INTRODUCTION

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Speaking at the ACT's Annual Dinner last month, Niall FitzGerald, Chairman of Reuters and past Chairman of Unilever, (see *News,* page 5), discussed the important role that treasurers can play in their companies and how they can contribute in many areas, some of which may be regarded as outside a treasury.

It is, therefore, appropriate that in this month's Technical Update, we are covering a diverse range of subjects – all of which are in the news because of new or potential developments. For example, we discuss the latest standard from the International Accounting Standards Board (IASB) – *Exposure Draft 7 (ED7) Financial Instruments: Disclosures* – and present our thoughts on the review into the ongoing protection allowed shareholders through pre-emption rights.

Another important issue is how Nigel Turnbull's report on internal controls may provide a framework for narrow definition with the US Sarbanes-Oxley Act.

Then in Technical Update Extra, we bring you the second in our special series of reports on International Swaps and Derivatives Association (ISDA) agreements. ■

Disclosure draft overloaded

The ACT calls for the IASB standard on disclosures to be postponed – it says many of the requirements would be better in an Operating and Finance Review.

The International Accounting Standards Board (IASB) has published *Exposure Draft 7 (ED7) Financial Instruments: Disclosures*. The new standard combines *IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and *IAS 32 Financial Instruments: Disclosure and Presentation*.

The ACT response to ED7 was largely supportive of good and adequate disclosures, but it noted that many of the new requirements were qualitative risk and policy descriptions. It believes that these would be better off in an Operating and Finance Review (OFR) or Management Discussion and Analysis (MD&A).

The new draft removes some disclosure requirements of previous standards that were regarded as too onerous. It also aims to simplify other disclosures and add some extra requirements.

However, the ACT believes that information on financial risks needs to be placed in context with the overall business risk. For this reason it recommends that the new standard should be postponed. Instead, it should be included in any future consideration of OFR or MD&A-style disclosures.

The ACT also expressed concern about sensitivity analysis replacing interest rate risk information, such as details on the amounts of fixed-rate financial assets and liabilities and maturities. Sensitivity analysis can be revealing, but would be calculated off arbitrary changes in the risk variables and dependent on the timeframe of the analysis. It may be better to provide the raw data on exposures (as modified by derivatives) and allow anyone analysing the company to model their own risk scenarios.

Analysing sensitivity to a single risk variable could be unwise where there are inter-dependencies. For example, commodity prices are not independent of exchange and interest rates. Furthermore, it could be positively misleading if the risks on financial assets and liabilities are considered in isolation from any offsetting or compounding sensitivities in the main revenues of the business.

The ACT said that when reviewing ED7 item by item, it was difficult to object to any single extra requirement. An entity's capital structure, for example, is important and information on the firm's policy for managing capital will be useful to users of the accounts.

However, taken as a whole, the requirements could add up to a significant extra amount of information. This will be burdensome on companies preparing accounts and may even serve to confuse users as to what are the really crucial facts. The ACT warned that focusing on provision of data and analysis for financial items – at the expense of attention to underlying business risks – was a trap finance personnel should avoid falling into.

If all the proposals in ED7 are adopted, there is a danger of excessive prominence being given to the risks from financial instruments. This may deflect attention from the more important performance and risk factors in the main business of the reporting entity.

Responses that the IASB has received from other organisations are by and large in favour of extended disclosures. However, a fair number have agreed with the ACT that the information should form part of an OFR. Problems such as overly complex information, an unbalanced approach by concentrating on one risk type and the sheer volume of information have also been raised.

The aim of *ED7 Financial Instruments: Disclosures*:

- Disclose the significance of financial instruments for an entity's financial position and performance and incorporate many of the requirements previously in IAS 32.
- Provide qualitative and quantitative disclosures about exposure to risks arising from financial instruments. The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent of exposure to risk, based on information provided internally to a company's key personnel. These disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.
- Provide specified minimum disclosures about credit risk, liquidity risk and market risk. Market risk includes interest rate, currency and other price risks and would be dealt with through sensitivity analyses.
- Disclose totally new qualitative information about the entity's objectives, policies and processes for managing capital. It also aims to give quantitative data about what the entity regards as capital and whether, during the period, it complied with any capital targets set by management and any externally imposed capital requirements. If it has not complied, the consequences of such non-compliance must be detailed. ■

For the full ACT response go online at: **www.treasurers.org/technical/papers/resources/ed7response.pdf**. ■

Pre-emption rights discussed

Paul Myners, Chairman of Marks & Spencer, who is undertaking a study into shareholders' pre-emption rights (see *Technical Update*, page 51, *The Treasurer*, November 2004), has published a discussion paper seeking views about the application of such rights.

