Bond investors left out in the cold

JSE backtracks on critical reforms in the latest version of the proposed amendments to the debt listing requirements

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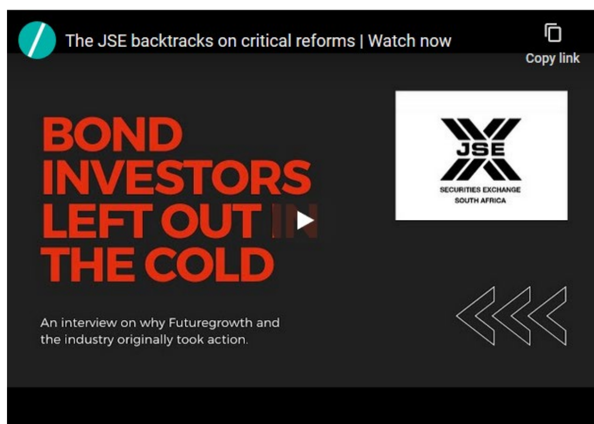
Bond investors have gone on a long, multi-year journey with the JSE to enhance investor protection only to see the stock exchange backtrack on key principles agreed in October last year.

Olga Constantatos, who has participated in the negotiations from the start, takes us through why Futuregrowth and the industry originally set out on the journey:



After years of negotiation between the investment industry, the JSE and other stakeholders, the JSE published the fourth version of the amendments to the bond market's regulatory framework, the Debt Listings Requirements (DLR), in January. It fell well short of the improved regulatory mechanisms that were agreed in October 2019 and, we believe, does not provide an acceptable standard of investor protections in its current form.

Not knowing how much would change in six months after reaching an agreement in October, we wrote at the time:

The JSE has recently proposed some bold – and, in our view, welcome and overdue - amendments to better balance investor protections against the needs of other stakeholders.[1]

Timeline

September 2018 - version 1 of the draft amendments to the DLR released for public comment. Futuregrowth (and other ASISA members) provide written comment to the JSE.

January 2019 – JSE hosts Indaba Day for input from stakeholders on the proposed version 1 amendments to DLR.

April 2019 – version 2 of the draft amendments to the DLR released for public comment. Futuregrowth (and other ASISA members) provide written comment to the JSE.

September 2019 – version 3 of the draft amendments to the DLR released for public comment. Futuregrowth (and other ASISA members) provide written comment to the JSE.

October 2019 – JSE arranges a meeting with stakeholders (banks, arrangers, investors and the JSE) to discuss proposed version 3 amendments to the DLR. Agreement reached on key principles of transparency of comments and legal advice paid by the borrower in certain events.

January 2020 – version 4 of the draft amendments to the DLR released for public comment. JSE addresses disclosure and noteholder meeting protocols but backtracks on key principles agreed in October and waters down responsibilities of the debt officer.

[1] https://www.futuregrowth.co.za/newsroom/are-bond-investors-getting-a-raw-deal-again/

In this article, we identify where the JSE has moved forward but also highlight where the stock exchange has materially backtracked on proposed amendments agreed just eight months ago.

Debt Listing Requirements V4 scorecard
Progress made
Improves conflicts of interest disclosures
Introduces better regulations and protocols governing investor meetings
Requires debt issuers to appoint a debt officer (but doesn't go far enough)
Still missing
An independent party to protect investors' interests – debt officers appointed by issuers
Reversals on October agreements
No requirement for transparency of investor comments on legal terms and conditions, no ability for investors to properly negotiate appropriate lending terms and conditions with the borrower
Investors still have to bear legal costs to protect our rights

"The JSE has materially backtracked on many of the proposed improvements to investor protections that were contained in earlier drafts of the proposed amendments to the Debt Listings Requirements."

WHAT HAS BEEN ADDRESSED

1. Disclosures and reporting

Given the history of corporate and SOE malfeasance in South Africa's recent history, there was unanimous agreement among all investors and the JSE that significant improvements needed to be made to the timing, nature and frequency of company and SOE disclosures and reporting.

