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To

International Accounting Standards Board

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London E14 4HD

United Kingdom

March 29th, 2024

Submitted electronically

Dear Sir/Madam

Subject: Exposure Draft - Financial Instruments with Characteristics of Equity: Proposed amendments to IAS 32, IFRS 7 and IAS 1

I am pleased to respond to the call for comments on the Exposure Draft on Financial Instruments with Characteristics of Equity: Proposed amendments to IAS 32, IFRS 7 and IAS 1.

I appreciate the IASB's efforts in addressing issues arising from the need to clarify the classification requirements in IAS 32, and to propose improvements to the presentation and disclosure of information about financial liabilities and equity instruments.

I thank you for the opportunity to respond to this Exposure Draft. Please do not hesitate to contact me should you wish to discuss any of my comments.

Yours sincerely

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(Disclaimer: The opinions expressed in this Comment Letter are those of the author. They do not purport to reflect the views or opinions of the Department, College or the University).

Background Note:

My submission is restricted only to Question 1 of the ED, relating to the role of relevant law in determining the principles that must inform classification outcomes under IAS 32, where I have differing views and suggestions for modifications. In all other 'pragmatic' respects, I support the proposals or have no substantive suggestions to offer. This comment letter is based on a combined reading of the three documents published by the IASB i.e. Exposure Draft (ED), Bases for Conclusions (BC) and Illustrative Examples/Implementation Guidance (IE). Consequently, the comments submitted herein are based on views developed in relation to a holistic interpretation of all three documents.

Response to Question 1—The effects of relevant laws or regulations (paragraphs 15A and AG24A–AG24B of IAS 32)

1. As the Board notes, the notion of a contract is central to IAS 32 (ED para. BC12, page 6). IAS 32, para. 13 defines 'contract' and 'contractual' as referring to:

   "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing" (emphasis original).

   The definition in its present form has very limited tractability in aiding clear discrimination for the purposes of classification of financial instruments, particularly in light of issues raised and sought to be addressed in the development of the FICE ED. The suggestion that the definition of a contract for the purposes of IAS 32 should be enhanced and suitably illustrated, was evident from feedback submitted by constituents in response to the FICE Discussion Paper (DP) issued in 2018.

   In particular, while the definition in IAS 32 seeks to centre attention on the economic dimension of contracts (the reference to law being limited to the aspect of general enforceability), it does not go far enough. A transaction cost economics lens (Williamson 1975, 1985) would readily reveal that considerations of asset and firm specificity, transaction complexity, and ex-ante uncertainty are integral to the negotiation and ongoing modification of contracts, through which the mode of organizing contractual rights/obligations between counterparties are settled. In this view, the selection of a suitable governance structure and its degree of specialization (for example, the use of non-standard clauses, arbitration, escrow etc.) would therefore depend on considerations of complexity, verifiability and enforceability. Consequently, the selection of a suitable mode of financing (debt or equity) or the balance of debt and equity-oriented features within complex, compound or hybrid financial instruments is predicated on contextual perceptions of ex-ante

contractual incompleteness and ex-post maladaptation. In turn, these aspects do not operate in isolation but are closely linked to prevailing legal and regulatory considerations, specific to an applicable jurisdiction.

<u>Of essence therefore, is the contention that a basket of contractual and legal rights and obligations cohere to determine the substance of a contract and the intent of counterparties.</u> Even if one were to solely emphasise standalone (or incremental) contractual rights and obligations (to the exclusion of those arising under statute or regulation), this would appear to take us implicitly towards an agency theory view of the firm. In this view, the firm appears as a "legal fiction" that underpins a nexus of intertwined contractual relationships among counterparties alongside "divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals" (Jensen, Meckling 1976). However, even in such a view, the role of statute and judicial precedent in imposing contractual boundaries, enforcing contractual obligations, and administering consequences in the event of non-performance, cannot simply be ignored. These do not just determine the "extent to which contracting is relied upon" and the "viability" of organizing various configurations of the contractual nexus, but can more directly "change the rights of counterparties ex post, and they can and do serve as a vehicle for redistribution of wealth" (Ibid.). This latter aspect has direct implications for the ex-ante assessment of contractual cashflow characteristics of financial instruments.

