

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Consultation Document on Listing Authority Policies

5th July, 2010

The Malta Financial Services Authority (MFSA), acting as Listing Authority in terms of the Financial Markets Act, invites comments by not later than the 26th July, 2010 on two policies which will be adopted in respect of certain applicants for admissibility to listing on a Regulated Market as further detailed in the attached. Interested parties are invited to send their comments in writing addressed to the Listing Authority, MFSA or via e-mail on su@mfsa.com.mt

Background

The corporate bond market in Malta is characterised by a large take up of these by local retail investors. In order to safeguard the interest of these investors, the Malta Financial Services Authority, acting as the Listing Authority, has been requiring Issuers of bonds offered to local retail investors to satisfy certain conditions for admissibility to listing. These conditions are set out in policies adopted by the Listing Authority which are subject to review from time to time.

The purpose of this circular is to provide the financial services industry and the general public with a brief background on the Listing Authority updated policy concerning the Sinking Fund requirement as well as the adoption of a new policy requiring a financial assessment report to be submitted by applicants for admissibility to listing of corporate bonds marketed to local retail investors. This circular also serves as a consultation document on the new policies.

The Listing Authority may in due course adopt further policies in the interest of retail investors whose aim is to focus on increased transparency by Issuers regarding their financial status, extent of aggregate borrowings and other matters.

Listing Authority Policies

Sinking Fund

The Sinking Fund policy has been applied by the Listing Authority over the past couple of years. The purpose of the policy is that of seeking to ensure that in carrying out their financial management, bond Issuers do not overlook bond-holders' interests. This is carried out by requiring Issuers to establish a reserve funded from operating profits to at least partly finance the redemption of the bonds upon maturity. This creates an obligation on the Issuer to manage the assets of the company diligently in the interest of bond holders.

The new Sinking Fund policy introduces the following changes to the framework which is currently applicable:

[a] Definition – This is being included in order to ensure that there is a common understanding of the meaning of the term ‘Sinking Fund’. The new definition is based on the primary objective for requiring the establishment of a Sinking Fund as outlined above;

[b] Required Funding of Sinking Fund – There are various methods that may be applied for the determination of the amount, which should be allocated to a Sinking Fund. The current policy makes no reference to a single set of criteria which must be applied by an Issuer for the determination of the amount to be allocated to a Sinking Fund on an annual basis. In this regard, a definite set of criteria have been established;

[c] Commencement Date – To date it has been a policy of the Listing Authority that the Sinking Fund should be established within two years from the issue of the bond, irrespective of the term of the bond. In order to ensure a more prudent application of the conditions of the Sinking Fund, it is considered appropriate that the commencement date for the funding of the Sinking Fund is reduced from two years to one year where the term of the bond is five years or less;

[d] Sinking Fund Custodian - To date it has been a policy of the Listing Authority that the Issuer should appoint a Trustee for the purpose of ensuring that the assets of the Sinking Fund are safeguarded and used in the best interest of bondholders. As the appointment of a Trustee gives rise to the transfer of legal ownership of the Sinking Fund assets from the Issuer to the Trustee with the consequent implications this gives rise to and as the main objective of the Listing Authority is to ensure that the Sinking Fund Assets are ‘controlled’ rather than ‘owned’ by a third party which is to assume certain monitoring duties in their regard, it is felt more appropriate for the Sinking Fund assets to be held by a ‘*Sinking Fund Custodian*’ rather than a ‘*Trustee*’. The new policy requires that the Sinking Fund Custodian is vested with certain prescribed duties, which have the purpose of ensuring that the assets within the Sinking Fund are used in the best interest of bond holders. In order to ensure that the entities who are to act as Sinking Fund Custodians are fit and proper and are properly equipped to provide this service, the Sinking Fund Custodian must either be a credit institution or an investment services licence holder having a Category 2, 3 or 4 licence issued by the MFSA;

