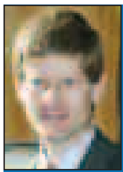

INTRODUCTION

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The ACT aims to contribute to public debate, governmental and regulatory policy and the overall development of issues impacting the professional interests of the ACT's members. This can occur at a very general policy level or at the more immediate and practical level. This month's technical update illustrates the various extremes where the ACT has been influential, or where we hope to be so.

The continuation of the UK's existing restrictions on dealing when in possession of relevant non-public information and the very specific clarifications given by the Inland Revenue on the tax treatment of interest ratchet clauses in loan agreements are both examples of the ACT's voice being directly successful.

In other areas the influence of treasurers may be less obvious, but the work we all do to develop and improve our treasury management practices does over time have an effect. We hope the two articles in the Update Extra section help to trigger some ideas that can be applied in the near term.

The potential for corporates to make use of CLS (see Technical Update Extra page 50) may help in the management of settlement risks, and the summary of the IFRS briefing note is to help borrowers in their plans to explain to their lenders the consequences of the change to IFRS. ■

Clarification on ratchet loan tax

In a ratchet loan the rate of interest is linked to a ratio such as Total Debt/EBITDA. For many years, if a UK company pays interest that is dependent upon the results of the business, the interest has been treated as a "distribution." That makes it non-deductible for tax purposes. The provisions were designed to prevent mischief such as extracting profits in the form of tax-deductible interest on profit participating loans.

A few years ago, it was realised that the tax law also caught loans where there was no intended profit participation, but the rate of interest was varied to reflect the improved creditworthiness of the company if its profits increased, i.e. the rate of interest increased if profits fell, while reducing if profits rose. Accordingly, in 2000 the law was changed to stop interest being treated as a distribution if the interest reduced as "results" improved and vice versa.

After the relieving legislation was enacted, doubts emerged as to whether it was wide enough to encompass linkages more complex than a simple link of interest to profits. A common case in practice is for the rate of interest to increase if the ratio Total Debt/EBITDA increases, and vice versa. Arguably, "Total Debt/EBITDA" is not the same as "results" which might mean that the new relieving legislation was inapplicable, leaving the interest non-deductible.

This caused considerable uncertainty in the syndicated loan market, where such provisions occur reasonably often. When the Inland Revenue was approached for guidance, its initial reaction was that there might still be a problem. The ACT took up the issue along with the Loan Market Association. A careful analysis of the original law and the relieving provisions, plus the supply of actual market documentation, has persuaded the Inland Revenue to confirm that in third party situations, a ratio based ratchet such as Total Debt/EBITDA is capable of benefiting from the new rules. The Inland Revenue has published an additional section in the Inspectors' Manual on its website, at **www.inlandrevenue.gov.uk/manuals/ct123manual/ct1552b.htm**. ■

Derivative dealings during a takeover

The Takeover Panel is concerned about the use of derivative instruments to build up stakes in securities during a takeover without being bound by the existing disclosure rules. For example, the purchaser of a contract for differences (CFD) over a share has an economic exposure to the price of that share. The writer of the CFD retains the legal ownership of the share but has no economic interest in the share and will rather be motivated by the desire for doing further CFD business. Accordingly, they will normally be willing to exercise the voting rights of the hedged shares in accordance with the wishes of the CFD holder. It is proposed therefore that the Takeover Code should be extended to apply to dealings and holdings in CFDs.

During an Offer Period the Code requires disclosure of dealings in options and derivatives only "if the person dealing in such options or derivatives owns or controls 1% or more of the class of securities which is the subject of the option or to whose price the derivative is referenced." If the person's only holding is in the form of derivatives then, no matter how large that holding, it escapes the disclosure provisions. The Panel is proposing that:

- long positions in shares in the offeree and (where appropriate) the offeror should be disclosed at the 1% threshold;
- short positions should not of themselves require disclosure;
- long positions in the shares themselves, derivatives and written put options should all count and be aggregated for this purpose;
- the gross long position should be counted, without any allowance for related short positions.

The Panel is also proposing an amendment to require disclosure of any dealing which has the effect of taking a person's aggregate long position through the 15% threshold or, if previously between 15% and 30%, through a whole percentage point (and comparable reductions in a long position).

Another of the existing rules requires a person who acquires shares taking his holding to 30% or more to make a cash offer to all shareholders. At present, cash settled long derivatives positions do not generally count in determining whether the relevant holding thresholds have been reached for the purposes of any of these rules. The Panel is considering changes so that all dealings in long derivatives and options are treated as dealings in the underlying shares for the purpose of the Code and the mandatory bid rules. ■

What is Inside Information?