In this respect, some of the feedback received in response to the 2018 FICE DP are instructive. Thus, it has been highlighted that:

"(A) contract that is subject to the classification criteria is always embedded in the legal framework around it. This may make a difference when terms are imposed by law and as a consequence are not explicitly stated in the contract. As an example: a contract may be classified as an equity instrument because the terms of contract do not provide the holder with the right to put the instrument back to the issuer. If the legal framework overrides this contractual term and in effect, the holder has the right to put the instrument back, then the classification outcome may change." (BusinessEurope Comment Letter, page 13).

The following submission highlights a specific challenge arising from "the interaction between the contractual rights and obligations and regulation":

"In particular with new financial products developed in the aftermath of the financial crisis: (a) many financial institutions have issued convertible bonds that may be mandatorily convertible into a variable number of own shares and/or written down; (b) the trigger event and form of resolution could be at the discretion of the regulator and it is not clear in advance which form of resolution the regulator will choose;" (EFRAG Comment Letter, page 3).

These and other submissions raise the substantive question of whether (a) contractual and legal rights/obligations are always as clearly separable as contemplated for the purposes of para. 15A (proposed), and (b) where statutory provisions over-ride or substantially modify contractual

rights/obligations, then would the impact of ignoring the statutory over-ride or modification, not be detrimental to the classification outcome?

In particular, research into contract design indicates that since ex-ante contractual completeness is not feasible owing to a very wide range of obstacles, counterparties may be benefited by trading-off front-end transaction costs (through writing more detailed contracts that seek to anticipate myriad states, outcomes in each state etc.) against back-end transaction costs (litigation). Consequently, this has potential implications for the balance between vague and precise contractual terms, such that counterparties may seek to make deliberate choices between whether the "proxies" for signalling the realized state of the world, should be integrated within contractual "rules" or delegated via "standards" to law enforcement for interpretation (Scott, Triantis 2006; see also Posner 2005) Thus, anticipating the costs and effects of litigation into contractual terms has the potential for efficient contract design. Drawing an analogy from this, it is possible to argue as an example, that the level of detail and specificity in the courses of action within the general bail-in powers available to regulatory authorities, can potentially influence ex-ante, the choice of contractual terms of bail-in instruments. Even if contracts cannot be informationally complete, they can be "obligationally complete" (Scott, Triantis 2006). However, the 'obligation-completeness' of contracts need not necessarily be accomplished through exhaustive contract-writing, particularly if these are spelt out in detail within relevant law/regulation. In such cases, it is only reasonable to expect that 'detail-filling' of at least some rights/obligations are delegated by contract (therefore absent) to regulation. This is an aspect that requires further consideration in standard-setting.

It is observed that the Board decided early on in the ED phase to focus on practice issues and thereby limit recommendations to "providing a practical boundary for classification purposes" (AP 5C, December 2021). However, such an approach, while apparently pragmatic, is not consistent with the stated objective of principles-based standard-setting. It is therefore submitted that further thought be undertaken towards developing a principled approach on the interaction of contractual rights and obligations, and relevant law for the purpose of classification of financial instruments per IAS 32. This is likely to enhance credibility and ensure consistency with other recent contract-centric standards such as IFRS 15 and IFRS 17, that also incorporate multiple references to the consideration of precedent and legislation (acknowledged in para. BC14(b) of the current ED).

It is noted that a possible approach suggested by at least one constituent during the DP phase was to consider commencing from contractual terms, but ensure thereafter, that a substantive determination of contractual rights and obligations is predicated on an adequate consideration of "laws and regulations that clarify, limit or explain the terms of the contract" (PwC Comment Letter, page 23). It is noteworthy that the initial guiding principles proposed by Staff, for evaluating the interaction of relevant laws and contractual rights/obligations, included the proposed principle that where an existing contractual right/obligation is affected by a statute/regulation in a manner such that it is rendered unenforceable or becomes avoidable (specific reference to "limit, modify or prohibit" - see AP 5F, September 2021), then the effect of such laws should be considered in classifying financial instruments. It was also asserted at that point that all legal provisions need to

considered "that are relevant to a financial instrument and that are legally enforceable at initial recognition of the instrument." (AP 5F, September 2021).