[e] Use of the Sinking Fund Assets – The current policy of the Listing Authority is that the Sinking Fund assets may only be used: **[i]** to repurchase the securities of the same issue; and **[ii]** for investment in certain admissible assets. This policy is being retained, however it is being refined to refer to defined investment parameters which are similar to those set out in Schedule II of the Investor Compensation Scheme Regulations, 2003. This policy is also being enhanced in order to give the Issuer the opportunity to use the assets in the Sinking Fund as collateral where it is facing liquidity problems. Certain safeguards in this regard are being proposed, such as a requirement that the Sinking Fund Custodian’s prior permission should be obtained from the Issuer; **and**

[f] Disclosure - Transparency is one of the fundamental means of achieving investor protection in securities regulation. In this regard, the revised listing policy requires certain fundamental information on the Sinking Fund and the Sinking Fund Custodian to be included in the prospectus of the Issuer, which is currently standard market practice. A ‘comply or explain’ policy has to be adopted wherein the Directors of the Issuer are required to include a section regarding compliance

with the requirements of the Sinking Fund in their report included in the interim and annual financial statements of the Issuer. Furthermore the Issuer should draw up an annual report addressed to the Listing Authority and the bond holders, regarding the extent of compliance by the Issuer with the requirements relating to the Sinking Fund and that a copy of such a report is included in the annual financial statements of the Issuer.

Financial Soundness of Applicants for Admissibility to Listing

The Listing Authority is concerned about the possibility that companies may resort to tapping the Regulated Market to obtain liquidity where this is not available from credit and financial institutions in view of poor creditworthiness and other financial difficulties which the particular company might be facing. In this regard, in order to reduce the possibility of this eventuality, an additional safeguard is being introduced whereby applicants for admissibility to listing are requested to demonstrate their financial soundness and strength to the Listing Authority, by submitting an assessment of financial soundness from their auditors or bankers or from a credit rating agency. Certain criteria for the preparation of this report are also being introduced as part of this new Policy.

Applicability of Policies

Following the end of the consultation period, and once the Listing Authority has considered any feedback received, the new Policies once finalised, will be published in their final format and enforced on new applications from corporate applicants for admissibility to listing of bonds available to local retail investors, with the exception of licensed credit institutions which are already subject to strict prudential requirements.

Listing Authority Policies

[1] Sinking Fund

Definition: “A pool of assets, created for the purpose of establishing a reserve by means of which, all or part of a debt may be redeemed.”

Applicability: The Sinking Fund should generally be a requirement of all local bond issues aimed at retail investors with the exception of Government bond issues and bond issues by credit institutions, and its setup and operation should be fully disclosed in the prospectus.

Required Funding of Sinking Fund: The Issuer should be requested to make an annual instalment to the fund, which should be calculated as a percentage of the company’s profits **after tax** but before preferred and ordinary dividends. Where the Company issuing the bond is a Special Purpose Vehicle (SPV) of a Group, the calculation must be extended to the profits of Group Companies financing the SPV. The required instalments should be made so as that the value of the Sinking Fund at the time of maturity of the bonds is at least 50% of the bonds to be redeemed.

Commencement Date: Issuers are to be required to commence funding the Sinking Fund by not later than 1 year from issue of the bonds if the term of the bond is 5 years or less and by not later than 2 years if the term of the bond is over 5 years.

Sinking Fund Custodian: The Sinking Fund Custodian must either be a credit institution or an investment services licence holder having a Category 2, 3 or 4 licence issued by the MFSA.

The Sinking Fund Custodian should undertake the following activities:-

[a] Take control of the assets of the Sinking Fund, which must be segregated from the other assets of the Issuer

[b] Monitor whether the Issuer actually fulfils the obligation to make a yearly payment to the Sinking Fund;

[c] Seek to ensure that at maturity date, the Sinking Fund will have accumulated at least 50% of the principal amount which will be paid to bond holders. If this is not possible, the Sinking Fund Custodian should ensure that the failure of the Issuer to fully achieve the Sinking Fund was due to justifiable reasons;

[d] In case where the Issuer had pledged assets to the Sinking Fund, the Sinking Fund Custodian should audit that no misappropriation would have taken place during the term of the bond;

[e] Monitor that the portfolio of assets within the Sinking Fund is managed (by the Issuer or any other person appointed by the Issuer) within the parameters set in the investment allocation principles set by the Listing Authority as further detailed below;

[f] Authorise the use of the assets in the Sinking Fund as specific collateral (over and above any general hypothecs) where the Issuer is experiencing liquidity problems which could result in the failure of the Issuer. In this regard, a board resolution from the Issuer which states that the company needs to use the assets in the Sinking Fund as collateral due to its financial situation, would need to be presented in order to allow the Sinking Fund Custodian to an issue an authorisation in this regard;

[g] Draw up an annual report addressed to the Listing Authority and the bond-holders, regarding the extent of compliance by the Issuer with the requirements relating to the Sinking Fund. A copy of such a report is to be included in the annual financial statements of the Issuer.