Pre-emption rights stem from the Companies Act 1985 and protect shareholders against having some of the value of their holdings transferred to new shareholders and the dilution of their percentage ownership in a company.

The issues Myners put forward include:

THE PRE-EMPTION GUIDELINES' FLEXIBILITY

- Should criteria for disapplication of pre-emption rights be set out in the guidelines and, if so, what should they be?
- Should the 'comply or explain' or shareholder engagement models be applied to pre-emption rights?

DIRECTORS' DUTIES TO SHAREHOLDERS

- Is there any evidence of shareholder value abuse in the US where pre-emption rights are either limited or non-existent?
- Should the UK move to a US-style 'liability approach', with class action litigation used to obtain compensation, rather than the current approach that confers an absolute right on minorities to avoid dilution?
- Can the current approach be more flexible, allowing a company to choose various pre-emption right options, such as 5%, 10% or 20% limits to non-rights issues with the market pricing shares accordingly?

STUDY: Paul Myners, M&S Chairman, is undertaking a study into shareholders' pre-emption rights and their impact on raising new finance.

FEASIBILITY OF OTHER CAPITAL-RAISING MODELS

- Do these offer a practical way around the 'pre-emption rights' problem when raising funds in terms of size of issue and speed, and the relative costs?

CAPITAL RAISING IN THE US

- Where does the advantage lie? What are the constraining effects of pre-emption rights that safeguard shareholders' value and owners' rights but restrict company flexibility?
- Why doesn't the lack of pre-emption rights in other jurisdictions deter UK investors and what price is placed on the additional risk?

Myners will also consider if growth in the overseas ownership of UK companies has implications for the application of pre-emption guidelines and whether the views of international investors are sufficiently taken into account.

THE ACT – A LONG-STANDING SUPPORTER OF PRE-EMPTION. The current guidelines emerged from an initiative taken by the ACT and the Association of British Insurers (ABI) in 1987. This successfully discouraged the National Association of Pension Funds (NAPF) from restricting the statutory flexibility.

The guidelines indicate that pre-emption rights should not apply to a company seeking to issue new shares that constitute less than 5% of its existing share capital over a 12-month period. There is also a 7.5% limit for issues over three years. A committee of the ABI and NAPF will consider proposals from companies seeking to go beyond these guidelines.

The Pre-emption Group, which has investor, banking trade bodies and listed company representatives (the ACT is included), was set up as a continuing forum to review the guidelines and their flexibility and consider any proposals about them which went beyond specific company issues. It has not met since 1999. ■

In the November issue (page 51) *The Treasurer* published a picture of M&S Chief Executive Stuart Rose, incorrectly named as Chairman Paul Myners. Apologies to Mr Myners, Mr Rose and our readers for the error and any confusion this caused.

Associations back credit rating draft

The ACT and the treasury associations of France (the AFTP[1]) and the US (the AFP[2]) have responded to the draft: *Code of Conduct Fundamentals for Credit Rating Agencies*, issued by the International Organisation of Securities Commissions (IOSCO).

The response followed the associations' joint draft, *Code of Standard Practices for Participants in the Credit Rating Process*, published on behalf of the International Group of Treasury Associations (IGTA).

The IOSCO and the associations' codes are similar in the way they set down expectations for confidentiality, dealing with conflicts of interest, transparency and integrity of the rating process.

The IOSCO code provides a high level template for individual codes which credit rating agencies would devise internally. The code would also be used by local regulators when putting their own guidelines in place.

The treasury associations welcomed the IOSCO code and, in particular, the approach to avoid legislation to regulate credit rating agencies. They favour the operation of a competitive market supported by codes of conduct.