Investors need to have access to real-time information to make informed investment decisions in a rapidly evolving environment. As such, we commend the JSE for improving the minimum disclosures companies and SOEs, that raise debt on the JSE, need to uphold.

Notable improvements now include:

- Debt issuers must make public their current policies on conflicts of interest and disclose all instances of such conflicts (including the director's personal interests) on their website.[2]
- Debt issuers must publicly disclose the process of nominating and appointing directors of the issuer, including details of any fit-and-proper and conflicts checks to evaluate the

[2] DLR v4, sections 7.4-7.6

suitability of candidates. Changes to this policy, and the reasons for deviating from the policy, need to be publicly disclosed.[3]

- Disclosure will now be required when an SOE or a municipality transacts with (either through procurement or through lending) with a "domestic prominent influential person" ("DPIP") or a related party.[4] Transactions of this nature can pose an unacceptable conflict of interest and raise the risk of decisions that are not in the best interests of the company. Examples that come to mind here are loans made to politicians that exceed their capacity to repay or on more favourable terms than less-influential citizens can get.[5] Another example is the procurement of services undertaken between an SOE and the CEO's step-daughter[6].

THE TAKEOUT: The required public disclosure of conflicts of interest and director fit-and-proper checks gives investors valuable information. This information will allow us to make adjustments to decision-making, pricing and exposure to the debt in response to changes in the risk profile of corporate and SOE debt instruments.

2. Noteholder meeting protocols

The new draft regulations also introduce better regulations and protocols for investor meetings. Investors will now be able to call a meeting of noteholders to:

- discuss/agree on matters of mutual concern;
- vote on decisions; and
- collaborate where the borrower is not meeting its obligations.

Our experience of the history of investor engagements at Umgeni[7], PPC[8] and other issuers have taught us that the ability of investors to engage with each other and with the issuer needed significant improvement, particularly so in instances where:

- the issuer is not meeting their obligations;
- where investors require additional information; or
- when the issuer wants to change material terms of their loans.

The new proposed amendments to the DLR has also made overdue changes that enable investors to call a meeting of noteholders. It also ensures voting on decisions is based on the percentage value of investments held, as opposed to the previous outdated and iniquitous voting by a show of hands.

THE TAKEOUT: Investors can now call meetings when we want to discuss matters of mutual concern, vote on decisions or act collectively when the borrower is not meeting its obligations.

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[3] DLR v4 draft, sections 7.7-7.8
[4] DLR v4, sections 7.9-7.17
[5] VBS: The Great Bank Heist by Advocate Terry Motau SC, found here: https://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=8830
[6] https://www.fin24.com/Economy/Eskom/kokos-stepdaughter-got-r800m-tender-in-eskom-looting-scandal-report-20190310
[7] https://www.businesslive.co.za/bd/national/2017-08-17-headless-umgeni-water-worries-large-investor/
[8] https://www.futuregrowth.co.za/newsroom/investor-rep-needed-to-challenge-bond-market-status-quo/

3. Appointment of a debt officer

To protect investor interests, the version 4 draft amendments require debt issuers to appoint a debt officer. Investors proposed that, in the absence of an independent bond trustee or investor representative, the debt officer needs to be someone of sufficient stature within the organisation (a CFO or Treasurer[9]) and to meet the same fit-and-proper requirements as directors.

Investors believe that the purpose of this role should be to:

a. ensure the debt issuer meets its obligations to investors;
b. act as a central office to coordinate investors' concerns/comments in the primary issuance phase and;
c. coordinate investors' efforts to organise ourselves, get legal opinion and meet to make decisions in situations when the issuer does not meet its obligations (as was experienced by investors in African Bank, Steinhoff, Umgeni Water, PPC and others).

