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▸ **New rules for the reduction of share capital for private companies** come into force on 1 October 2008. The Companies (Reduction of Share Capital) Order 2008, published on the Office of Public Sector Information website, prescribes the form in which a solvency statement must be made so that a private company can reduce its share capital without getting a court order. The reserve created from that reduction is treated as realised profit and is therefore distributable.

▸ **Inadequate controls on confidentiality in debt capital markets** are flagged by the FSA in issue 28 of its Market Watch newsletter. Firms involved in the debt capital markets should review their systems and controls to manage the interaction between the public and private side, including such simple matters as ensuring conversations by the syndicate desk cannot be overheard. The FSA also reminded firms that since March 2008 they are required to keep phone recordings of voice and electronic communications for six months and occasionally longer if an investigation is in train.

▸ **Additional disclosures by non-investment grade issuers of debt securities** have been recommended by the European High Yield Association and the Loan Market Association. The principles being sought for securities that are listed or otherwise publicly traded are:

1 Disclosure of debt documentation and amendments covering all its material debt facilities and inter-creditor arrangements, including agreed amendments and waivers, to be available via the issuer's public website or a public news service.

2 The offering memorandum should also disclose the key terms of the issuer's other material debt facilities and other financings, including key payment terms availability, interest rate, maturity and amortisation, financial covenants, guarantees and security, and terms of any inter-creditor arrangements.

3 Ongoing disclosures should be promptly made of material amendments and waivers of any terms of its debt facilities, new or refinanced material debt facilities, and payment or covenant defaults.

While some elements of this investor wish list may be commonplace for speculative-grade issuers, on other proposals issuers will need to assess carefully the merits of any additional voluntary disclosure and indeed whether it is even permitted under confidentiality clauses in other debt agreements.

INTRODUCTION

By Martin O'Donovan
ACT assistant director, policy and technical

The summer holidays mark a definite slowdown in financial activity. It is particularly frustrating for treasury departments that want to make rapid progress on projects only to find that key people are away from their offices. For governments and the financial authorities across Europe nothing much happens in August, but the corollary is that officials clear their desks at the end of July and announce all manner of ideas and consultations, before heading off to the beach. For that reason this month's Technical Update is distinctly overweight on a host of changes that might affect a corporate treasurer.

UK's capital raising process comes under scrutiny

Managing the process for issuing additional equity has been in the news, principally around rights issues by banks and subsequent movements in share prices.

The heart of the matter is whether the UK rights issue regime is fitter for purpose than the US book build/placement routes. The ACT and others, such as the Association of British Insurers (ABI), maintain that the system of pre-emption rights for existing shareholders in UK and EU company law is superior to the use of placements in the US.

In a letter to The Financial Times newspaper, John Grout, the ACT's policy and technical director, said: "Discouraging dilution of control and transfer of value from existing shareholders to newcomers is very important as part of minimising long-run cost of capital for companies."

In July, Alistair Darling, the chancellor of the exchequer, created a working group to look at the efficiency of the UK's capital raising process. In response, the ABI has prepared a discussion paper with some helpful proposals:

- the government should use its powers under the Companies Act 2006 to reduce the rights offer period to two weeks; and
- more time could be saved if rights trading was allowed, on a contingent basis, ahead of any extraordinary general meeting required to authorise a new allotment of shares.

Rather more controversially, the ABI has also suggested a code of conduct for underwriters, sub-underwriters and investors to refrain from short-selling and stock lending throughout the issue period. A good idea but is it workable in the real markets?

The chancellor's working group was conceived to look at fundraising by financial institutions. However, the working group will also examine current market practices of public companies raising equity capital even though non-financial listed companies are significantly under-represented on the group, and the banks/brokers that are represented include those that have decried the rights system and advocated US-style placings/book buildings for many years.

The ACT sent its comments to the working group in August.

Meanwhile the Financial Services Authority (FSA) responded rapidly, without the usual consultation, and introduced a requirement, effective from 20 June, for the disclosure of significant short positions in stocks of companies that are undertaking rights issues. Although short-selling in itself is not abusive, the FSA took this step out of concern that an increased potential for market abuse through short-selling during rights issues existed in current market conditions. Any person who has reached, or exceeded, a short position which represents an economic interest of 0.25% of the issued capital of a company during the period of a rights issue must make an announcement on a regulatory information service by 3:30 pm on the following business day. The FSA is looking at further measures in this area.

Unconnected with this, but in similar vein, the FSA had earlier announced its conclusions after a public consultation on the need for disclosure of positions in shares held via contracts for differences (CFDs). The FSA has decided to implement the most rigorous of its original proposals – namely, a disclosure threshold of 3% taking the aggregate of any long CFD holdings and other holdings of voting rights (such as shares) in that issuer.

The combination, excluding any safe harbours, was exactly as recommended by the ACT. This welcome news for issuers and traditional long-only investors will be less popular with investment banks and hedge funds.