However, the associations also proposed changes to the draft. The IOSCO proposals would require agencies to publish disclosable information about a listed issuer brought to their attention in confidence. The associations opposed this, saying that it would change the relationship of trust that allows issuers to make full and proper disclosure to a rating agency. Issuers should abide to the applicable public disclosure rules but the credit rating agencies should not be forced into a policing role.

The ACT believes that many of the IOSCO proposals will help build confidence in the ratings process. For example, the proposals state that agencies should: 'Prior to issuing or revising a rating, advise the issuer of the critical information and principal considerations upon which the rating will be based.'

This would ensure feedback from the agencies and help avoid misunderstandings and dissatisfaction.

For the full response got to: **www.treasurers.org/technical/papers/index.cfm# ratings**.

Notes: [1]Association Française des Trésoriers d'Entreprise.
[2]Assocation for Financial Professionals. ■

IN BRIEF

- The **Financial Services Authority** (FSA) has sent a letter on IAS 39 and interim financial statements to the CEOs of all listed companies. It reminds them of the listing rules which require clear disclosures on the application of IAS 39 in any preliminary, annual or interim results. The FSA also said that listed companies may publish their first interim accounts under IFRS within 120 days of the end of the period, instead of the normal 90 days.

- The **International Primary Market Association** (IPMA) and the **International Capital Markets Services Association** (ICMSA) have agreed with the UK listing Authority (UKLA) that the £100 per tranche MTN listing fee should be paid within 30 days, instead of when the pricing supplement is submitted.

- The **Accounting Standards Board** (ASB) plans to publish an exposure draft of a reporting standard for the Operating and Finance Review before 2005. New UK standards on earnings per share, foreign currencies and financial instrument disclosures are also imminent. These will be based on the corresponding IFRS in each case.

- The **Companies (Audit, Investigations and Community Enterprise) Bill** has received Royal Assent. Its provisions will come into force in April 2005 and cover auditor regulation, accounting enforcement and investigations. It will also relax the prohibition on companies indemnifying directors.

- A **Confederation of British Industry** (CBI) report has called for a moratorium on financial services regulation. The CBI said that in the next two years, more than 20 EU measures will be imposed on companies, resulting in regulation and consultation overload. The report includes a 16-point plan to sustain the UK's pre-eminence in financial services.

- The recent **Special Commissioners'** decision in Mr R and Another v Holden (Inspector of Taxes) was a reminder of the care that must be taken when setting up companies that are intended to be non-UK residents. Such companies must be able to demonstrate that decisions are made overseas. In this case the documentation in the transaction was executed overseas by a non-resident director. However, the company failed to provide sufficient evidence that the offshore director had properly considered the documents before to executing them. As a result, the company was unable to prove it was resident overseas.

- The **Committee of European Securities Regulators** (CESR) has published a draft concept paper outlining how it will measure whether a third country's Generally Accepted Accounting Principles (GAAP) are equivalent to International Financial Reporting Standards (IFRS). Once the prospectus and transparency directives are implemented, third-country issuers of securities in the European Union (EU) will need to prepare financial statements using EU-endorsed IFRS. They may, however, be able to use third-country GAAP if this is deemed equivalent. ■

Turnbull Report matches up to Sarbanes-Oxley

The Financial Reporting Council (FRC) has confirmed that the Turnbull Report on internal controls provides a suitable framework for evaluating the effectiveness of internal controls over financial reporting, as required under the Sarbanes-Oxley Act (SOX) section 404(a).

Richard Fleck, Chairman of the FRC review group preparing the guide, said: "This is good news for companies that are already using the Turnbull Report in the UK and Ireland and those who wish to use it to meet these US requirements as well."

UK and other foreign companies registered with the Securities and Exchange Commission (SEC) in the US need to comply with the SEC requirements for reporting years ending on or after 15 July 2005 (see *No shelter from the storm*, page 16, *The Treasurer*, October).

Section 404(a) on the management assessment of internal controls states that:

- The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act (1934) to contain an internal control report, which shall:

- State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
- Contain an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

In addition to section 404 further requirements are set out in SEC Rule 33-8238. This stipulates: 'the framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognised control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.'