The legislation necessary to implement the Market Abuse Directive (MAD) in the UK is about to go before Parliament and the question has arisen whether or not the UK should "go beyond" the Directive requirements to preserve the existing UK standards on insider trading.

The directive prohibits anyone in possession of inside information from dealing (or attempting to deal) in relevant securities or encouraging others to deal. The definition covers "information in relation to financial instruments or issuers that is precise, not in the public domain and which, if it were made public, would be likely to have a significant effect on the prices of those instruments or on the price of related derivative instruments. Information that would be likely to have a significant effect on prices is information a reasonable investor would be likely to use as part of the basis for his investment decision." Note that the information must be "precise".

In the UK there is a slightly wider definition than used in the MAD. Currently there are restrictions on trading in securities by persons possessing relevant information not generally available (RINGA). RINGA is defined to include information such as the directors' consideration of a major reorganisation or a change of strategy for the issuer which would probably be excluded from the MAD definition of "inside information" as not being sufficiently specific.

The ACT, in its submissions to HM Treasury, has agreed with the Treasury's and FSA's own explanation that the restrictions are needed to "explicitly prohibit people from trading to their advantage and to the disadvantage of others on the basis of information not generally available to investors." An example would be information about the state of negotiations over a major contract. Knowing which way it was heading, even if not finally decided or signed, is valuable nonetheless. The end result has been that the proposals going to Parliament are expected to retain the UK's wider definition for a further three years. However unless new legislation is subsequently introduced, the UK will thereafter revert to the narrower EU definition.

Retaining rules in the UK that are different from the rest of Europe does not help achieve the sought after uniformity across the EU financial markets. In many other areas the ACT would resist creating additional burdens on the UK industry, often known as "gold plating". But surely in this case it cannot be morally or legally right for insiders to be able to benefit from special private information albeit that such information is not precise? ■

DMO considers ultra-long gilts

Arising out of the December pre-budget report the Debt Management Office (DMO) has been consulting about the possible introduction of ultra-long (circa 50-year) conventional and index-linked gilts and ultra-long conventional and index-linked annuity-type gilts. There has been strong demand from the UK pension industry and other investors for long-dated high quality bonds and this is likely to increase in the future as a result of demographic changes and the evolution of risk management practices within pension funds (i.e. closer matching of assets and liabilities). The current supply of ultra long and indexed gilts falls short of demand.

Following the issue of the EIB longevity bond created by BNP Paribas late last year the debate has widened as to whether the government should issue gilts with similar features. In a way it can be argued that the state already bears the risk of being the ultimate provider of pensions to the destitute. Therefore it might be in their interests to encourage the commercial provision of pensions through the Government taking on some of the burden of longevity risk through a formal gilt arrangement.

The DMO views these broader issue about the transfer of longevity risk onto the Government's balance sheet as going beyond a strict interpretation of debt management considerations. Accordingly, the issuance of longevity bonds is not currently envisaged for 2005-06, although the DMO and HM Treasury may revisit this issue at a later date.

At the same time, the DMO has announced that any new index-linked gilts will have a three-month as opposed to the current eight month inflation lag. This is to move the UK into line with current international best practice. ■

IN BRIEF

- **The Department of Trade and Industry** (DTI) has published guidance for British companies on the changes to the reporting and accounting provisions of the Companies Act 1985. The guide is at one level very straightforward, but is also technically detailed by including full cross references to legislation and links to other websites The guidance is available at www.dti.gov.uk/cld/N0000J8Q.doc

- The **FSA** has published its *Financial Risk Outlook 2005* outlining its views on priority areas both at the personal level and through to the risk management by firms of complex and relatively illiquid instruments. It warns of risks from proprietary trading and that with falling credit spreads investors are searching for yield without considering the fundamental investments risks.

- The **FSA** has also produced its first *International Regulatory Outlook*, reflecting the level of forthcoming regulatory initiatives from international sources. This document details the array of international regulatory activities that will affect UK firms and consumers.

- The **International Organisation of Securities Commissions** (IOSCO) has published in final form its Code of Conduct Fundamentals for Credit Rating Agencies. This code is welcomed by the ACT. Its fairly high level principles broadly cover the same ground as the Code devised jointly by the ACT and the treasury associations in France and the US. See www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf

- A working group initiated by **The European Securities Forum** (representing major international banks operating in the European securities markets) has published a report proposing the full dematerialisation of UK securities and an extension of shareholder rights to ensure enfranchisement of investors who hold shares through a nominee. See www.eurosf.com

- The **ACT** has responded jointly with the AFTE in France to the CESR (Committee of European Securities Regulators) consultation on regulating the credit rating agencies. The treasury associations have proposed that no regulation is required, at least until the effects of the IOSCO Code can be assessed. See www.treasurers.org/technical/papers/index.cfm #ratings