INTRODUCTION

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In the Technical Update section, we aim to keep you informed of the areas where the ACT is trying to influence or lead the development of new regulations, law or practices likely to affect corporate treasuries. There are always so many spheres which may be relevant to the wider practice of treasury that we cannot always play an active part in all of them, but we can, nonetheless, keep you informed. And information at an early stage, at least allows more time for you to plan your reactions.

We welcome feedback on any topics covered here and, indeed, would value suggestions on any additional technical areas that we could cover. In that spirit, we are glad to include a practical reaction to the Association of British Insurers' bond standards paper from Gerry Bacon, Group Treasurer at Vodafone, in this month's Technical Update Extra. ■

EU emphasis on governance

Corporate governance has been the flavour of the month for several years in the UK and the US, and the European Union (EU) is now working hard to catch up with certain practices.

A flood of new initiatives has come out of the EU in the past month. These are aimed at improving governance across member states and achieving consistency from country to country.

At this stage, the Commission is trying to encourage, rather than require convergence. It has put out two recommendations for listed companies – one to ensure a strong role for independent directors and the other giving guidance on disclosure of director remuneration, plus greater control over approving remuneration policy.

On directors' pay, it says there is an inherent conflict of interest if executive directors take part in setting their own earnings. To resolve this, remuneration policy, including the basis for performance-related elements, should be fully disclosed. This policy must also be put to a shareholders' vote which may be binding, or just advisory. Share schemes should be subject to approval at the Annual General Meeting.

The Commission sees an important role for independent non-executive directors in helping to balance the different interest groups within listed companies. "They have a role to play both in companies with dispersed ownership, where managers need to be made accountable to weak shareholders, and in companies with controlling shareholders, where independent directors can help protect minority shareholders," said Commissioner Fritz Bolkestein.

The recommendation is for a fair balance between executive and non-executive directors to avoid either group being put in a dominant position. The board should also have the diversity of knowledge, judgement and experience to complete their tasks, and all directors should be able to devote sufficient time and attention to their duties. Minimum standards are defined for the creation and composition of Nomination, Remuneration and Audit Committees.

Proposals for a directive on shareholder rights have been released for consultation to make sure that shareholders really can exercise their

influence and ensure management is acting in their best interests. The key focus is to solve problems with cross-border voting, including the flow of information ahead of shareholder meetings. Shareholders must get information in good time irrespective of where they live, and the voting mechanisms used – be they post, proxy or electronic.

Next on the agenda will be a directive to improve transparency. Proposals to be released soon will introduce some rather more challenging rules aimed at eliminating some of the practices that led to the downfall of Enron and Parmalat.

Although listed companies already have to disclose related party transactions under IAS 24, the fourth and seventh accounting directives are fairly limited in terms of the categories of related parties where disclosure is required. These directives will be amended so that the obligations on non-listed companies line up more closely with IAS 24.

Non-consolidated Special Purpose Entities (SPEs) can disguise an entity's true financial position. Although SPEs are captured on group balance sheets if they meet the IAS definitions of a subsidiary, the Commission's aim is to require disclosure of all off-balance sheet arrangements and their financial impact. This would apply to all companies whether listed or not.

The proposed directive may also require directors, as a minimum, to have collective responsibility to the company for drawing up and publishing the annual report and accounts. Member states may go further and allow direct responsibility to shareholders and even other stakeholders, but this would be a radical, new and unwelcome concept under UK Company Law.

The EU wants to make sure directors bear liability for their actions and that sanctions are applied to directors who fail in their duties in respect of the annual report and accounts. These sanctions, which may be criminal, must be 'effective, proportionate and dissuasive'.

In September the Institute of Chartered Secretaries and Administrators (ICSA) published a guidance note on the roles of the chairman, chief executive and senior independent director under the UK's Combined Code. ■

IAS 21 health warning

When funding international operations by using intragroup loans which form part of the net investment, treasurers must be aware of a peculiarity contained in IAS 21, paragraph 33.

If the loan is in the currency of the parent, there will be a foreign currency difference in the foreign operation and this will be recognised in its profit or loss.

If the loan is in the currency of the subsidiary, the exchange difference will arise in the parent's profit and loss. In both these cases the exchange differences are reclassified to equity on consolidation.