EFFECTIVE: Nigel Turnbull's report on internal controls measures up to the standards required by SOX section 404(a).

The Turnbull Report framework will satisfy this rule. ■

Keeping to ISDA's schedule

There are many important issues that will require negotiation before accepting the terms of the schedule to an ISDA 1992 master agreement. **Gary Walker** and **Guy Usher** reiterate the point that swap documentation is far from being a standard form that can be automatically accepted.

The documentation for a swap agreement will nearly always end up being intertwined with other contracts for financial assets and liabilities to which the swap user is a party. It is the swap schedule which will govern this inter-relation with other agreements and parties.

THE SCHEDULE – AN OVERVIEW. The five-part schedule is the vehicle through which the parties amend the terms of the master agreement to reflect relative creditworthiness and to address certain operational and structural issues. By and large, bank swap providers send 'standard' schedules to their corporate counterparties. These rarely take into account entrenched/negotiated positions, either between the end-user and the bank, or between the end-user and the banking community in general. Often, such schedules are inaccurate and unsophisticated formulations that are 'sold' to the end-user as market standard and non-negotiable. A review of such schedules invariably reveals glaring defects – particularly in relation to micro-hedging transactions.

PART 1. TERMINATION PROVISIONS. There are three concepts, in particular, within part 1 of the schedule, that are generally misunderstood, but greatly influence the sensitivity of the master agreement to a default by one or other of the parties. These concepts are:

SPECIFIED ENTITY: By designating a specified entity in relation to one of the parties (X) to a master agreement, any financial problems in the specified entity will feed back into deals done under the master agreement. The occurrence of certain events (including cross default and insolvency) will give the other party (Y) the right to terminate all transactions between X and Y.

To illustrate the far-reaching consequences of such a designation, imagine that a bank stipulates, with respect to a corporate customer, 'insolvency of any affiliate' as a termination event. (Note that this is a paraphrase. Typically, the actual provision within the schedule will read: 'specified entity' means, in relation to party X for the purpose of Section 5(a)(vii), any affiliate'. This is hardly a transparent formulation.)

If a relatively insignificant affiliate of the end-user is wound up, the bank can legitimately use this event to terminate all outstanding transactions under the master agreement. If this happens at a time when the end-user is significantly out of money, the end-user will rue the fact that, had it considered the matter, it would have sought to narrow the ambit of the designation. It could have done this either by restricting the meaning of 'specified entity' to certain named affiliates, or by subjecting the definition of 'affiliate' to a 'material net assets' test.

But a lack of transparency within ISDA documentation, coupled with a belief that the documentation itself is standard form and does not merit a read in the first place – as well as endemic reluctance to seek expert external advice – all conspire against the end-user. This can prevent the user from considering the issue at all.

Executive summary

- **In the schedule to an ISDA 1992 master agreement, the parties involved amend terms to reflect creditworthiness and address operational and structural issues.**
- **There are three concepts in part one of the schedule – termination provisions – specified entity, default under specified transaction and cross default. They are generally misunderstood and can make a master agreement more sensitive to default by a party.**
- **A lack of transparency in ISDA documentation, coupled with the belief that it is standard form, combine to prevent end-users from considering termination provisions, such as 'specified entity', in detail.**
- **Banks always require end-users to make tax representations. A breach here can leave the end-user having to gross up for any witholding taxes – but with no right to terminate the agreement.**
- **Requirements to deliver documents in connection with the master agreement should be scrutinised. The end-user should also consider which documents need to be seen from the bank itself.**

DEFAULT UNDER SPECIFIED TRANSACTION. A specified transaction is a derivative transaction between any combination of the parties to the agreement and their respective specified entities and credit support providers. It is broadly defined but excludes derivatives entered into under the master agreement itself. *Figure 2* provides a matrix of specified transactions.

A default under a specified transaction has far-reaching consequences. As an example, suppose a bank designates, with respect to its end-user swap counterparty, 'default by an affiliate of the end-user under a specified transaction' as a termination event. (Note again that this is a paraphrase. Typically, the schedule will read: 'specified entity means, in relation to party X for the purpose of Section 5(a)(v), any affiliate.')