However, progressively through the development of the ED, explicit reference to this aspect has been completely omitted. The net effect is that the final ED appears to have moved from an interim position of recommending analysis based on contract-specific terms and including law/regulation (at least) selectively, to a final position in which the focus is entirely on additional or incremental contract-specific terms. For reasons highlighted earlier, such an approach is unlikely to provide the principles-basis required to capture the full economic perspective that would be necessary for an appropriate classification of the underlying financial instrument. Additionally, there is a heightened risk of 'structuring of contract terms', such that contractual rights/obligations are deliberately designed to supplement law/regulation with the intent that they qualify for inclusion and thereby influence outcomes in classification analysis under IAS 32.

2. Notwithstanding the foregoing and considering the ED on its proposed terms, some observations are raised here with respect to proposed drafting. Question 1 on page 9 of the ED, and proposed draft of Para. 15A refer to the phrase "and are in addition to". This is an apparent reference to the general or over-riding principle that only those legally enforceable rights/obligations are to be considered that have contractual origin and specificity as opposed to 'sui generis' rights or obligations that arise under relevant law and are therefore affected by modifications to the law that apply to the entire class of similar instruments. Further, Application Guidance under proposed Para. AG24B refers to the phrase "is in addition to" – here the reference is in respect of "a contractual right or obligation that is not ***solely*** created by laws or regulations" (emphasis added). A specific principle is being invoked in AG24B that such a right/obligation should be considered in its entirety i.e. principle of non-severance or non-disaggregation in cases where such contractual right/obligation augments or supplements incrementally, a right/obligation already specified under relevant law (irrespective of whether such right/obligation is referenced explicitly or implicitly in the contract).

   By its very nature, the latter category is meant to address instances where the contractual right or obligation is in substance *not additive to* relevant law (certainly not in the manner contemplated under proposed para. 15A), but is instead replicative, and supplemental or incremental to an aspect of prevailing law (irrespective of whether or not there is explicit reference to the corresponding legal provision in the contract). This is consistent with the notion of "more specific than" that the Staff evolved during the ED phase, but, that has subsequently been dropped in developing the ED. The requirement of non-disaggregation of the "contractual right or obligation into contractual and non-contractual parts" in para. AG24B is clearly suggestive that what is contemplated here (unlike para. 15A) is in essence a right/obligation that derives from a corresponding statutory or regulatory right/obligation, yet surpasses it in some manner.

Consequently:

(a) It appears that although AG24B is intended to represent application guidance only, the intention is the establishment of a principle (non-severance in case of a contractual right/obligation that is parallel to a statutory right/obligation and yet transcends it). Therefore, it seems necessary to include this principle within the text of the standard itself, and to clarify the distinction between being additive (para. 15A) and being supplemental (current para. AG24B). In particular, it may be necessary to clarify that while such latter right/obligation does not strictly fall within the confines of para. 15A (a), however, in specie, it does not fall within the ambit of para. 15A (b) either, since the right/obligation ***in its specific form*** (e.g. higher contractual minimum dividend than that specified by relevant law) does not ***directly*** arise from a corresponding statutory or regulatory provision, and therefore has a negotiated character and effect of altering the substantive nature of the financial instrument. This is particularly important in view of the recognized principle underlying IAS 32 that "law and regulation can be changed unilaterally by an authority without agreement from the counterparties" (see FICE DP, p.132). Consequently, contractual rights or obligations that do not solely originate from, but are incremental to rights or obligations established by relevant laws or regulations, have character both in specie and validity, that extend beyond the generality and contingent temporality of statutory provisions that are outside the control of counterparties.

(b) At a minimum, to distinguish between the two, the phrase "in addition to" in para. AG24B is confusing. Therefore, in Qt 1 para. (b) of the ED, the draft wordings in para. AG24B and in para. BC26 (particularly in view of clear drafting in BC 23 i.e. "incremental"), an alternate deployment is essential. One possible approach is to state for the purpose of these sections of the ED (and finally amended IAS 32) that:

> "An entity shall consider a contractual right or obligation, which is not solely created by laws or regulations but ~~is in addition~~ **supplements or is incremental** to a right or obligation created by **(such)** relevant laws or regulations, in its entirety in classifying that right or obligation."