However, if the intragroup loan is denominated in a currency other than the currency of the parent or the subsidiary, the exchange differences that arise are not reclassified into equity on consolidation. Instead they will be recognised in the profit and loss account. ■

Response to hedging issues

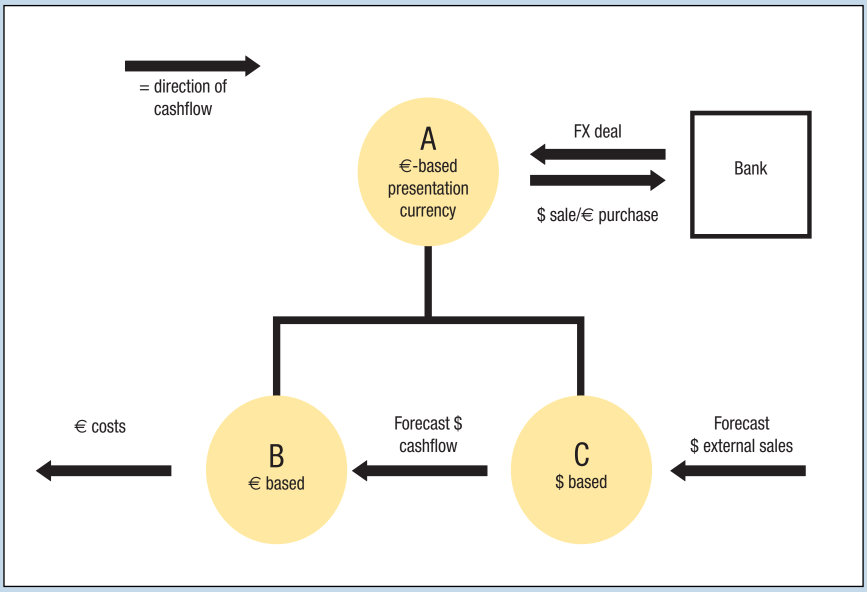
The ACT has responded to the International Accounting Standards Board's (IASB's) Exposure Draft covering 'Cashflow hedging of forecast intragroup transactions', a move which could allow the hedging of overseas subsidiaries' earnings.

At issue is the question whether an intragroup forecast cashflow could generate an exposure that counts as a hedged item. Previously, there was a special exception in guidance note IGC 137-14 which allowed hedge accounting, but this was removed in December 2003.

The ACT lobbied the IASB on this subject earlier this year and stressed its relevance for treasurers at a private meeting with IASB board members. These efforts are now bearing fruit. The Exposure Draft proposed a method that indirectly allows hedging of forecast intragroup items, which the ACT supports, but considers 'surprising'.

The IASB's proposals for hedging of forecast intragroup cashflows can be illustrated by examining *Figure 1*.

Figure 1. Proposals for hedging of forecast intragroup cashflows



Group A, which has a manufacturing subsidiary – B with a euro cost base and functional currency and a selling subsidiary – C which buys products from B in dollars and sells them on in dollars. If Group A selects the euro as its presentation currency, the group has an exposure overall in that costs are in euros and sales in dollars.

Prior to the December 2003 revised version of IAS 39, the forecast dollar sales from B to C could be designated as a hedged item, but this is now disallowed. Under the new mechanism proposed, the forecast external dollar sales by C could be designated as a cashflow hedged item in the consolidated financial statements – even though sales by subsidiary C are being made in the functional currency of that entity. This is the 'surprising' element, since there is not an exposure in the subsidiary, yet it can count as an exposure on consolidation. This is at odds with a fundamental feature in IAS 21 that says measurements should be made against the functional currency.

It will be interesting to see if this new principle provides the means to hedge the earnings of overseas subsidiaries. It seems to let a UK company designate a portion of its US subsidiary's forecast dollar sales as a cashflow hedge on consolidation, and set this portion to equate to the subsidiary's expected profits for the next year. The fair value gains and losses would then be carried forward in equity and a good accounting match obtained, which has not been possible to date.

The UK's own Accounting Standards Board (ASB) has been consulting on the same subject via Financial Reporting Exposure Draft (FRED) 30, third supplement, and the ACT has responded to this with the same message. The ASB was itself concerned about the IASB's departure from the principles in IAS 21.

For full responses see **www.treasurers.org/technical/papers/index.cfm#derivatives.** ■

Further consultation for listing rules

The UK Listing Authority, which is working on its review of the Listing Regime, is now consulting on the details of the proposed new rules. It expects to retain the compulsory sponsor regime for certain transactions and retain the class test – themes which the ACT supported when it responded to its original high level consultation.