The version 4 draft of the DLR includes a provision for an issuer to appoint a debt officer and outlines, in s 4.10, the requirements for such an appointment to be "fit-and-proper", much like a director. S7.3(g) requires the debt officer to be the CFO or Group Treasurer, fulfilling investor's requirements for this role to be staffed by someone with sufficient seniority and decision-making authority as described above.

WHAT IS (STILL) MISSING

1. Debt officer responsibilities fall short

While the concept of an "investor representative" or a "debt officer" is included in version 4 of the draft DLR (this role was called a Compliance Agent in version 3), we believe it falls far short of the roles and responsibilities required by investors.

Industry participants from ASISA[10] wanted to see the debt officer facilitate the proper negotiation of legal terms between the issuer and investors to allow for appropriate lending terms and conditions to be included in the loan documents and, once the bond has been issued, to ensure the issuer is meeting its investor obligations. Deletion of the October 2019 agreements severely hampers our ability to fulfil our fiduciary responsibilities on behalf of our pension fund members. The proposals made, and accepted, in the previous DLR and in stakeholder engagements with the JSE in October 2019 are standard market practice in other jurisdictions and are wholly absent in our market, significantly reducing investor protections.

THE TAKEOUT: The role and responsibilities of the debt officer are a long way off the "investor representative" initially recommended by investors. It is not independent of the issuer and critical responsibilities that would facilitate a proper negotiation between borrower and lenders and to ensure the issuer meets its obligations to investors are absent.

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[9] DLR v4, clause 7.3(g)
[10] ASISA: The Association for Savings and Investment South Africa

WHERE THE JSE HAS BACKTRACKED

1. Ability to properly negotiate terms and conditions of loan documentation:

In other jurisdictions, investors are allowed to appoint either a legal advisor to act for investors as a collective, or a bond trustee to ensure investors' right are protected. In South Africa, we have neither of these. In an attempt to reach a mutually agreeable solution, investors compromised on this protection asking for, in the absence of a legal advisor/bond trustee appointed to act for investors/lenders, at a minimum, a requirement for transparency when individual lenders are providing comments on legal terms and conditions contained in the legal agreement between the issuer and investors (this document is known as the DMTN[11]). The JSE has deleted this requirement in version 4, and no substitute mechanism has been offered by the JSE, leaving investors in an invidious position.

2. Responsibility for payment of legal costs

In any other lending arrangement (for example, your home loan), it is entirely usual for the legal fees to be borne by the borrower in the event of a default, renegotiation of the debt or amendments to the contract. In the bond market, lenders must pay the legal costs of the borrower. Ask yourself this – would the lender (the bank) pay the legal costs when a homeowner (the borrower) defaults on their home loan? No, of course not. Can you understand why we investors are annoyed? Further emphasising the importance of this requirement as a key investor protection is the prohibition in the Collective Investment Schemes Control Act to fund legal costs from a portfolio of the collective investment scheme. Including the suggested requirement to have legal costs funded by the issuer would mean that investors in these schemes would be able to take legal advice (which would be paid for by the issuer) to enforce and protect our rights. The current position is untenable and leaves investors significantly exposed.

THE TAKEOUT: The JSE has done an about-turn on two crucial principles agreed upon in October 2019: investors' ability to properly negotiate terms and conditions of loan documentation with borrowers and the requirement that borrowers, not lenders, pay for legal advice. No substitutes to these critical protection mechanisms are offered in version 4 of the draft amendments.

The JSE's reasoning for the wholesale deletion of these two critical investor protections, included in previous versions of the proposed amendments to the DLR, cites legal opinions obtained that i) the JSE does not have the power to regulate processes which are subject to commercial negotiations and ii) that the JSE would not be able to comply with its statutory obligation to enforce these requirements. We believe their exclusion violates every principle of sound lending and enables issuers to divide and conquer by not allowing the investors to properly negotiate in the interest of the individual and pension fund investors we represent.

Although ASISA members requested copies of the legal opinions on which the JSE is relying, the JSE did not provide these. Despite not having sight of the legal opinions, we do not accept the rationale given by the JSE.