Use of Sinking Fund Assets: The use of the monies allocated to the Sinking Fund should be restricted to: [i] the repurchase of the securities of the same issue [Any use of the Sinking Fund to repurchase the bonds for cancellation, will be without prejudice to the requirements to maintain the required Sinking Fund for outstanding bonds]; and [ii] investment in admissible assets as follows:

- (a) at least 25 per cent of the total amount shall be maintained in an interest bearing bank account denominated in the same currency as the bonds and held with a bank established in the EEA or invested in Malta Treasury Bills; and
- (b) not more than 75 per cent of the total amount shall be invested as follows:
 - (i) at least 50 per cent (in this case 37.5 per cent of the total Sinking Fund) shall be invested in Malta Government Stocks or in local SICAVs that invest principally in Malta Government Stock; and
 - (ii) the balance may be invested in debt instruments denominated in the same currency as the bonds, issued by local or international entities which are unrelated to the Issuer, have an investment grade of not lower than "A" by a reputable credit rating agency and which are quoted on an investment exchange.

Moreover, the Issuer should only be allowed to use the assets within the Sinking Fund as collateral to obtain further financing for business purposes where it is facing liquidity problems. In this regard, before the assets within the Sinking Fund are utilised to address such problems, the permission of the Sinking Fund custodian should be obtained. Furthermore, the Listing Authority should be informed. This is without prejudice to the ability of the Issuer to grant the bank a general hypothec over its assets (including the Sinking Fund assets) as may be required in the ordinary course of its business.

Disclosure in Prospectus: The Issuer's prospectus should include proper disclosure regarding the nature of the Sinking Fund (including the fact that): [i] the Sinking Fund assets remain the assets of the Issuer, [ii] the identity, the role and the function of the Sinking Fund Custodian [iii] the manner in which the amount to be allocated to the Sinking Fund will be calculated; and [iv] the manner in which the regular disclosure to bond holders regarding the Sinking Fund will be carried out.

Disclosure in Directors' Report: A 'comply or explain' policy should be adopted wherein the Directors of the Issuer are required to include a section regarding compliance with the

requirements of the Sinking Fund in their report included in the interim and annual financial statements of the Issuer. The report should clearly outline the reasons for any breaches of the Sinking Fund requirements.

[2] Financial Soundness of Applicants for Admissibility to Listing

Applicants for admissibility to listing of corporate debt securities aimed at local retail investors (with the exception of credit institutions) are to be required to demonstrate their financial soundness and strength to the Listing Authority. The assessment of the financial soundness and strength of applicants is to be made by the Issuer's auditors or bankers or by a credit rating agency.

For this purpose, as part of the application to the Listing Authority for admissibility to listing, Issuers are to submit a report drawn up by their auditors or bankers or by a credit rating agency which should include:

- (a) The credit history of the Issuer, in particular the extent to which it has honoured its payment obligations to its bankers and other creditors over the past five years from the proposed date of the Issue;
- (b) An opinion on the ability of the Issuer, based on its financial situation, its track record and its business plan for the following years, to be able to generate sufficient profits and cash flow to honour interest payments during the life of the bonds it intends issuing as well as to repay the capital upon their maturity; and
- (c) Where the proceeds of the bonds are to be used to finance a specific project, an opinion as to whether in the worst case scenario, should the project not be successful, the Issuer will nonetheless have sufficient funds from its existing operations, to be able to honour its bond interest payments and repayment of capital upon maturity of its bonds.

The Listing Authority may adopt further policies in the interests of retail investors which focus on requiring increased transparency by Issuers regarding their financial status, extent of aggregate borrowings and other matters.