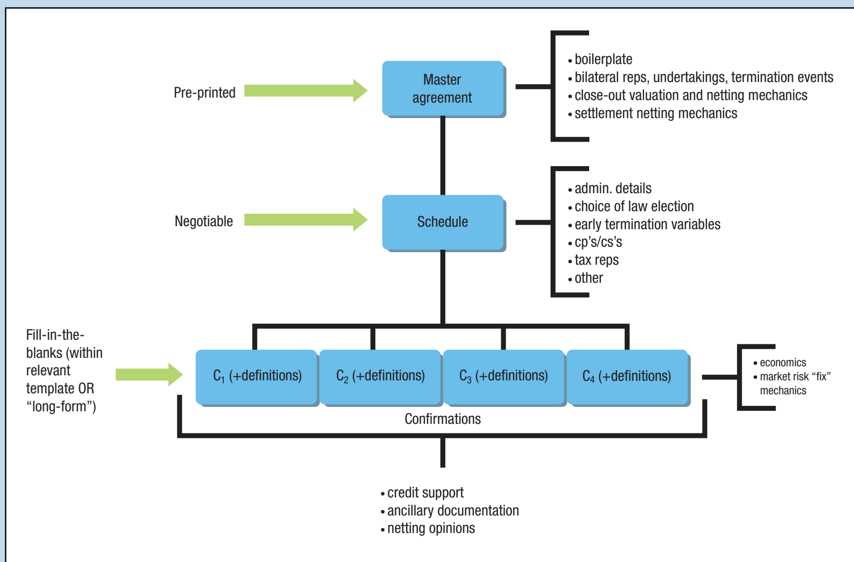
Such a designation will mean that a default by any affiliate of the end-user under a derivative transaction between that affiliate and the bank, or any credit support provider or specified entity of the bank will give the bank a right to terminate all transactions under the master agreement.

The same analysis applies to defaults by the end-user (or by any credit support provider of the end-user) in respect of other specified transactions. It is fair to say that very few end-users appreciate the additional early termination risks inherent in such seemingly innocuous provisions.

CROSS DEFAULT. Cross default is a similar concept to the regime applicable to defaults under specified transactions, but there are differences:

- It bites on specified indebtedness (i.e. obligations in respect of borrowed money) and not on derivative exposures.
- It is subject to a threshold test i.e. the amount of defaulted principal must exceed a given figure before a cross default is triggered.
- It relates to all third-party indebtedness and not just exposure subsisting between the two

Figure 1. The ISDA contractual framework.



The schedule is used to tailor the generic provisions of the master agreement

Figure 2. Matrix of derivative transactions within the specified transactions definition.

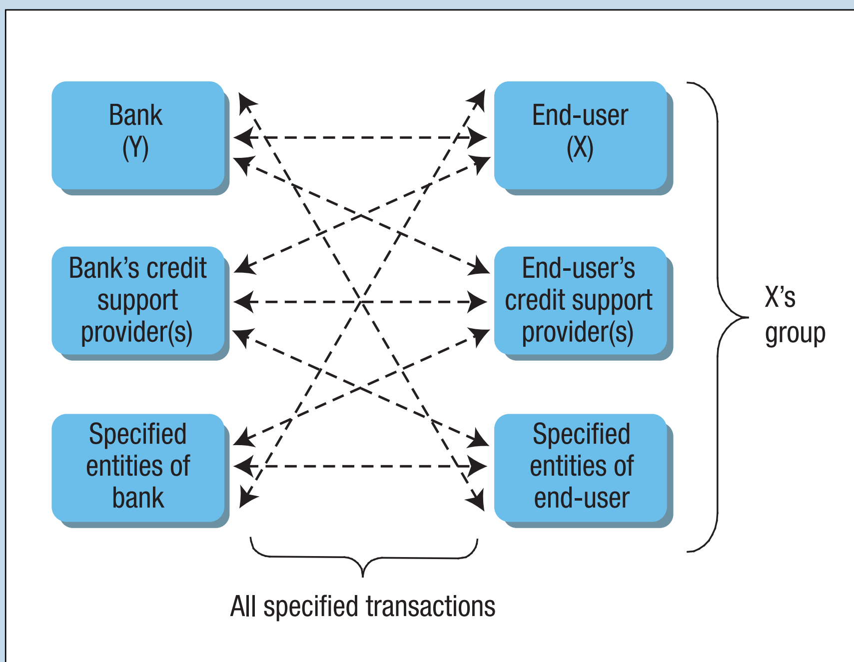


Table 1. Cross default vs under specified transactions – in detail.

