Publication: Mail & Guardian, Business
Date: Friday, November 24, 2017
Page: 4

JSE debt-list rules fail SOE investors

The exchange has been slow to act on calls for better protections and compliance monitoring

COMMENT
Olga Constantatos & Tarryn Sankar

Not transparent: The JSE's weak debt-listing rules are 'enabling' poor governance at state-owned enterprises. Photo: Gustav Butlex

In August 2016, Futuregrowth announced it would temporarily suspend lending to some state-owned entities (SOEs) until it could conduct in-depth governance checks, and subsequent events have highlighted just how critical the issue of good governance of parastatals is.

Our view has been affirmed — that good governance is much more than a mere box-ticking exercise and, crucially, the "who" and the "how" of governance deserves appropriate scrutiny and disclosure, which must go beyond the mere documented governance processes. Good governance is tied to responsible investing and is key to ensuring that public entities, mostly funded with public money, are sustainably managed.

Key themes

The rules governing debt capital market issuers are weaker than those governing equity market issuers. But repeated attempts by investors to improve listings standards and public disclosure requirements have been met with resistance.

To access public capital markets, debt issuers should subject themselves to a greater degree of scrutiny and commit themselves to a greater level of transparency and disclosure than is currently happening.

The JSE has been slow to support debt investors' calls for better protections and it has not been proactive about monitoring issuers to ensure compliance with requirements.

The SOEs and corporates that raise debt capital on the public capital market (the JSE) are bound by the JSE debt listings requirements (DLR). In many cases, the shares of corporate issuers are listed on the JSE's equities exchange, and investors in their debt also benefit from the regular Stock Exchange News Service (Sens) and other equity disclosures required by the equity listings requirements.

But the SOE debt issuers do not have listed equity and investors are reliant on the disclosure and reporting requirements of the DLR, which are inadequate because they do not require adequate reporting and disclosures to allow investors to make long-term investment decisions.

Improvements to the JSE's DLR need to be aligned more closely with the equity listings requirements, which have much higher disclosure obligations and established practices of disseminating information via Sens.

The aim must be to improve the standards governing South African debt capital markets, which will strengthen the reporting and disclosure requirements, and give all debt capital market investors the appropriate information that is currently not available.

Futuregrowth's Andrew Canter says: "A public capital market, such as the JSE equity or bond market, is a safe, fair and regulated place where buyers and sellers can meet. It is, in fact, a public amenity, like a road or a park, where any participant (whether professional or amateur) can enter on an equal access basis, and participate on a level and safe field of activity.

"The JSE's bond market is anything but that. It has been designed and run to enable opaque pricing, lack of transparency on a range of terms and information, and a lack of fairness. In effect, the JSE is an enabler of both malfeasance and poor governance."

The South African debt capital markets operate in terms of the Financial Markets Act no 19 of 2012 (FMA), according to which the JSE's DLR objectives are "to provide the JSE's users with an orderly marketplace for trading in such securities and to regulate the market accordingly", "to contain the rules and procedures governing new applications and continuing obligations applicable to issuers of debt securities" and are "aimed at ensuring the business of the JSE is carried on with due regard to the public interest".

This last objective is worthy of detailed examination. Our core argument is that the JSE is not adequately fulfilling this important objective.

Some examples

As is well known, Eskom's 2017 annual financial statements (AFS) were the subject of a qualified audit opinion, specifically for irregular expenditure. The newly amended DLR, effective from October 31 2017, contains a rare example of a useful amendment to protect investors: all issuers with qualified audit reports must annotate their debt instrument codes with a "Q". This clause also exists as part of the ELR for equity instruments.

But, as of November 13, none of Eskom's debt instruments contains this annotation. When queried, the JSE's response was that the changes effective from October 31 are not retrospective and so, because the qualified audit report was issued in July, no annotation was required for Eskom's bonds. We believe this goes against the JSE's stated mission to "ensure the business of the JSE is carried on with due regard to the public interest". A qualified audit opinion for the most recent annual financial statement is information that an investor should know.