It is not going to take up the ACT's suggestion to relax requirements relating to working capital statements. It will still be necessary to make a 'clean' working capital statement. A qualified statement explaining how the company plans to finance itself for the next 12 months if it does not have fully committed funding will not be allowed.

As expected, the Financial Services Authority (FSA) is introducing high-level Listing Principles which will allow a degree of flexibility in interpretation. They can also be used to ensure that the spirit, as well as the letter, of the rules is followed. There will be significant changes to the regime for debt and specialist securities.

The FSA proposes to align the requirements for debt securities with those of the directives. It also plans to establish a listing particulars regime for issuers of specialist securities to provide flexibility in the presentation of historical financial information.

Further proposals will require shareholder approval of break fees in a takeover if these are more than 1% of market capitalisation. There will be additional rules relating to companies that purchase their own equity securities.

The FSA paper also covers proposals on the implementation of the Prospectus Directive. It considers that the proposed new rules dealing with prospectuses are not fundamentally different from those at present. However, changes will be introduced to areas such as the introduction of passport rights; the requirement to include a summary; the ability to draw up prospectuses in several parts; the incorporation of information by reference into a prospectus; the filing and publication of the prospectus; and the languages and annual information update. ■

Insurance fears calmed

Concerns that the Insurance Mediation Directive would regulate all insurance arrangements organised centrally within a group was allayed in a Financial Services Authority (FSA) speech in July (see *Technical Update*, page 61, *The Treasurer*, September). This has now been confirmed in the Insurance Mediation and Mortgage Mediation, Lending and Administration (Miscellaneous Amendments) Instrument (2004) which will come into effect shortly.

This is a major triumph for the campaign by the Association of Insurance and Risk Managers (AIRMIC), supported by the ACT. In its guidance the FSA states that "a group company that is providing services solely for the benefit of other group companies would not normally be regarded as providing a service to a third party." It, therefore, does not fall within the scope of the directive. This principle will also apply to insurance services extended to a joint enterprise or joint venture. ■

DTI set to examine pre-emption rights

A study to examine whether or not the current application of pre-emption rights hinders companies from raising finance to innovate and grow their businesses has been announced by the Department of Trade and Industry (DTI).

Paul Myners, Chairman of Marks & Spencer, will chair the study, supported by an advisory group of representatives from the high-tech sector, private equity companies and City investment institutions. A public consultation is expected in early November.

The study follows representations from the biotechnology industry that the current application of pre-emption rights in the UK makes it difficult, and more expensive, for companies to finance research and product development. The industry argues that this is not in the interests of its shareholders. Current application largely follows the pre-emption guidelines issued by institutional investors, but the rights themselves are enshrined in law.

The conclusions will help to inform the government's thinking in advance of a planned review by the European Commission of the EU Second Company Law Directive. As it currently stands, the directive requires a public company, issuing new shares, to offer them to its existing shareholders first unless they have previously agreed otherwise. Sections 89-96 of the Companies Act implement the requirements of the directive in this country.

In considering whether to waive their rights, institutional shareholders usually follow guidelines issued by the Pre-emption Group (which comprises representatives of listed companies, investment institutions, corporate finance practitioners and the ACT). The guidelines state that pre-emption rights should not apply to a company seeking to issue new shares which constitute less than 5% of its existing share capital within a12-month period. There is also a 7.5% limit for issues over three years.

The Company Law Review considered the issue of pre-emption rights in detail back in 2001. It recommended that the present statutory pre-emption requirement should be retained. ■

Paul Myners, Chairman of Marks & Spencer, is to chair the DTI study of pre-emption rights.

IN BRIEF

■ **The Organisation for Economic Co-operation and Development** (OECD) has published a study into the transfer pricing issues connected with intra-group stock option schemes. Earlier in the year, the Inland Revenue produced its own guidance on UK-UK transfer pricing rules re share plans.

■ **Charlie McCreevy**, an Irish chartered accountant, has replaced Fritz Bolkestein as EU Commissioner for Internal Market and Services. He takes office this month.

■ **The European Public Limited-Liability Company Regulations** (2004) came into force on 8 October, creating the legal framework for a new form of company – the European Company or 'Societas Europaea'.

■ A recent Court of Appeal case – **Concord Trust v the Law Debenture Trust Corporation plc**, which looked at a bond trustee's refusal to act without an indemnity, confirmed that a bond trustee should not shoulder personal liability, and that the burden of proof is on the party asserting unreasonableness.