CROSS DEFAULT

APPLICABLE TO: Specified indebtedness (full universe of debt).
TRIGGER: Cross default or cross acceleration.
THRESHOLD: As agreed between the parties.

DEFAULT UNDER SPECIFIED TRANSACTIONS

APPLICABLE TO: Specified transactions (limited universe of derivative counterparties).
TRIGGER: Cross acceleration only.
THRESHOLD: None applicable.

parties and a limited guarantor/affiliate network.

- It acts as a cross-default provision 'proper' (and not merely as a cross-acceleration clause) and so is correspondingly more sensitive.

Table 1 compares the two regimes – default under specified transaction and cross default – in detail.

The two regimes are inconsistent *inter se*, incomplete and require thought around the areas of scope of application and thresholds. ISDA acknowledges the existence of these shortcomings, but inexplicably has never sought to address them. However 'savvy' members of the market invariably amend their master documentation to account for them. As always, expert advice is the only way the end-user can ensure signing up to a contract that is both understood and wanted.

At a practical level, it is worth remembering that a corporate's own deposits with a bank will fall within the definition of specified indebtedness for the bank. This is good news for the corporate if ever the depositee bank runs into difficulty as the corporate will be able to terminate transactions outstanding under its master agreement with that bank. However, many banks will carve out deposits for this very reason. Alternatively, it may be that few deposits will ever be large enough to breach the threshold required to trigger a cross default in the first place.

However, there are solutions to these problems and a well-advised corporate will know them. Note that these are only some of the issues that arise in respect of Part 1 of the schedule. There are many others.

PART 2 – TAX REPRESENTATIONS. Nearly all of the English incorporated companies transacting vanilla derivatives business with English incorporated banks (or with London offices of foreign incorporated banks) only need to make (and receive in return) the 'standard' payer representations set out at part 2(a) of the schedule. They can safely ignore the payee representations And in all other cases, specialist tax/legal advice should be sought.

It is worth remembering that banks will always require end-user counterparties to make representations of one kind or another, for reasons other than a change in tax law or a failure to provide relevant tax documents. A breach of representations will lead to the end-user having to gross up for any withholding taxes but with no right to terminate.

PART 3 – AGREEMENT TO DELIVER DOCUMENTS. Any requirement on the part of the end-user to deliver documents in connection with the master agreement should be scrutinised. Is the requirement consistent with what the end-user is required to deliver under its committed loan facilities? Does the bank already hold the information? Is the requirement to deliver tax forms logical? Does the bank want a legal opinion and is that reasonable? At the same time, the end-user should think about what documents it requires to see from the bank itself. At the very least, it ought to ask for a copy of the bank's authorised signatory list.

PART 4 – MISCELLANEOUS. For English-law governed master agreements entered into by English incorporated end-users, there are a couple of points worth mentioning. First, a process agent will only be required if the bank counterparty is incorporated overseas. Evidence of the process agent's appointment is a worthwhile stipulation in this regard.

Second, where the bank counterparty is the London office of a foreign bank, the correct structural route is to enter into the master agreement with the overseas head office of the bank. The bank's London office will then have to to be designated under Part 4(d) as a multi-branch office. The (structurally flawed) temptation is for the end-user to enter into the master agreement directly with the London office.

Third, if single-transaction (versus cross-transaction) settlement netting is to apply, it is necessary, to state that the disapplication set out at Part 4(i) will not apply. This wording always seems counter-intuitive.

PART 5 – OTHER PROVISIONS. All provisions inserted into this part of the schedule need careful and considered review. Many are not required and even those that are legitimate are often poorly drafted or have undesirable credit, legal, tax, accounting and other implications. Again, expert external advice is the principled and recommended course of action in each case.

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Note: It is the schedule to the ISDA 1992 master agreement which is being considered here, since the 2002 version has yet to gain widespread acceptance or usage. ■