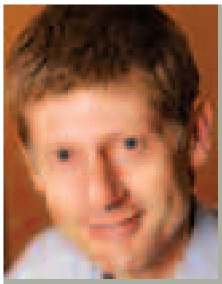
IN BRIEF

Misleading disclosures on issuance fees in the primary debt market are concerning the **Financial Services Authority**. In some cases sole lead managers have sought to attribute notional fees to bought deals where no fees were in fact paid, giving the impression that the transaction was executed on a book-build basis. Firms are also reminded they should be making full disclosures of fee or expenses rebates to issuers. Deliberate disclosure of inaccurate fees and commissions is likely to breach part 6 of the Financial Services & Markets Act 2000 and rules made under it.

The **Court of Appeal** decision in Indofood International Finance Ltd v JPMorgan Chase Bank could have important implications for **back-to-back group loans** in the UK, since it held that a company interposed between the principal company and the bond-issuing company with a view to treaty reduction of withholding tax would not beneficially own the interest it received from the principal company, meaning that the treaty in question would not apply. It is unclear whether the principles applied in the case are confined to identical back-to-back financing arrangements. Nevertheless, it may be sensible for existing back-to-back financing arrangements in the UK to be reviewed to identify any potential risks and for such loans to be for different amounts, on different terms and with different payments dates.

The EU Pensions Directive came into force in the UK in March 2006. As a result, pension schemes with members working in other European Economic Area (EEA) countries, other than on short-term secondments, will need to be fully funded from September 2008. Annual valuations must be conducted and any deficit made up within approximately one year of the deficit being identified. The regulations apply if a UK pension scheme accepts contributions from employers in respect of EEA workers and the obligations persist while any such member is entitled to or is receiving any benefits.

The position of **loan transfers to hedge funds** has been clarified by the **Court of Appeal** in Argo v Essar. The borrower's syndicated loan agreement included a provision that restricted transfers to a "bank or financial institution". The court held that a hedge fund was a financial institution and removed a previous characteristic that a financial institution should have the ability to make loans or advances during the drawdown period of the loan, but would still exclude insubstantial entities.



INTRODUCTION

By Martin O'Donovan
ACT Technical Officer

An informal forum of bond issuers, investors and intermediaries has been engaged in prolonged dialogue (see main story, opposite page) to find areas where market practices can be improved to the benefit of all parties. The forum participants concluded that since bond investors and borrowers had to act in partnership, education about the normal workings of the market and understanding of the issues could be improved. Investors want help from issuers in understanding applicable terms and conditions and the risks involved, and in getting hold of all the relevant information. Issuers, on the other hand, while accepting the need to provide information, are wary of incurring liability by going too far and doing the investors' work for them. Ultimately, it is a market of professionals who should act professionally. ■

ICAS backs principles over rules for standards

Should accounting standards be based on rules or principles? With the need to get to grips with issues raised by the adoption of international financial reporting standards (and the ubiquitous IAS 39), this is a question treasurers are increasingly asking. One answer has been provided in a report entitled *Principles Not Rules: A question of judgement*, published by the Institute of Chartered Accountants of Scotland (ICAS) and available on its website.

The report's title gives the game away and the tone is set in the opening sentence: "The key to true and fair financial reporting is the balanced exercise of judgement." This sentiment is backed up by a well-researched and considered narrative which concludes that a principle-based approach to standard setting (with a clear hierarchy of overarching concepts and limited further guidance) is not only desirable but essential in serving the needs of business and the public interest, and that the global convergence of accounting standards cannot be achieved by a detailed rules-driven approach. It is not the role of accounting standards to anticipate abuse and to incorporate rules to prevent such abuse.

The report acknowledges that a focus on principles places an obligation on preparers and auditors to exercise professional judgement, which is at odds with the tick-box mentality often associated with the implementation of rules-based standards. As a result, any move to a more principles-based approach would affect the training requirements of current and future finance professionals.

The report also regrets that the fear of lawsuits and second-guessing by regulators has resulted in preparers and auditors requesting more rules and being reluctant to exercise their judgement.

This may well strike a chord with treasurers, whose interest lies in managing their company's economic risks and who become frustrated by the application of accounting rules which give rise to economically perverse results. The report authors highlight this in the example of an foreign exchange exposure mitigated by a hedging instrument, giving the desired economic impact of reducing exposure. It would make sense for this reduction in economic exposure to be reflected in the performance statement in the form of a neutral profit and loss impact (or close to neutral, depending on the efficacy of the hedge). However, IAS 39 does not embody such a principle. Instead, complex rules must be applied, combined with onerous documentation and effectiveness-testing requirements. Even if these could be satisfied, profit and loss neutrality remains an outcome which is effectively optional, and so accounting volatility may or may not be seen, despite the company being economically hedged – so much for true and fair!

As part of this project ICAS decided to focus on the controversial area of accounting for financial instruments, and held two brain-storming workshops with different groups of experts, including ACT nominees. The first looked at whether, and to what extent, the current version of IAS 39 could be distilled into higher-level principles, and the second explored what an alternative model for financial instruments might look like if started from scratch.