[11] DMTN: Domestic Medium Term Note Programme

The reasons for our position are:

1. The JSE's job is to create and manage a fair and level playing field where borrowers and lenders can meet, negotiate and transact. Presently the corporate bond market is a skewed playing field.
2. Where commercial negotiations do not achieve an appropriate outcome (as we have experienced over the years of malfeasance in the corporate bond market) there is a need for a regulatory solution.
3. Many of the provisions of the DLR (e.g. SENS requirements) arguably fall within "processes which are subject to commercial negotiations" and yet are already part of the existing regulations. It appears to us that this is inconsistent.
4. Investors' view is that the JSE's oversight of the corporate bond market does not support or enable a proper commercial negotiation to take place. The removal of these provisions perpetuates this problem.
5. Finally, the JSE is required to enact Debt Listings Requirements that, *inter alia*, protect investors. The JSE is the regulator, with all the powers of enforcement that come with that role. As such, before instruments are listed, the JSE must satisfy themselves that the regulations have been met by the potential issuer.

We do not understand, nor accept, the rationale provided by the JSE on backtracking on either of these key terms.

WHERE TO FROM HERE?

Futuregrowth and other industry participants have given our feedback to the draft 4 of the proposed amendments to the DLR. The JSE has undertaken a public comment period to the draft 4 amendments, which ended on 17 February 2020. Once the JSE has considered all comments received during the public comment period, it is expected that the JSE will submit the proposed amendments to the regulations to the Financial Sector Conduct Authority (FSCA). The FSCA will then consider this draft, as well as the feedback from the industry players, before deciding whether or not to enact version 4 of the amendments to the DLA.

UPDATE as at 30 APRIL 2020

The JSE submitted a new version ("V5") of the DLR to the FSCA in March 2020. V5 is substantially the same as the previous V4 and so – once again – despite investor's significant objections, the JSE has proceeded with issuing a set of regulations that lack any meaningful investor protections.

FSCA's public comment period on V5 ended on 30 April 2020. Futuregrowth, together with the ASISA FISC members, has submitted detailed written objections to the amended DLR. Our objection to FSCA is twofold: i) we object to the amendments as they have been proposed as they lack meaningful investor protections; and ii) we object to the process followed by the JSE in arriving at this V5 of the DLR. Our request to FSCA is that the FSCA exercise its powers to amend the DLR so that adequate investor protections, as we have detailed above, are included in the DLR.

The recent Land Bank Event of Default is another example of the urgent need for appropriate and fair investor protections in the bond market. Investors are being asked to navigate this Event of Default without any meaningful investor protections and our correspondence to the FSCA has highlighted this as further evidence to support our objections to V5 of the DLR.

We await the FSCA's response and will update when we have further information.

SUMMING IT UP

The JSE needs to do better – your and my pension demand nothing less.

Futuregrowth has been beating the drum for better investor protections for the market and our clients for years because we have a fiduciary duty to uphold on behalf of our pension fund investors.

Together with the other ASISA members, we have engaged in good faith negotiations with the JSE during the extended process of amending the DLR. We have committed significant time and resources to attend meetings with the JSE and other stakeholders, and we have provided extensive and detailed comments on all four versions of the proposed amendments to the regulations. To date, the JSE has not responded in detail to each of the investors' comments raised in versions 1-3.

In addition, the latest draft, version 4, disregards many of the alternatives proposed, and compromises made, by Futuregrowth and ASISA members over the past two years of public participation in the process of amending the DLR.

While many of the proposed changes in version 4 are welcome, the JSE's reversal on protections governing legal costs and the appropriate negotiation of lending terms leaves us with an unacceptable standard of investor protections. As they stand, we believe the protections do not meet the standards required by the Financial Markets Act (FMA).

To date, the JSE has not given the industry an acceptable explanation as to why it has backtracked on the agreements that were reached by all stakeholders at the October meeting last year.

The JSE needs to do better – your and my pension demand nothing less.

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