a) deduct from the liabilities of the bank the nominal value of the debt obligation being converted; and

(b) record the result obtained under paragraph (*a*) and any additional consideration received for the conversion in the stated capital account maintained or to be maintained for the class or series of shares into which the debt obligation has been converted.

Subsection 80(1) of the BA states that a bank shall not issue any subordinated debt unless it is fully paid for in money or, with the approval of the Superintendent, in property.

Table of Concordance:

Section Description	BA	TLCA	ICA	CCAA
Consideration for share	65	68	69	74
Conversion privileges	69	71	72	76
Addition to stated capital account	78	81	82	85
Consideration for debt	80	83	84	87

The table of concordance makes cross-references to other provisions of FRFI legislation that may be of relevance to the reader.

* Rulings describe how OSFI has applied or interpreted provisions of the federal financial institutions legislation, regulations or guidelines to specific circumstances. They do not negate the need to obtain any necessary approval of the transaction under the relevant federal financial institutions legislation. Rulings are not necessarily binding on OSFI's consideration of subsequent transactions as these transactions may raise additional or different considerations. Legislative references in a Ruling are not meant to substitute provisions of the law; readers should refer to the relevant provisions of the legislation, regulation or guideline, including any amendments that came into effect subsequent to the Ruling's publication.