A report, *Principles Not Rules: Report on proceedings of financial instrument workshops*, summarises some of the issues raised. It can also be downloaded from the ICAS website. ■

European bond market: how we can all do better

Ideas to improve the functioning of the European primary bond markets have been put forward by a group of market participants drawn from all sides of the market: investors, issuers and intermediaries. The informal forum came together under the sponsorship of the Association of British Insurers (ABI) and the BVI Bundesverband Investment und Asset Management and included representatives from the ACT.

The dialogue had its origins in a wishlist published by a group of 26 investors in 2003 and a subsequent discussion paper from the ABI in 2004. This further initiative was deliberately not prescriptive and was instead intended to take a pragmatic approach, highlighting best practice. Participants in the dialogue were united in their belief in freedom of contract. There was no agenda to arrive at standard terms but the group was clear about the potential for improvement in information flows and the need for better understanding of the practical effect of covenants.

- There was consensus on the need for more timely availability of information on new issues, and more information on certain aspects of the issuer and the issue. A draft prospectus, or "red herring", should be made available to investors at least three days before pricing of new deals. Disclosure would ideally involve the publication of half-yearly figures, even where paper is denominated in units of a value greater than €50,000, which is not a formal requirement under the European transparency obligations directive. Members of the forum will continue to explore with regulators and others ways to ensure timely website access to all public prospectus information.

- There is a need to address some ambiguities in terminology. Specifically, there is a need for education and better understanding of use of the word "senior".

- With regard to covenants, there is an acceptance that these can be complicated and hard for investors to understand, especially for those working in a different language. The forum was clear that it would be both unrealistic and undesirable to seek harmonised standards, and recognised that issuers should have the freedom to propose conditions which reflected their needs. This led to the conclusion that greater education about the scope of typical covenants would be helpful and that there were ways of flagging the key features in covenants so that the market was better able to judge their implications and value. The credit rating agencies could perform a useful role in this, and the forum proposed to initiate a dialogue with them.

Not surprisingly, investors wanted to avoid losses that might arise when a leveraged buy-out or similar corporate event causes bonds to lose their investment-grade status. However, given the acceptance of freedom of contract, it would be inappropriate to develop model covenants or recommend change of control or other specific clauses. In earlier responses on behalf of issuers the ACT had maintained that terms and conditions were areas that should develop and evolve through normal market pressures. Interestingly, there has been heightened awareness recently of the change of control risks in certain sectors, with some issuers including an event risk clause for commercial reasons.

In general, dialogue between investors and issuers has been all too rare, but all parties are finding it increasingly worthwhile to improve communications and understanding of the respective positions of borrowers and lenders. Inevitably there will be different stances on certain matters, but it must be better if positions are taken on the basis of mutual understanding rather than ignorance or indifference. ■

For more on change of control clauses, see page 10 of this issue.

The full bond forum report is available on www.treasurers.org/technical/papers/resources/eurbondmarket_report.pdf.

FSA set to implement Transparency Directive

Implementing measures for the EU Transparency Directive have been put forward by the Financial Services Authority. The proposals cover three main areas: the enactment into UK law of the directive's provisions on annual and half-yearly reports and interim management statements; changes to the disclosure requirements on acquisitions or disposals of major shareholdings; and the storage and dissemination of transparency directive information. ■

IN BRIEF

The **IASB** is consulting **on performance reporting** through an exposure draft on proposed amendments to IAS 1 *Presentation of Financial Statements*. Entities would be required to present all non-owner changes in equity (in other words, recognised income and expenses) separately from changes in equity that arose from transactions with owners. Income and expenses would be shown either in a single statement, or in two statements. Dividends and related per share amounts would appear on the face of the statement of changes in equity or in the notes.

Working capital statements in limited access acquisitions are discussed in the FSA's latest *List!* publication. In a hostile takeover it can be difficult to comply with the prospectus directive requirement for an issuer to make a statement on the adequacy of working capital of the enlarged group for the next 12 months because of limited access to information on the offeree. Recommendations from the Committee of European Securities Regulators on the consistent application of the prospectus regulation (No. 809/2004) state that a working capital statement in a prospectus must be "clean" or "qualified". If the issuer cannot comply, the UK Listing Authority has decided that the offerer may explain why not and instead give a 12-month working capital statement on an unenlarged group basis, but with the proviso that if access to the relevant information is gained before close, a supplementary prospectus will be produced with a revised working capital statement for the enlarged group.

A briefing paper from the **Loan Market Association (LMA)** deals with **confidential and price sensitive information** in syndicated loan markets. The paper – available on www.treasurers.org/technical/lmaguide.cfm – is aimed at the lenders but serves as a reminder to borrowers that the confidentiality undertaking in the LMA agreements falls away at signing and that they should therefore insist on including the language requiring any potential purchaser of a participation to sign a confidentiality agreement. Further details are in the ACT/Slaughter & May guide to the LMA documentation (pages 52 and 67), available at the web address above.

Sarbanes-Oxley has made 58% of **board directors** feel that the regulations have made boards overly cautious, and should be repealed or overhauled, according to a survey by Korn/Ferry International. 28% of responding directors in the UK endorse a similar action to remedy the Combined Code.