Equity listings requirements require a much higher level of disclosure from directors, management and advisers of listed companies and further require that any changes to directors' declarations (as documented in schedule 13 of the equity listings requirements, which require extensive disclosure from each director about their experience and integrity), are made publicly and within 14 days, mostly via Sens announcements.

These provisions do not exist in the DLR and this has resulted in little to no disclosure about the process followed to appoint directors of SOE boards, specifically the criteria used, such as skills mix, experience and qualifications, and the extent and results of any probity and conflicts checks.

Debt investors have no mechanism that allows them to come together when bond terms need to be negotiated and voted on. Furthermore, there is no mechanism that allows a legal adviser for bond investors as a collective to negotiate with the issuer in cases of default or breach.

This is an important investor protection. For example, in July 2017, the minister of water affairs and sanitation did not extend the term of the entire board of Umgeni Water, which has about R1.5-billion in publicly listed bonds. This left the utility without a board.

As no mechanism exists for investors to discuss issues of common concern or to solicit legal advice collectively, it was left up to each investor to take up the issue with the relevant authority, something that Futuregrowth did. This is time-consuming and not cost-effective because each investor incurs legal costs and it allows the issuer and the arranging bank to fragment investors' concerns — the old divide-and-conquer strategy.

"In effect, the JSE is an enabler of both malfeasance and poor governance"

In the case of Umgeni Water, the JSE was also not helpful. We suspect a JSE-listed equity company operating without a board of directors would be grounds for immediate suspension of trading in that share. To our knowledge, the JSE took no public action regarding Umgeni's bonds.

Subsequent to a series of meetings between Umgeni, the department and Futuregrowth, the minister appointed an interim board.

There is no effective mechanism in the JSE's DLR for fair engagement in the legal agreements under which borrowers issue bonds, for example, such as the domestic medium-term note programme bond documentation. Although individual lenders may give feedback and comment, there is no mechanism for constructive or efficient legal advice for lenders, and bank arrangers can — again — divide and conquer investors.

The idea that a borrower is substantively able to write her or his own loan agreement is offensive to any sense of correctness in borrowing and lending public money. Does your bank allow you to write your own home-loan documentation?

The listing requirements are the appropriate platform for embedding adequate investor protections and disclosures. This will ensure that all issuers (of debt or equity) are subject to the same rules and standards of reporting and that all investors will have equal and timely access to relevant information to make investment decisions.

Many layers of improvements are needed, such as to the governance practices of capital market issuers, not only to the disclosures made by these entities but also to the implementation of much higher and more consistent standards of accountability, transparency, compliance with the law (especially the Public Finance Management Act) and better oversight.

In the case of the SOEs, the inconsistencies in standards between various executive authorities (as represented by different ministries) need to be urgently resolved and a common understanding of acceptable practices, transparency, behaviour and consequence management needs to be adopted. Looking back at the past year, we realise that our concerns about SOE governance were but a scratch on the surface of what has subsequently emerged. We had no way of knowing the extent of the allegations revealed by the information that has surfaced since then and continues to be released.

Urgently improving the standards required to list, and maintain a listing, on the JSE's debt capital market is an step in delivering on our fiduciary responsibilities to our pension fund clients and ensuring that their money is adequately protected.

The following disclosures should be a requirement for all public capital market issuers, and thus part of the disclosures required by the DLR:

- Annual public disclosure of the board and all subcommittee charters, including terms of reference, mandates, decision-making levels and quorum requirements;
- Annual public disclosure of all current and previous directors' and executives' dealings with the company;
- Disclosure of all board and subcommittee (including all procurement and lending committee) member changes via Sens at the time of the change, including the reasons for the changes, details of CVs, experience, results of conflicts and fit-and-proper tests for incoming members;
- Annual disclosure of board and subcommittee nomination and appointment processes and decision makers;
- Annual public disclosure of the entity's conflicts of interest policy, contentious issue policy and politically exposed person policy, including details of how this policy has been applied, deviations from the policy, and remedial action taken to address deviations; and
- All public disclosures to be made via Sens.

Olga Constantatos is the credit and equity process manager and Tarryn Sankar is an investment analyst, both at Futuregrowth