■ **The Bank of England** has updated the list of eligible securities that it takes as collateral against its lending as part of its Open Market Operations. A copy of the updated list is available at **www.bankofengland.co.uk/links/ setframe.html**.

■ **The Auditing Practices Board** (APB) has published five ethical standards to replace existing guidance from the auditing profession on the principles and procedures auditors must comply with.

■ **CREST** has allowed issuers and agents to transmit dividend and interest payments and related tax vouchers electronically in a single message. It is no longer compulsory for issuers to distribute tax vouchers exclusively in the form of hard copy.

■ **The Inland Revenue** has announced changes to the rules on disclosure of tax schemes. Where the promoter is not able to make the required disclosures because of legal professional privilege, then the client will have to make the disclosure instead. The client must make a disclosure within five days of the first transaction under the scheme. ■

Issuers focus on covenants

New issuers should remember that their bonds may exist for a long period, so flexibility is important. Although most of the points recently raised by investors can be reduced to simple economics, issuers and investors must work out the 'must haves' and 'nice to haves'. The rest is down to pricing, says **GERRY BACON**.

In July the Association of British Insurers (ABI) produced a position paper entitled *Standards in the Sterling and Euro Fixed Income Credit Markets* (see *Technical Update Extra*, page 62, *The Treasurer*, October). This covered:

- Covenants – change of control, negative pledge and call options;
- documentation standards and disclosures; and
- appointment of independent trustees.

The ABI's approach was based on principles and best practice, rather than prescription. It said: "Adherence to best practice should help the market recognise quality and price accordingly."

This followed a consultative document In October 2003 by 26 major European fixed-income investors entitled *Improving Market Standards in the Sterling and Euro Fixed Income Credit Markets* (see *Hotline*, page 11, *The Treasurer*, November 2003).

They argued that European debt capital markets would become more efficient and less volatile if a number of key features are introduced, including:

- Minimum covenants for corporate issuers;
- issuer call options;
- more rigorous documentation standards;
- improved disclosure;
- more widespread use of ratings;
- a focus on secondary market liquidity; and
- better understanding between issuers and investors.

Although some of these proposals can be adopted by corporate issuers, there is a downside to many of them.

MINIMUM COVENANTS. Investors said that in the event of a change of control they wanted the right to put their bonds back to the issuer at par or by reference to government bond plus launch spread if higher.

This could be detrimental to shareholders of a target company with a large portfolio of existing bonds. The acquiring company would have to arrange financing for uncertain put possibilities.

This is exacerbated for UK-listed companies that need to provide working capital statements for large acquisitions showing they have sufficient finances to cover a 12-month period. Prior to making a bid, they would have to review the terms and conditions of the target company's bonds to check for any refinancing needs..

When Vodafone acquired Mannesmann in 2000, it did not need to increase the €30bn acquisition facility to cover Mannesmann's €9bn of outstanding bonds as there were no change of control provisions. Given the size of the facility, an increase of this magnitude might have prevented the acquisition from proceeding.

Investors should also recognise the frequent gains to the status of a target company's overall credit after it has been acquired and should not wish to put shareholder interests in jeopardy. Again, using Vodafone as an example, both Mannesmann and AirTouch's bondholders were better off following acquisition as their bonds' credit ratings improved from around BBB+ to A.

Additionally, when Vodafone participated in the auction for AT&T Wireless ('AWE') earlier this year, it made allowance for the value that would be transferred from shareholders to AWE bondholders, caused by an improvement in AWE's credit and consequent increase in its bond price.

Investors have also called for improved negative pledge covenants and a disposal of assets restriction. However, corporates need standard documentation across their borrowing portfolio. If they have already issued bonds using current market conditions for documentation and pricing, they will not want subsequent bonds to cause a decline to a lower common denominator via cross default provisions.

Secondly, corporates require flexibility to arrange their financial affairs in the best interests of all their stakeholders. In the case of financial distress for European industries, the London Approach is to bring together a group of banks to provide rescue finance, which usually needs to be secured. It would be unreasonable if the negative pledge covenant in bonds prevented this. In the US, Chapter 11-style arrangements provide for a standstill and different arrangements. Unless the insolvency regime in the UK and Europe is modified it would not be right, and possibly contrary to directors' duties, to agree to lose the flexibility to give additional security.