Final FSA rules are expected in February 2009 for implementation before September 2009. ■

Far-reaching issuer liability proposals

For issuers with securities traded on a regulated market, a statutory liability already exists for fraudulent misstatements made in any periodic disclosures required by the Transparency Directive. HM Treasury has now announced proposals to extend issuer liability:

- to securities on the AIM and PLUS markets;
- to a broad range of ad hoc and periodic disclosures to markets to take in disclosures by means of a recognised information service;
- to permit sellers, as well as buyers, of securities to recover losses incurred through reliance on fraudulent misstatements; and
- to permit recovery for losses resulting from dishonest delay of a disclosure.

When these matters were under review by Professor Davies, the ACT argued for a proportionate response, but the proposals now go further than we think reasonable.

The worry is that an overly rigorous regime would discourage issuers from keeping the market informed other than through the bare legal minimum of disclosures. As it is, the proposals to extend the liability relate to fraudulent or dishonest misstatements and delays and do not cover simple negligence. ■

Special resolution regime for banks

HM Treasury has announced plans for a special resolution regime for failing banks, with the intention to legislate later this year. While no regulatory system can or should prevent the failure of any bank, the aim is to reduce the impact of problems that could pose a wider threat to financial stability.

There is to be a more clearly defined split of responsibilities between the Financial Services Authority (FSA), the Bank of England and HM Treasury. If the FSA determines that a bank has breached its threshold conditions, it can put it into the special resolution regime. The Bank of England will then decide what measures to employ, including liquidity support, transfer of all or part of the business to the private sector, or a new insolvency procedure. HM Treasury will determine whether public funds can be used to take a bank into public ownership. Invoking the insolvency procedure will trigger the Financial Services Compensation Scheme.

The special resolution regime will be governed by the Financial Stability Committee (FSC) of the Court of the Bank of England, which will oversee the Bank's functions in relation to financial stability.

Some details of the special resolution regime still need to be sorted out – in particular, the anomaly that the governor of the Bank would be accountable to the FSC, which he chairs. ■

Pressures mount on rating agencies

The financial authorities seem torn as to how they should treat the credit rating agencies. While they value their independent assessments of creditworthiness and even enshrine ratings levels in their regulations, they are also nervous of their market influence and remain largely unregulated.

In the US, credit rating agencies must register as nationally recognised statistical rating organisations, and the European Commission is now proposing legislation to authorise rating activities. In particular, a directive/regulation is proposed to achieve appropriate management of conflicts of interest, improvements in quality of output, and increased transparency of the agencies' activities. There are no plans to interfere with rating methodologies or rating decisions.

Supervision and enforcement would be the task of an agency such as the Committee of European Securities Regulators (CESR), setting an unwelcome precedent for a Europe-wide super-regulator. Currently, financial regulation is handled separately in each EU state and CESR is a forum for recommendations and debate.

At the same time the European Commission is looking at possible approaches to excessive reliance on ratings within existing EU legislation. In fact, the same idea is currently being taken up by the US Securities and Exchange Commission, which is redrafting many of its rules to remove references to ratings where practical.

At present credit rating agencies voluntarily agree to comply with the code of conduct of the International Organization of Securities Commissions (IOSCO). The code covers such matters as avoidance of conflicts, use of information, and provision of sufficient information to let the market judge and assess rating agency activities, performance and reliability. Credit rating agencies self-certify their compliance, while in a paper issued at the end of July, IOSCO is exploring a number of options for monitoring their compliance. ■

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The Basel Committee on Banking Supervision has proposed new guidelines on computing capital requirements for an incremental risk charge to capture price risk in the trading books caused by credit migrations, moves in credit spreads and price changes due to defaults. The extra capital required would be over and above the default risk already reflected in a bank's value-at-risk models. The latter were insufficient to capture the losses arising from market price changes in the trading book in the recent market turmoil. Any changes will not be effective until January 2010.

Auditor liability limitation agreements have become possible in the UK under the Companies Act 2006. The Financial Reporting Council has published guidelines for company directors looking at what should be covered in such agreements, the relevant factors for directors to consider, and the process for getting shareholder approval. In conjunction with this, the Institutional Shareholders' Committee (which includes the ABI and the NAPF) published a statement on what institutional investors are likely to expect from companies seeking shareholder approval. It includes a reminder that companies do not have to enter into auditor liability limitation agreements; that directors should always have regard to their duties; that investors will support a proportionate liability that is fair and reasonable but that there should be no fixed cap; and that audit committees should disclose how they assured themselves in their negotiations with auditors that audit quality will be preserved and enhanced.

Originators of securitisations could be penalised with an onerous capital requirement. A highly controversial change to the European Commission's Capital Requirements Directive would mean that originators would be treated for capital purposes as if they held 15% of the issue even if it had been fully distributed. The aim is to encourage originators to retain an exposure to any issues in the hope that they will do better due diligence on the issue and that their interests will thus be more aligned with those of investors. An alternative option is that banks acting as investors should only invest in credit transfer products if the originators and distributors retain at least a 10% exposure themselves. Both these ideas would wreak havoc for Europe as a financial centre and could even damage normal loan syndications and secondary trading.