The illustrations used i.e. BC23, BC25 and proposed AG24B are all instances where the underlying right/obligation is ***not in addition to*** those that are specified under relevant law, but instead are based on applicable law and go beyond, by supplementing or incrementing those rights/obligations.

(c) A further question arises: para 15A intends to establish the principle for determination of the extent to which rights/obligations under law or regulation, are to be considered in classification of the financial instrument under IAS 32. The illustrations in para. BC13 provide preparatory context to the eventual rejection of the "all-inclusive approach (BC14), the 'static v/s dynamic referral approach' (BC17) and the 'reproduction' approach (BC18), in favour of:

> "an approach that considers only contractual rights and obligations that are in addition to those established by relevant laws or regulations. These contractual rights and obligations are subject to

negotiation and agreement between the parties to the contract and, therefore, can be modified by mutual agreement." (para. BC20). (emphasis added).

However, the examples given in BC13 i.e. "financial instruments with 'bail-in' provisions" and "ordinary shares with statutory minimum dividends" highlight typical *statutory* provisions applicable to such instruments (sui generis) rather than illustrating rights/obligations that "are in addition to" by having contractual specificity and origin. The subsequent discussion of these illustrations in para. BC21 as per the proposed approach, and the conclusion in para. BC22 that in such cases:

> "…it would be appropriate for the rights and obligations established by the relevant laws or regulations not to be considered when classifying those instruments because the laws or regulations would exist regardless of whether they are included in the contract." (para. BC22, page 9).

are typical of the approach taken in developing the standard i.e. illustration of the principle proposed in para. 15A ***by exclusion*** (through examples of when to exclude), rather than ***by inclusion*** i.e. examples of when to include rights/obligations that have contractual specificity and origin in addition to sui generis rights/obligations applicable under relevant law. Robustness of the standard would be enhanced if the BC can discuss 'inclusive' illustrations of contractual rights/obligations that are in addition to those that have been specified under relevant law/regulation. For example, non-standard contractual rights/obligations relating to limitations on close-out, set-off, or sale or transfer of collateral in respect of secured financing arrangements, that may potentially alter the characteristics of underlying cash flows.

(d) The reference in paras. BC15(c) and BC22 of the ED, to Instrument E illustrated in para. B4.1.13 of IFRS 9, are meant to support the contention that an "all-inclusive" approach would be inconsistent with the classification of financial instruments in accordance with the "**contractual terms** of the financial instrument" (see para. B4.1.13 of IFRS 9) that are essential for "assessing the contractual cash flow characteristics of financial assets" (see para. BC15(c)). Given that the notion of contractual cash flow characteristics emerges as a central principle in classification and disclosure, and further in view of the injunction under para. 15A (b), an apparent inconsistency in para. B4.1.13 of IFRS 9 seems to arise (see also BC4.191 of IFRS 9). The following modifications to the example in Instrument E in para. B4.1.13 of IFRS 9 are therefore suggested:

i) "That is because that power, and the resulting payments, **even if included in the contract**, are not **solely** **contractual terms** of the financial instrument."
ii) "**In contrast**, the contractual cash flows would not be solely payments of principal and interest on the principal amount outstanding if the **contractual terms** of the financial instrument permit or require the issuer or another entity to impose losses on the holder (e.g. by writing down the par amount or by converting the instrument into a fixed number of the issuer's ordinary shares) as long as those contractual terms are genuine **and are in**

addition to or incremental to any requirements imposed under relevant legislation, even if the probability is remote that such a loss will be imposed."

3. The draft Illustrative Examples and Implementation Guidance document accompanying the ED do not provide any illustrative examples relating to effect of relevant laws/regulations. The need for detailed examples in relation to the definition and interpretation of contractual terms for the purposes of IAS 32 has been highlighted during feedback to the FICE DP (see Comment Letter by Petrobras, for example). Attention is also drawn to para. 20 of AP 5E (September 2021) where the Board decision to "focus on addressing specific practice problems instead of introducing a new classification approach" is emphasised alongside the need to supplement such an approach through the use of "illustrative examples to facilitate consistent application" (see also para. 47(b) of AP 5 (October 2019)).

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