ISSUER CALL OPTIONS. Investors have offered to negotiate a better call option than the Spens-call (i.e. in the sterling market the borrower redeems at a price flat to the reference gilt). In the US, there are standardised call provisions for investment-grade issuers but again often at penal rates.

The debate centres around economic value and the issuer's need to change documentation or repurchase bonds.

Vodafone has seen examples of consent solicitation and tenders which have been akin to issuer calls. Following the acquisition of AirTouch in the US in 1999, it merged part of that business with another US operator in 2000 and formed mobile operator, Verizon Wireless. Prior to the merger of the businesses Vodafone obtained a bondholder consent solicitation and the covenants of the AirTouch bonds were removed and replaced by those of Vodafone with a Vodafone guarantee. This provided consistency of covenants. The consent solicitation required a percentage of bondholders (who were registered) to agree and once satisfied, it mandatorily altered the documentation for all bondholders. The cost was small, particularly when compared to repurchasing all the bonds using the call provisions of the AirTouch bonds.

At the point of issue, corporates should ensure the terms and conditions of bonds do not need changing in the future or, alternatively, seek a fallback make-whole repurchase price, as is

Executive summary

- **The ABI has entered the debate over minimum covenants for bond issuers and documentation standards, following on from the Group of 26 investors, but there are downsides to many of these proposals for issuers.**
- **Investors are seeking specific actions from issuers in the event of a change of control which may adversely affect shareholders in a target company with a large bond portfolio.**
- **Demands relating to call options should consider economic value and the issuer's need to change documentation or repurchase bonds.**
- **Making a company's prospectus available on its website is a good idea – but difficult in practice.**

common in the US. Furthermore, if a repurchase is discretionary, and driven by economics rather than need, supply/demand factors should permit a tender process to occur at much better economic value (and probably approaching fair value) than US or European bonds' terms currently permit.

The alternative option of defeasing bonds already exists in the US but is not used very often due to unfavourable economics and a difficulty in obtaining legal opinions. Defeasance often requires the collateralisation of AAA securities that yield a lower return than purchasing the bonds at Treasuries plus some spread.

DOCUMENTATION STANDARDS. Making a company's prospectus available on its website, as suggested by the 26 investors, is a good idea in theory but difficult in practice. For example, US, Japanese, Australian and Swiss investors require different forms of access to information, due to different securities legislation.

For some 'one-off' issues, bond documentation may not be available during the roadshow, nor even at the point of closing the books. As the offering circular is supposed to be the principal selling document, it should be made available in good time and this should be explained by lead managers to issuers. Furthermore, regular issuers should ensure their shelf statements (US or Medium Term Note) are as up-to-date as possible at all times. However, unexpected problems can arise. In late 1999, during Vodafone's Mannesmann acquisition, its $8bn registered shelf statement, which allowed US dollar bond issues, was rendered unusable as the Securities and Exchange Commission required its finances to be updated for Mannesmann's results. At the time, Vodafone did not have access to Mannesmann's records. Consequently, it issued three Section 144A bonds, totalling $5.25bn, with registration rights and undertakings to file new financials within a certain time after completion of the acquisition.

DISCLOSURE. Issuers should disclose accounts regularly. However, when companies are acquired and become part of a larger group, the purchaser may not want to produce consolidated accounts for such entities, possibly under different accounting standards. Vodafone has acquired listed businesses in the US, Germany and Japan where some bonds are still outstanding. It has not, thankfully, needed to produce mini-consolidated accounts under US, German and Japanese Generally Accepted Accounting Principles (GAAP). Instead it has provided Vodafone consolidated information and the bonds trade in line with Vodafone bonds.

RATINGS. This should also be determined by supply and demand characteristics rather than prescription. If investors feel more comfortable with higher ratings and the issuer does not have them, then the issuer's spread ought to be higher. This is why Vodafone has three identical ratings (mid single A, stable outlook) to optimise its pricing and to give investors as much information as possible.

SECONDARY MARKET LIQUIDITY. There have been times when large liquid issues have attracted better pricing than smaller issues and vice-versa. Issuers may also obtain better pricing by using a strong trading lead manager with a reputation for providing good secondary liquidity. Vodafone has had investors, post-issues, complaining about certain banks' secondary pricing. This has caused it to look elsewhere for lead managers as their future pricing is unlikely to be as good as others.

Better understanding between issuers and investors also goes without saying. In any negotiation, if each side puts themselves in their opposite number's shoes a better overall deal is likely to be reached.

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