Pension accounting ideas meet with stiff opposition

The Accounting Standards Board (ASB) discussion paper on pensions accounting has stirred up widespread resistance.

Commentators from all sides have objected to the suggestion that pension liabilities should be discounted at the risk-free rate rather than the AA bond rate as they are at present. The UK pensions minister Mike O'Brien has written to the ASB to say that the move could prove "seriously detrimental to pension provision".

The worry is that by decreasing the discount rate and increasing the liabilities, any pensions deficit becomes much larger, thus encouraging the closure of defined benefit schemes.

The ACT's response to the ASB paper warns the ASB to be mindful of the consequences of its actions in the real economy and that "it is not the role of the accounting standard setters to be driving this sort of social change".

The ACT response added that the valuation of assets and liabilities should be consistent. Even ignoring the premium for default risk, a long-term investor can capture other constituents of the market return, notably liquidity and maturity risk premiums. The margin of the AA bond rate over the risk-free rate is a justifiable proxy for these elements.

Another controversial element the ACT cannot accept is the proposal for recognising the actual returns on assets in income each year rather than the expected returns, as IAS 19 does. The IAS 19 method more closely reflects the holding of a very long-term asset position and taking a view on overall returns rather than being driven by short-term market effects.

In general, there can be many different arguments and justifications for various different treatments the area of pensions accounting. Unless the justification to go in one direction or another is overwhelming the best option may be to accept the least bad solution, knowing that it is not perfect and is possibly arbitrary. ■

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The fair value measurement of financial instruments has had a significant influence on the reported performance of financial firms and the market generally. The Committee of European Securities Regulators is concerned about the use of prices in illiquid markets as compared to the use of valuation techniques and modelling, and whether methodology disclosure is sufficient.

The valuation of own liabilities at fair value is an accounting trend that many corporates would argue against, even though it is a long-term aim of the International Accounting Standards Board. Corporates may be concerned it distorts financial ratios and gives an unrealistic picture of their financial position, especially where the intention is to repay at maturity and at par. A report (entitled Calculating Adjusted Debt and Interest for Corporate Issuers) from Standard & Poor's explaining its methodologies gives credence to this view. S&P explains that to calculate its key performance indicators it will adjust debt numbers back to amortised cost in cases where they have been marked to market as part of a fair-value hedge or under the fair-value option.

The adoption of Rome I regulations on contract law was supported by the ACT in its submission to the UK Ministry of Justice. The UK has for many years opted out of certain sections of the Rome Convention on international contract law and had secured a similar opt-out from the EU's proposed Rome I regulations. The problem for treasurers lay in introducing uncertainty as to which country's law would be applicable in financial contracts such as bonds. The ACT and CBI had been urging the UK government to renegotiate the drafting of the regulations. We are pleased that acceptable wording has been agreed, and the ACT now recommends that the UK opt into Rome I.

Ratings volatility is being considered by S&P as an element to be factored into its credit ratings. It proposes to set a cap on a rating based on the maximum projected deterioration in rating over one- and three-year time horizons were the issuer to be subjected to moderate stress scenarios. For example, an AA rating would imply a maximum one-year decline to no lower than A, and to no lower than BB over three years. The ACT supports this concept. S&P is also proposing adding a subscript identifier to ratings of structured finance issues. This too has been supported by the ACT as it is a refinement we have been seeking.

ACCOUNTING ROUND-UP

■ **The IASB's proposals** for reforming its financial accounting standard IAS 39 are still open for comment. The ACT would welcome comments on its draft submission, available on www.treasurers.org, which advocates that corporates' own liabilities should not be marked to market, and that fair-value hedging should be replaced by cashflow hedging. The criterion for hedge accounting would be relaxed and be based on achieving an economic hedge.

■ **A more general review** of the complexity and relevance of company reporting requirements has been launched by the Financial Reporting Council. It wants to investigate the risk that corporate reporting requirements are making reports more complex but not more useful or understandable. The project team welcomes comments.

■ **The Department for Business Enterprise & Regulatory Reform** has published guidance on the changes introduced by the Companies Act 2006. It also identifies those parts of the Act that still apply to companies using international accounting standards.

■ **Clarifications on hedging** of a net investment in a foreign operation have been published in IFRIC 6. Net investment hedging should only be applied in the consolidated accounts and for the FX differences arising between the functional currencies of a foreign operation and any parent entity, and not the differences between a foreign operation's functional currency of the parent's presentation currency. The hedging instrument can also be held by any entity in the group, other than the foreign operation itself being hedged.

WEBSITE WATCH

http://www.

The European Corporate Governance Institute is an independent association of academics, legislators and practitioners whose primary role is to undertake, commission and disseminate research on corporate governance, based on impartial research. The aim is to improve corporate governance by encouraging the interaction between different disciplines, such as economics, law, finance and management. See **www.ecgi.org/index.htm**